FINAL REPORT

of

THE ROYAL COMMISSION

into the

TRICONTINENTAL GROUP OF COMPANIES

31 AUGUST 1992

VOLUME 3
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# TRANSACTION REPORT 1

## ATOLL CORPORATION PTY LTD

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A. **Background and Summary**

1 Atoll Corporation Pty Ltd ('Atoll') was a shelf company incorporated in Queensland which became a private investment company owned by Mr Robert Sng, a resident of Singapore. Mr Bill Peh, a business associate of Mr Sng then living in Perth WA, later became involved as guarantor of Atoll.

2 Atoll was lent $13.2m by Tricontinental on 5 October 1987, to purchase shares and options in Pelsart Resources NL, a mining company commencing operations in Indonesia. The funds were drawn down and used for that purpose on 7 October 1987. Pelsart share scrip and options constituted the chief security for the loan. This was an example of margin lending.

3 As can be seen from the chronology below, Tricontinental had granted an earlier and smaller facility to Atoll in January 1987 for $1.5m, $420,000 of which was drawn down by 5 October 1987. This earlier facility had a history of default resulting in service by Tricontinental of Notices of Demand to the directors of Atoll on 14 August 1987.

4 On Tuesday 20 October 1987, fifteen days after the grant of the $13.2m facility, the stock market crash occurred in Australia, as a result of which the value of the Pelsart shares and options constituting the main security dropped by 45%, putting the facility in immediate default of security covenants.

5 Interest was paid in respect of the $13.2m facility from October 1987 until January 1988, when payments ceased. After that month Atoll was continuously in default of both interest payments and security covenants.

6 In July 1988, the Tricontinental board approved an extension of the $13.2m facility, with interest payable in arrears, until September 1988. In
December 1988 Tricontinental, which until that time had been accruing interest in respect of the loans, stopped accruing interest and wrote off $6.5m of the principal amount as a bad debt.

The first action to enforce the security occurred in April 1989. In the event, a total of $11.767m has been lost.

B. Chronology

The chronology of relevant events is as follows:

1987
January  Grant of facility for $1.5m by Johns
27 May    Tricontinental complained of borrower’s default to Cleary and Hoare, borrower’s solicitors.
14 August Notices of demand for defaults
25 August Meeting between Johns and Sng
26 August Extension of $1.5m facility for 12 months
27 August Sng provided cheque to cover shortfall in cover
15 September Letter from Kevin Parry to Johns, authorised Sng and Peh to discuss confidential matters on his behalf.
21 September Sng requested $13.26m facility from Johns
25 September Johns received financial details of Peh, proposed guarantor, on Cleary and Hoare’s letterhead
5 October  $13.2m facility shown as approved by directors Johns, Smith and Ryan
7 October  Drawdown
12 October Credit submissions prepared
20 October Default in share cover

1988
February  Default in interest payments
26 May    Sng requested extension of facility 2 and capitalisation of interest
21 June  
Johns met Sng in Brisbane and agreed to deferral of interest, and probably to extension of loans till 30 September 1988

29 June  
Credit submission for extension prepared

27 July  
Board endorsed extension until September 1988

September  
Deed of set-off over moneys on deposit enforced

December  
Tricontinental ceased accruing interest, issued notices of demand and wrote off $6.5m.

C. Narrative

(a) First facility for $1.5m

Account manager

Mr Johns was managing director of Tricontinental from 1 January 1986 to 21 May 1989 and his lending discretion at the time of the Atoll transaction was up to $6m on secured lending. He was the account manager for Atoll. Mr Sng, principal of Atoll, approached Johns for a margin lending facility. Johns' dealings were with Sng, or on occasions Mr David Williams of Cleary & Hoare, Atoll's solicitors in Brisbane (who was also a nominee director of Atoll).

First credit submission

The first credit submission, dated 28 January 1987, for a loan for $1.5m for the purchase of shares in Eastern Resources Australia Ltd, with a security covenant of ‘1.25 times cover’, contained no specific financial information about Atoll or Sng. This was not unusual in margin lending transactions at Tricontinental, presumably because it was the shares which were to provide funds for repayment on resale. Johns apparently accepted Sng's verbal assurances of his asset position, so far as it was seen to matter, as there was no relevant documentation. The letter of offer was amended by Johns, apparently within his discretion, so that the purpose was altered from the specific purpose of purchasing Eastern Resources shares to any "investments as approved by Tricontinental in its sole discretion". The
amended letter of offer was approved and signed the day before the credit submission was prepared, thus illustrating the fact that the submission was for record purposes only.

Default in relation to first facility
On 27 May 1987, Mr Johns signed a letter prepared by Mr Neil Hunter complaining to Cleary & Hoare about Atoll's conduct of its first facility, of which only $110,000 had been drawn down. Notices of demand were served on 14 August 1987 by Minter Ellison. On 25 August 1987, Johns directed a memorandum to Alistair Clark agreeing to Sng's request for an extension of the $1.5m facility for twelve months, reducing the share 'times cover' from 1.25 times to 1.1 times, and permitting use of the facility for the purchase of shares in Pelsart, Jason Mining and Parry Corporation. There was no information in that document about the prospects of Pelsart Resources. Earlier that day, Johns had met Sng after having complained to him of the conduct of the facility. It seems that Sng must have given Johns reason not to call in the facility and given assurances for the conduct of future facilities. Johns reduced the extension fee by half within the terms of his discretion.

(b) Second Facility for $13.26m
Circumstances of grant of facility
In September 1987, Johns met both Peh and Sng and, as a result, a letter was sent by Sng to Johns dated 21 September, requesting the second facility of $13.2m. The facility was approved on 5 October, and a letter of offer sent on 7 October. On 21 September 1987, David Williams of Cleary & Hoare had informed Grander Resources Pty Ltd in Hong Kong that Atoll had purchased Pelsart shares and options as nominee for Grander Resources. Sunshine Stock Brokers Ltd Hong Kong had issued a 'buy' note dated 24 September, directed to "Tricontinental Merchant Bankers A/C Client". It seems that someone was confident that Tricontinental would approve the loan. On 25 September a letter on Cleary & Hoare
letterhead was prepared and forwarded to Tricontinental advising that Mr Peh, a proposed guarantor of the facility had "a net worth of approximately A$10 million". The origins of the letter remain uncertain. Both Mr Williams and Mr Hoare of Cleary & Hoare denied authorship. The probability is that it was typed by Miss Rigato, a secretary at Cleary & Hoare, on Mr Sng's instructions, and signed by her 'Cleary & Hoare'.

On 12 October 1987 the relevant credit submission was prepared, some five days after funds had been drawn down. Approvals for the credit submission were recorded by Lynton Stott as having been given to him orally by Ryan and Smith on 5 October 1987, according to the recommendation sheet of the credit submission. Johns was the third director approving.

The credit submission contained no credit history of Atoll and, in particular, no reference to the borrower's defaults in relation to the first facility. It also contained no financial details of Atoll or of Sng or Peh, and the share cover was 1.2 times cover, despite a guideline of 1.5 for mining shares. It does not appear on the evidence that Johns had any information concerning Peh's worth, upon which either he or the board could rely, other than the information contained in the letter on Cleary & Hoare letterhead of 25 September 1987. Ryan appeared to be aware of an 'upside' in the facility, which was to take a profit share (20% or $2m, whichever was the lower) to try to recoup an earlier loss to Diamond Hill - a separate facility in default, with which Sng had some family connection, never made entirely clear in the evidence. Johns approved an alteration to the share cover and the profit share, despite the fact it was probably not within his discretion to do so. Without evidence from Mr Johns, it is not possible to determine whether he approved the changes before or after the directors' approval was obtained by Stott. He agreed to the changes on 5 October 1987. The letter of offer indicates the changes occurred after it
was prepared. Mr Stott has no independent recollection of what he told the directors about share cover.

There was some suggestion that Sng and Peh may have had access to market sensitive information regarding Pelsart Resources NL. By letter dated 15 September 1987, Kevin Parry informed Johns that "... Bill Peh and Robert Sng act in an advisory role for me ...". At that time, Parry Corporation was the major shareholder in Pelsart, holding more than 55% of Pelsart’s issued capital. In August 1987, Johns had approved extension of the $1.5m facility and its use to purchase shares in Pelsart, Jason Mining and Parry Corporation. By letter dated 26 May 1988, Sng told Johns that Sng and Peh had been ‘virtually solely responsible’ for the acquisition of Parry Corporation by Hang Lung Development Ltd, a Hong Kong company. In the absence of evidence from Sng, Peh and Johns, it is not known what information (if any) was available to them from the relationship with Parry Corporation, which may have motivated the purchase of Pelsart shares.

Default in second facility

The facility was in default of security covenants immediately after the stock market crash on 20 October 1987. Interest was not paid after January 1988. Defaults in security covenants and interest payments continued throughout 1988. By letter dated 26 May 1988 Sng and Peh informed Johns of four matters:

(i) proposed efforts to promote Pelsart and so maintain its share price, particularly with the assistance of Hong Kong interests;

(ii) their inability to meet interest payments;

(iii) the adverse effect of the stock market crash on them; and

(iv) their willingness not to "throw in the towel".
Monitoring of default

From February 1988 onwards, a picture emerges of Tricontinental attempting to contact Sng and experiencing difficulty. In their letter of 26 May, Peh and Sng indicated that they were unable to meet their interest bills for the next six months. They asked Johns to capitalise interest instalments as they fell due. Johns’ response, by letter of 2 June 1988 to Mr John Hoare of Cleary & Hoare, expressed an urgent need for the matter to be discussed. Then, by memorandum of 24 June 1988, Johns told Stott, Hunter and Mountford that he had reluctantly agreed to interest being payable in arrears. The write-off of $6.5m referred to above occurred in December 1988.

D. Role of Mr Johns

As account manager, Mr Johns was the central figure at Tricontinental for this transaction. He must accept primary responsibility for all decisions made and actions taken or omitted.

E. Role of Other Managers

(a) Mr Lynton Stott

Mr Stott was assistant general manager, credit and securities, from April 1986 to April 1989. His role in obtaining verbal approvals for the second transaction has been mentioned in para 13 above. Stott said in evidence that it was his practice to make a contemporaneous note of the director’s approval and later transcribe that on to the credit submission. However he also said he had only been asked to seek verbal approvals from directors where they had no credit submission before them on three or four occasions. He also said he believed the probable reason Johns asked him to do it was that “he (Johns) didn’t have time himself”. He had no independent recollection of steps he took or enquiries he made in relation to Atoll or what he told Smith and Ryan, but he said he would not have made the note he did without approval being given by the directors. He
conceded he would have had no information other than a memo of instruction, or a note of verbal instructions, from Johns. The "research" he would then have done was checking any available information in the library on Pelsart. The recommendation page containing his notations of verbal approval would have been available at the board meeting in late October 1987.

The credit analysts reported to Mr Stott and when necessary it was the credit manager who would take up any matters of inquiry or concern with the account manager. Mr Adgemis, Mrs Rogers and Miss Coutts were credit analysts in the Tricontinental credit department at the time of the Atoll transaction. Adgemis signed the credit submission dated 28 August 1987, Rogers signed the submissions dated 28 January 1987 and 29 June 1988 and Coutts signed the submission dated 12 October 1987. Stott gave evidence that they were not expected to check independently the information provided by the account manager (in this case, Johns) for the purposes of signing a recommendation at the bottom of the credit submission. Their evidence confirmed this.

Mr John Adgemis

Mr Adgemis' submission was prepared to record Mr Johns' exercise of his discretion to vary the security cover and to extend the facility. He was not informed, before preparing this submission to extend, that there had been service of a letter of demand on Atoll. He regarded himself as a "glorified clerk", and he said he had no responsibility for explaining anything in the credit analysis to anyone other than his credit manager. If Johns were involved as account manager, Adgemis saw himself "rubber stamping" an approval already made.

Mrs Zulal Rogers

In substance Mrs Rogers' evidence confirmed that of Adgemis and she added that she had never refused to sign any credit application.
Miss Claire Coutts
Miss Coutts also confirmed the essentially clerical nature of her role.

Credit Committee
Mr Stott gave evidence that the credit committee's function in relation to approvals within Johns' discretion, such as the first facility of $1.5m, was to note, not to recommend.

(b) Mr Neil Hunter
Letter of offer
Mr Hunter prepared the letter of offer in relation to the second facility, dated 5 October 1987, and gave evidence that he must have been told that there was a verbal approval to have undertaken the task of preparing the letter of offer.

Securities
Mr Hunter was responsible for supervising the taking of securities from Atoll for each of the two facilities. These were share scrip in each case, and a personal guarantee of Sng's for the first facility and a personal guarantee of both Sng and Peh for the second facility. He gave evidence that it was common at Tricontinental to have a security such as a guarantee dated after drawdown.

Default in first facility - recognition by securities department
Atoll failed to perform its obligations under the first facility, as evidenced by Tricontinental's letter of 26 May 1987 to Cleary & Hoare and a letter from Minter Ellison to Mr David Dyring, who worked under Hunter, confirming that a letter of demand had been forwarded to Atoll. Hunter agreed that instructions for a letter of demand must always come from Johns in the case of his clients. He gave evidence at a number of points that defaults were always the responsibility of the account officer.
Problem loan reports for second facility

Mr Hunter was also responsible for listing Atoll on the problem loans reports from June 1988 onwards. Atoll's second facility was included by him in the report for 16 June 1988 as a loan for which interest was being accrued, the reason for the listing being non-payment of interest, which he said was done on the basis of what he was told by Johns. Although there had been default in interest payments since February (which the evidence shows were known to Johns), he had not been told until June to include Atoll in the list. He did not make an independent check. Later inclusions of Atoll in problem loans reports were also prepared by Hunter on the basis of what Johns told him. However the defaults referred to in those reports were characterised as margin call defaults; this was no doubt due to the acceptance after June that interest would be paid "six monthly in arrears". Hunter explained that an account officer would decide whether or not to use moneys held on deposit as security; and if an account officer did so decide, such moneys would generally be applied against principal.

Default in second facility - recognition by securities department


F. Role of Directors
(a) First facility

The Directors had no role in relation to the grant of the first facility other than to note it at a later board meeting.

(b) $13.26m facility

According to the documents, the directors approving this facility were Johns, Ryan and Smith. The board noted the $13.26m facility at the meeting on 28 October 1987. The board's main concern at this meeting was the impact of the crash of the share market on loans secured by shares. There is no explanation as to why the credit submission of 12 October 1987 could not have been written on the day of approval, ie 5 October, and
circulated before approval was granted. But the loan seems to have been approved in principle before the letter of offer was forwarded, and it appears that no director other than Johns saw the later credit submission.

24 It seems that Johns supported the Atoll facility because of his faith in the maintainable value of the Pelsart shares, and the reliance based on a particular mine in Indonesia which was in production. Johns reduced the share cover in relation to the facility from 1.5 down to 1.2, apparently on 5 October. Stott should have informed Ryan and Smith of this if he knew of it before he spoke to them. His belief is that he did not know of it until later.

25 Mr Stott's evidence about the verbal approvals is set out in para 19 above. Neither Mr Smith nor Mr Ryan could recall giving verbal approvals to Stott. Ryan could not recall considering the credit submission, and he also gave evidence that there were only two or three or four occasions when he was asked to approve a credit submission without having the benefit of a full written submission. Moreover, he said he would expect it to be Johns who would seek an approval for such a submission. He also gave evidence that he does not believe this credit submission was circulated to directors at all between 12 October and 28 October 1987, when the transaction was noted by the board.

26 Ryan identified a number of concerns he would have had if he had been shown this particular credit submission, and asserted he would have rejected it if he had known of defaults in respect of the first facility. Ryan could recall that the loss of $2m suffered from Diamond Hill was to be offset by a profit share in relation to the Pelsart shares. Smith said that he firmly believes he did not give a verbal approval to Stott.
(c) Monitoring of defaults, board reports

After the share market crash, it was Johns who made daily decisions as to whether or not to enforce covenants where there were breaches as a result of the crash.

Throughout the period from June 1988 to December 1988, Johns assured the board in the regular reports that no loss was envisaged in relation to the Atoll transaction. He indicated that this view was based on discussions he had with Peh and Sng as to how they were trying to rectify the problem of Atoll’s default. He does not seem to have required any objective evidence, or anything other than occasional assurances from Peh and Sng, that the transaction was truly one for which no loss should be envisaged.

The board did not request any checking of sources other than Sng and Peh. Further, Atoll was not requested to provide "top-up" security and did not appear in the managing director’s report of November 1987 listing clients who had failed to provide "top-up" security. It did appear the following month.

The letter of 26 May 1988 from Peh and Sng seemed sufficient for Johns to believe that they were still willing, and would soon be able, to discharge their indebtedness to Tricontinental; yet it also indicated that the guarantees in favour of Tricontinental were of uncertain value, and neither Sng or Peh had any immediate prospect of servicing the debt. Tricontinental complained of defaults to Williams in a letter later in May. Later correspondence from Sng and Peh indicated the position had not improved.

However Johns’ account of the situation apparently persuaded the board that there was no reason to suspend interest in June 1988, and that chances of recovery would be enhanced by capitalising interest and extending the facility to September 1988. Ryan’s suggestion of a specific provision of $5m for Atoll, probably made at the June or July 1988 board meeting, was
not accepted. The written information provided to the board at the June meeting was as follows:

"Default has occurred through non-payment of interest. Principals are believed to be of substance with Group Managing Director pursuing payment of outstanding interest and proposal for repayment of facility. No loss envisaged".

It seems clear that Johns was always looking at the Pelsart shares for repayment and security in relation to the facility, and was not looking to the borrower and guarantors personally. Ryan perceived the Atoll transaction in the same way, and explains the lack of financial information in the credit submission by reference to the fact that the loan was short-term and the prime security was the Pelsart shares.

As described above (para 21), Hunter included Atoll in the problem loan report for the board at the request of Johns. Johns described Peh and Sng as persons "believed to be of substance" in communications with the board, even though they raised in explanation of default the fact that they had been exposed to the stock market crash. It seems clear that Johns' assessment of the situation was based purely on what Peh and Sng told him of their efforts to improve the situation.

When the loan was not repaid in September 1988, Johns spent several fruitless weeks trying to contact Sng and Peh. In December, notices of demand were served.

(d) Provisioning/writing-off

Mr Ryan gave evidence that he referred, in the audit committee meeting of 23 August 1988, to the view he had previously expressed that provisions for Atoll of $5m would be prudent. He did not, however, say that he raised the matter explicitly. Mr Weir could not recall considering Atoll at that meeting. There was in fact no write-off until December 1988; it was then $6.5m. Attempts were made from January to April 1989 to sell the
shares held as security in one parcel. In May the decision was taken to sell
them on the open market. The market price was stable at around 10¢
between late May and August.

G. Events After May 1989
36 After May 1989 the Atoll facility continued to be in default of security
covenants and payment of interest. On 16 August 1989 Tricontinental
instructed Burdett Buckeridge & Young ('BBY') to sell the Pelsart shares it
held as security. Over the next two months BBY sold all the Pelsart shares
at an average price of 2.5¢ per share. No action was taken against Atoll
for recovery because of the probability that it would yield nothing for
Tricontinental.

H. Expert Evidence
(a) Mr James Perry
37 Expert evidence was received from Mr Perry, stockbroker and member of
the Australian Stock Exchange Ltd. His expertise was not challenged.
Description of Pelsart stock
He gave evidence that Pelsart was, in his opinion, a second-rate
exploration-cum-mining company of dubious parentage, the securities of
which could be accurately described as a speculative investment. While
not doubting the accuracy of this description, it must be noted that the
share price had risen from 95¢ in March 1987 to $1.10 when Tricontinental
paid for them in late September, and had reached $1.85 in the four weeks
before the crash.

Timing of exercise of power of sale
He also considered the timing of Tricontinental's exercise of its power of
sale in relation to 8,047,000 Pelsart shares and 7,384,000 Pelsart options
held as security in relation to the Atoll facilities. It was his opinion that a
large number of the securities could have been sold immediately after the
stock market crash, in the November - December 1987 period, and it was
also his opinion that speculative shares should be sold earlier rather than later after market crashes. He considered it feasible that all the shares could have been sold by the end of April 1988 at an average price of between seventy and eighty cents and, further, that the options could certainly have been traded in the November - December 1987 period through to the end of July 1988. He conceded that his views were necessarily subjective and alternative views were sustainable.

(b) Mr Peter Weaving

Expert evidence was also received from Mr Weaving, a banker of over forty years experience, which included an appointment as general manager of corporate finance at ANZ's merchant banking arm, ANZ Capital Markets Corporation Ltd. His expertise was not challenged. He gave evidence that there was very little difference overall in lending and credit assessment by trading banks and merchant banks, although he recognised that some merchant banks dealt in the high risk segment of the market. That aside, the only major difference was the term of loan facilities.

General lending principles

Mr Weaving outlined the general principles applying to a lending transaction as follows:

(a) The proposal must meet prudential standards and guidelines, including applicable Reserve Bank of Australia directives and requirements.
(b) The proposed loan transaction must be legal.
(c) The borrower's capacity to service and repay the facility should be clearly identified.
(d) The transaction must be profitable.
(e) The loan must be safe, in the sense that the lender must be capable of managing the risks involved.
Banks and the stock market crash

Mr Weaving conceded that, after the stock market crash, most banks adopted an approach similar to Tricontinental's, namely not to place undue pressure on clients when the market for selling shares was unfavourable. However he said that, in the case of other banks, this was subject to additional security being lodged to offset any decline in the value of shares held.

Further, he gave evidence that he would not have accepted at face value assurances of Sng after the crash, first as to inability to pay interest, secondly as to the fact that Sng and Peh had been severely battered in the stock market crash and, finally, as to the worth of Sng after the crash. He gave evidence that he would have "crystallised the position" and served demand notices.

The evidence of directors was that they had backed Johns in a general policy of 'wait and see' rather than rigorously enforcing covenants. They said that each case was considered on its merits; but no case of early enforcement came to the Commission's notice. On balance, the Commission believes that the failure to realise on securities at an earlier stage should be categorised as an error of judgment, rather than negligence, on the part of the directors - having regard to Johns' assurances. In the light of his additional knowledge of Sng and Peh's financial position, failure to issue demand notices may well have amounted to negligence on his part.

Prudential considerations

Mr Weaving dealt with prudential considerations in relation to Tricontinental's capital base and gearing and stated that the Atoll loans warranted "in-depth" analysis, having regard to the possible impact of any default in relation to the total exposure under the two facilities.
He expressed the opinion that Atoll's second facility was inappropriate and unacceptable in the light of the gearing, the speculative nature of the stock and the fact that there was no security additional to scrip and the personal guarantees to support the facilities. These personal guarantees have proved worthless, if only for the reason that neither Sng nor Peh now lives within the jurisdiction of Australian courts. Mr Weaving also made detailed criticisms of Tricontinental's evaluation of credit risk in relation to the second facility.

Conclusions and Findings

The first facility is mainly of interest because it provided Mr Johns with some knowledge of the state of Mr Sng's finances. Default notices had been served, drawing attention to the fact that payment of an initial advance of $100,000 was several months overdue and there had been a breach of security covenants for some time. In spite of this, Johns approved a further 12 months extension of the facility and, at the same time, reduced the required security cover from 1.25 times to 1.1 times. This was a very clear departure from the guidelines approved by the board, which called for a 1.5 times cover in the case of mining shares. It is to be noted that this variation was actually agreed to by Johns on 25 August 1987. It was signed off by other members of the credit committee on 1 September.

In spite of the unsatisfactory history of this comparatively small loan, Johns recommended the second, much larger, facility in early October. Given the bullish state of the market throughout 1987, and the fact that the shares concerned were second board speculative mining stock, based on an Indonesian enterprise that was only just starting, the standard requirement of 1.5 times share cover seemed very modest. Johns, however, recommended the reduction of this cover to 1.2 times. This is to be contrasted with Mountford's 1989 recommendations (see para 15.278 in vol 2 of this report) that minimum cover for mining shares should be 2.0 times, and this should be increased unless capacity to meet margin calls was
clearly demonstrated; it should also be increased in the case of second board companies.

It should also be noted that the security of Pelsart shares, taken by Tricontinental, represented 5.7% of ordinary shares and 10.1% of options. It was always going to be difficult to realise this security without depressing the market.

This was another case in which it appears that the approval of directors was obtained without any credit submission, even in a short form, having been prepared. The contemporary records show that Mr Ryan and Mr Smith signified their approval to Mr Stott, while Mr Carr and Mr Rawlins were unavailable. Neither Mr Ryan nor Mr Smith has any recollection of giving this approval, nor can either of them remember ever giving an approval to Mr Stott in such circumstances. Mr Stott cannot recall the particular transaction, but is adamant that he would not have noted the approvals of the two directors to himself if he had not in fact received them. The Commission is prepared to accept Mr Stott's evidence on this point, but it does so on a mere balance of probabilities, rather than with any great confidence. It is encouraged in its view by the number of other occasions on which directors are recorded as having given approval without having sighted a credit submission, and now say they have no recollection of having done so. The Commission believes that this practice was a good deal more frequent than the directors generally have been prepared to concede.

The formal credit submission, prepared some days later and never seen by directors, is largely irrelevant. However matters omitted from it would almost certainly have also been left out of any oral case put to Ryan and Smith when their approval was sought. The most glaring omission from the credit submission was any reference to the performance of the borrower
concerning the first facility. Also, no financial details were given for the borrower, Atoll, or the guarantors Sng and Peh.

On the same day that directors' approvals were recorded, Mr Johns agreed in discussion with Mr Sng to reduce the required share cover from the usual 1.5 times for mining shares to 1.2 times. It is not clear whether Mr Stott would have known of this at the time that he spoke to directors, but his own belief is that he probably would not have known. If this departure from guidelines was in fact agreed to by Johns without reference to the approving directors, it would represent, in the view of the Commission, a serious misuse of the managing director's authority.

Mr Johns' disregard of the legitimate interest of his fellow directors was demonstrated when he sought and obtained approval for the extension for this major facility in July/July 1988. He had received a letter from Sng and Peh at the end of May, telling him of their inability to meet interest payments and the adverse effect that the stock market crash had upon them. The credit submission set out all the hopeful matters upon which Sng and Peh were relying in suggesting that the situation would improve. It would have been a simple matter for the credit submission to have had attached to it the letter from Sng and Peh, and the notes of Mr Johns' later discussion with Sng on 21 June, to allow other directors to judge matters for themselves.

However it would have been embarrassing for Johns if they had come to a contrary view, because he probably agreed to the extension for 3 months, and certainly agreed to the deferral of interest payments, in the course of his discussion with Sng on 21 June. A letter of offer to that effect was prepared on 29 June, but it is not clear just when the credit submission of the same date was put to directors for approval, and it may well be that letter of offer was never sent. The proposals were approved by the board on 27 July.
At the June 1988 board meeting, the Atoll Corporation had appeared for the first time in the list of loans for which interest was still being accrued as at 16 June. The board on that occasion must at least have concurred with the view that no immediate action should be taken to enforce security. A different decision might well have been reached if Johns had given his fellow directors the full picture of Sng's financial difficulties which Sng had confirmed to him the day before.

Mr Johns must be held responsible for asking other directors to approve a high-risk transaction with so little supporting material, and without informing them of the borrower's default over its previous, much smaller, loan. This lack of frankness was carried through to the circumstances of the loan extension, when only the good news was conveyed to directors.

The approving directors can fairly be criticised for agreeing to such a high-risk loan on such limited oral information. They and Mr Johns were also at fault in agreeing to the security proposed. Even if the directors were not originally told of the 1.2 times cover, there is no suggestion that they protested when they did hear of it at the time of the extension. And, in any event, there was little point in taking as security the same shares which were to provide the source of repayment. If the security was ever called upon, it would necessarily be deficient.

This defect in the security highlights the absence of any proper margin lending policy for Tricontinental. This subject is dealt with at para 15.282(ix)-(xiii) of this report.
## TRANSACTION REPORT 2

### QUATRO, DISCTRONICS AND PRO-IMAGE TRANSACTIONS

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A. Background and Summary

Between January 1986 and March 1989 Tricontinental provided facilities to three companies in the Quatro Group, namely Quatro Limited (‘Quatro’), Disctronics Australia Limited (‘Disctronics’) and Pro-image Limited (‘Pro-image’). Quatro and Pro-image were public companies listed on the Australian Stock Exchange (‘ASX’). Disctronics was not listed on the ASX although in mid-1988 Disctronics Limited (formerly known as BGL International Limited) (‘Disctronics Ltd’) was listed on the ASX.

The major shareholders of Quatro were private companies controlled by its directors, including Mr John Kavanagh and Mr Kevin Donovan. Quatro’s main activities were investment in and the provision of management services to Pro-image, Disctronics and Whitehall Industries Limited (‘Whitehall’). In June 1986, Quatro held approximately 40% of the shares in Pro-image and Disctronics and, in August 1986, 43.5% of the shares in Whitehall.

Before the October 1987 share crash Quatro’s growth was exceptional, largely due to the performance of its subsidiaries, especially Pro-image. Quatro’s total assets were $170m as at 30 June 1987, 473% more than the previous year.

Disctronics was essentially a joint venture, formed in January 1986, between Quatro and Pro-image to build and operate a compact disc manufacturing plant in Australia. Pro-image was a video and broadcasting company which held the remaining 60% of the shares in Disctronics.

From January 1986, Tricontinental granted a number of facilities to Quatro, three of which were investigated and examined by the Commission.

(a) A facility for $4m was approved, in January 1986, to finance the restructuring of the Quatro group - in particular, the acquisition of shares in Pro-image and the provision of working capital (‘facility 1’);
(b) a facility for $15m was approved, in February 1987, to finance the acquisition of shares in public companies, or to allow the group to undertake a takeover of a listed or private company ('facility 2'); and
(c) a facility for $25m was approved, in March 1989, as part of a bridging facility to assist Disctronics with its purchase of a US company, Laser Video Inc, from Quixote Corporation ('facility 3'). Facility 3 was later amended to $10m and drawn down to $4.78m.

The security for facilities 1 and 2 varied over time, but mainly consisted of a mortgage over Quatro's shares in Pro-image and Disctronics, together with the deposit of convertible notes in Disctronics and a mortgage over shares held by Quatro in Battery Group Limited.

The security for facility 3, specified on the credit submission approved by the directors on 7 March 1989, consisted of the assignment to Tricontinental of the benefit of an irrevocable order relating to a Bank of New Zealand ('BNZ') facility to finance the purchase of 25m Pro-image shares at $0.50, together with the assignment of the benefit of a placement agreement from ANZ McCaughan to place a further 12.5m Pro-image shares at $0.90 per share, and the assignment to Tricontinental of the proceeds of sale of certain assets. The security for facility 3 was varied, on 20 March 1989, by deleting the assignment relating to the BNZ facility and requiring Quatro to provide sufficient additional shares in Pro-image to maintain 1.5 times security cover.

Tricontinental provided a number of facilities to Pro-image, including a facility in January 1986 for $7m, of which $2.5m was to be used to finance the establishment of Disctronics. In September 1988 the facilities granted to Pro-image were consolidated into one $20m facility, being Tricontinental's share of a $50m syndicated loan ('the syndicated loan').

The syndicated loan was established to permit Pro-image to repay all existing debt and to assist with the purchase of Communications Entertainment Limited.
from Quatro. At the same time Pro-image sold its 60% share in Disctronics to Quatro.

10 Tricontinental was to manage the syndicated loan and prepared a detailed proposal for syndicate members. The security for the syndicated loan consisted of a debenture charge over the assets and undertakings of Pro-image and its subsidiaries, together with mortgages over land and buildings in New South Wales.

11 In April 1987 Tricontinental provided a $33m facility to Disctronics to assist in the acquisition of plant and equipment. The facility was secured by a debenture mortgage over the assets and undertakings of Disctronics, guarantees from Quatro and Pro-image and a deed of subordination in respect of loans to Disctronics from Quatro and Pro-image.

12 In February 1987, Price Waterhouse prepared a valuation of Disctronics based on the directors’ estimate of future profitability, which valued the company at $118m. Tricontinental management believed this to be an extremely conservative estimate, and expected that a future public float of Disctronics would raise approximately $200m, part of which could be used to repay the Disctronics’ facility.

13 By mid-1987 the Disctronics plant was under construction. In July 1987 Disctronics acquired a UK compact disc manufacturing company at a total cost of more than 15m pounds sterling. It also commenced negotiations for the purchase of a similar operation in the US.

14 The effect of the stock market crash on Quatro was considerable. Following the crash the Quatro share price fell, from a lowest price in the previous quarter of $1.55, to $0.65. Pro-image shares fell from a lowest price of $2.15 to $0.90.
Quatro borrowed funds from a number of financiers including ANZ, HongKongBank, BNZ, Standard Chartered, Westpac and Tricontinental. All except one of these financiers extended facilities to the Quatro group in the order of tens of millions of dollars. Tricontinental was the largest lender after BNZ and ANZ.

Tricontinental’s loss on loans to Quatro was $7.984m, written off in 1991. $4.7m of this loss related to facility 3.

In December 1987, Disctronics entered into agreements to acquire a US compact disc manufacturer for a total sum of US$55.5m. US$29m was payable in January 1988, with the balance payable in or after January 1989. Payment of the second instalment was guaranteed by both Disctronics and Quatro. Tricontinental approved a guarantee and bill facility to Pro-image for US$24m to fund the acquisition, but this obligation was later refinanced by another lender.

In June 1988 Disctronics was floated by way of a takeover of Disctronics by BGL International Limited, which then changed its name to Disctronics Ltd.

An internal review of the Disctronics facility in August 1988, before completion of the float, noted a substantial shortfall in forecast sales. Despite this, continuation of the facility was recommended in view of "the adequate security cover, sound financial position, long standing and satisfactory relationship between Tricontinental and the companies within the Quatro Group".

By November 1988, less than two months after the establishment of the syndicated loan, Quatro defaulted on its share cover covenants. The price of Quatro shares dropped sharply. By February 1989, the shares were selling at $0.41 each.
In January 1989, Disctronics defaulted on the payment of the second instalment for its US acquisition. An arrangement was negotiated with the vendor to delay completion, but Disctronics was required to pay interest plus a US$0.5m fee for the extension of the time for payment.

In early 1990 Disctronics negotiated the purchase of another US company, Memory-Tech Inc, for US$13m, through a Cook Islands subsidiary. Doubt exists as to whether Tricontinental was told of the acquisition, although Mr Donovan is adamant that it was made with full knowledge of the company's Australian bankers, including Tricontinental.

In March 1989, Tricontinental granted facility 3 to Quatro for a maximum of three months to assist Disctronics to complete its US acquisition of Laser Video Inc. At the same time facility 1 was increased to $5m, even though Quatro had very recently been, over several months, in default of security covenants. No mention of this continuing default, which had been cured only by a rise in the price of the shares, was made in the credit submission prepared in support of the new and increased facilities.

In April 1989 Quatro defaulted on payment of interest to Tricontinental.

In May 1989 Disctronics defaulted on payment of interest to Tricontinental. Tricontinental made formal demands for payment.

In June 1989 all lenders to the Quatro Group agreed on an interest debt moratorium.

In December 1989 Pro-image defaulted on its interest payments.

Disctronics was unable to meet the revised schedule for payment of the US acquisition and, on 30 April 1990, ownership of Laser Video Inc reverted to the vendor. Disctronics forfeited the US$29m paid by it.
In November 1990, SBV approved a proposal for Tricontinental to negotiate with other lenders to Disctronics to assume all of its indebtedness.

On 24 December 1990 demands were served on Disctronics.

In February 1991 a receiver and manager was appointed by Tricontinental to Disctronics. At that time Disctronics shares were suspended from trading on the ASX. Disctronics continues to trade in receivership.

**B. Chronology**

The chronology of relevant events is as follows:

**1986**

- 20 January: Credit submission for Quatro facility 1 prepared
- 20 January: Credit submission to consolidate existing Pro-image borrowings and increase by $2.5m to finance first stage of compact disc production
- 30 January: Quatro facility 1 approved by Johns
- 26 February: Approval of Quatro facility 1 and Pro-image facility noted at board meeting
- 30 September: Credit submission prepared for Pro-image for additional $7m to fund initial capital expenditure on compact disc production and the purchase of additional shares in Disctronics
- 22 October: Approval of additional $7m Pro-image facility noted at board meeting

**1987**

- 11 February: Credit submission for Quatro facility 2 prepared
- 24 February: Quatro facility 2 approved by Johns, Ryan and Moyle
- 14 April: Credit submission for Disctronics $33m facility prepared
- 28 April: Disctronics facility approved by Johns, Ryan, Smith and Carr
2 July
Agreement to acquire UK subsidiary by Disctronics

December
Security top-up requested for Quatro facilities

24 December
Credit submission prepared to increase Pro-image facility by $33.7m to fund US acquisition by Disctronics

31 December
Agreement by Disctronics to acquire US subsidiary

1988

15 January
First payment of US$29.5m for US company

May/June
Disctronics equipment shipped to US and UK

10 June
Public float of Disctronics

27 June
Quatro facility 1 extended to 31 July 1989

11 August
Tricontinental indicated that it would consider a $20m participation in a $50m syndicated loan to Pro-image, to replace all existing funding

29 August
Review of Disctronics facility

21 September
Credit submission prepared for Tricontinental’s participation in syndicated loan

29 September
Pro-image credit submission approved by Johns, Carr and Morton

11 November
Pro-image syndicated loan agreement entered into

18 November
Security shortfall of $5.7m on Quatro facilities

24 November
Quatro undertook to provide additional security

1 December
Johns noted that security shortfall would be corrected by the next day

23 December
Johns noted that security shortfall for the Quatro facilities was $8.1m. Mountford told that additional security of $6.08m was to be provided that day

1989

3 January
Additional security received in respect of Quatro facilities. Security shortfall still existed and additional top-up was requested
12 January  Mountford informed Johns of $1.17m security shortfall on the Quatro facilities and noted that Quatro had undertaken to provide additional security by 20 January.

15 January  Disctronics failed to complete US acquisition.

23 February  Disctronics acquired US company Memory-Tech for compact disc production, for US$13m.

28 February  Credit submission prepared to increase Quatro facility 1 to $5m and approve grant of facility 3 for $25m.

6 March  Quatro underwrote Pro-image rights issue.

7 March  Quatro credit submission approved by Johns, Carr, Morton, Ryan, Smith and Moyle.

10 March  Johns informed of proposed reduction of Quatro facility 3 to $10m and changes to security.

20 March  Mountford approved changes to security for Quatro facility 3.

22 March  Security shortfall on Quatro facilities of $2.6m. Board noted Quatro credit submission.

4 April  Quatro agreed to provide additional Pro-image shares as security.

2 May  Tricontinental informed Quatro that facility 2 would not be extended beyond 31 May 1989 expiry date.

8 May  Disctronics defaulted on payment of interest and foreign exchange losses.

21 June  Quatro sold most of its shares in Pro-image to Peperback Pty Ltd ('Peperback'). Quatro facilities reduced by $12m.

21 June  Interest debt moratorium.

31 July  Quatro facility 1 expired.

27 October  Interest debt moratorium expired. Lenders enter into informal moratorium.

20 November  Informal moratorium extended to 30 September 1990.
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<td>Price Waterhouse report for the Pro-image syndicate indicated &quot;cash strapped to dangerous levels&quot;</td>
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<td>20 December</td>
<td>Pro-image defaulted on interest payments</td>
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<tr>
<td>29 December</td>
<td>Tricontinental served letter of demand on Pro-image following non-payment of interest</td>
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<tr>
<td>1990</td>
<td>Ownership of Laser Video Inc reverted to vendor, Disctronics forfeited payment of US$29.5m</td>
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<td>30 April</td>
<td>SBV extended Quatro facilities to 30 June 1990</td>
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<td>9 May</td>
<td>SBV and BNZ assumed all responsibilities under Pro-image syndicated loan in exchange for payment of 23c in the dollar</td>
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<td>17 July</td>
<td>Proposal for Tricontinental to assume responsibility for all Disctronics facilities to other lenders</td>
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<tr>
<td>16 November</td>
<td>SBV credit committee accepts proposal</td>
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<td>28 November</td>
<td>Demands served on Disctronics</td>
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<td>1991</td>
<td>Receiver and manager appointed to Disctronics by Tricontinental</td>
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<tr>
<td>January</td>
<td>Disctronics shares suspended</td>
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<tr>
<td>21 February</td>
<td>Receiver and manager appointed to Pro-image by SBV and BNZ</td>
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C. **Narrative - The Quatro Facilities**

33 (a) **Facility 1**

The credit submission dated 20 January 1986 for facility 1 was prepared by Mr Venner on instructions from Mr Atlas.

34 The submission proposed the granting of a $4m facility to Quatro, to assist with its purchase of 44% of the issued capital of Pro-image from Quatro Investments Pty Ltd, and to provide additional working capital. $2.8m of the amount to be lent was to be used to repay Tricontinental's then current facility
to Quatro Investments Pty Ltd.

The security for facility 1 was to be a first registered share mortgage over 5.5m shares in Pro-image together with signed blank transfers. Security cover was to be maintained at 1.3 times cover.

The submission was approved by Mr Johns, together with an alternative for Mr Ryan, on 30 January 1986. The facility may have been drawn down as early as 5 February 1986.

The submission contained extracts from the financial statements of Quatro, as at 31 December 1985, which stated that Quatro had a pre-tax profit of $384,000 and was to receive approximately $11m cash upon sale of its assets. The submission also stated that management fees totalling $100,000 per month were to be received by Quatro.

Mr Atlas conceded that the submission was deficient in that it did not contain information he had as to the financial position of Pro-image and Disctronics, as well as Quatro.

The submission did not include any restriction on other borrowings by Quatro, whether within or outside the Quatro group. Within five months of the approval of the facility Quatro’s debt had increased by $14m. Mr Atlas said that he was not aware of the increase in Quatro’s debt and would have been concerned by it had he known of it.

(b) Facility 2

The credit submission for facility 2 was prepared in February 1987 and proposed the granting of a $15m facility to Quatro to enable it to take positions in public listed companies or to allow the group to undertake a takeover of a listed or private company.
The security for facility 2 was to be a first registered mortgage over scrip purchased in public listed companies together with signed blank transfers with a minimum value of $22.5m. The only precondition to purchase of shares was that the shares purchased by Quatro were to be "acceptable" to the managing director of Tricontinental. The minimum security cover for facility 2 was 1.5 times cover, and the security cover for facility 1 was increased to 1.5 times cover.

The submission was approved by Johns, Ryan and Moyle.

Mr Atlas said that the funds advanced under facility 2 were in fact used to take up rights in Pro-image. Mr Ryan said that if this was the purpose of the loan, it should have been clearly stated in the submission. He said that he was not troubled by that use of the funds, but agreed that it should have been reported back to the board.

Mr Moyle said that buying shares in public listed companies was a different thing from buying more shares in a company in which a controlling interest was already held. Mr Moyle said that, where the purposes of a loan were specifically stated, he expected it to be part of the management of the account to ensure that the purposes were met.

The letter of offer, dated 4 March 1987, for facility 2 included a covenant by Quatro that it would not enter into future borrowings without Tricontinental's consent. Mr Atlas said that he believed this covenant was included in the letter of offer at the suggestion of Mr Mountford at credit committee level, and agreed that it would have been prudent to have included such a covenant earlier. Mr Atlas acknowledged that Quatro may have breached this covenant in that its total borrowings increased to $44m by the end of June 1987. He had no recollection of being informed of these borrowings by Quatro.
46 The submission included financial information relating to Quatro extracted from its financial statements as at 31 December 1986, including the after tax profits for the half year to 31 December 1986. The submission did not contain full details of borrowings, how the borrowings had increased or whether additional assets had been purchased with the funds borrowed. Mr Atlas accepted that the submission was deficient to this extent.

47 A later letter of offer, dated 3 April 1987, for facility 2 contained a condition that Tricontinental was willing to provide a guarantee facility for $5.4m. The guarantee facility was necessary because Disctronics had disputed a Customs claim and was required to provide a bank guarantee as security to Customs pending the outcome of the dispute. The guarantee was not referred to in the approved credit submission and there was no evidence that the directors in any way approved the guarantee. Atlas, Ryan and Moyle said they knew nothing of the guarantee facility. Mr Atlas said he assumed the guarantee had been authorised by Mr Johns. Mr Kavanagh said that the guarantee was granted after he had a meeting with Johns.

48 Mr Ryan said that he believed that the variation of the approval was not serious, but ought to have been brought to the board's attention. Mr Moyle said that whilst the credit risk was comparable, it was a matter which ought to have been put to the board for approval.

(c) Extension of facility 1

49 A credit submission dated 14 June 1988 was prepared to extend facility 1 for a period of 13 months.

50 Although, following the October 1987 stock market crash, there had been a decline in the value of Pro-image and Disctronics shares, the security for the Quatro facility still exceeded the minimum cover requirement of 1.5 times.
The submission did not undertake any analysis of Quatro's ability to service or repay the facility, nor did it disclose various management agreements which would have affected Quatro's ability to service the loan. Mr Atlas acknowledged that these matters should have been disclosed in the submission.

The submission was approved by Johns, Ryan, Moyle and Carr.

In November 1988 Quatro defaulted on its share cover covenants. The shortfall was $5.7m. Additional top-up security was requested on a number of occasions but, although some additional security was provided on 3 January 1989, a security shortfall continued to exist.

(d) Facility 3

A credit submission, dated 28 February 1989, was prepared to grant a $25m facility to Quatro to assist it in retiring a US$26m zero coupon note. It also increased facility 1 to $5m to assist Quatro with its working capital requirements pending the acquisition by Mr Kavanagh, through his investment company Peperback Pty Ltd, of Quatro's shareholding in Pro-image.

The submission was approved by Johns, Moyle, Smith, Carr, Ryan and Morton.

The security for facility 3 comprised:

(i) an irrevocable order by Mr Kavanagh to BNZ for the proceeds of a facility BNZ had undertaken to provide to Mr Kavanagh to finance the purchase of 25m Pro-image shares;

(ii) an irrevocable assignment of a firm placement agreement between Mr Kavanagh and ANZ McCaughan Limited to place 12.5m Pro-image shares at $0.90 per share; and

(iii) an assignment to Tricontinental of the sale proceeds of Mr Kavanagh's interest in Quatro.
Mr Ryan said that the proposed security involved little risk for Tricontinental as it provided a certain takeout by a third party of Tricontinental’s facility. He saw the facility as representing an opportunity for Tricontinental to raise substantial fees from an existing client and, ultimately, reduce its exposure to Quatro.

Both Mr Wigginton and Mr Mountford acknowledged in evidence that the credit submission did not make any reference to the fact that Quatro had been, until very recently, in constant default of security covenants since November 1988.

The credit submission for the extension of facility 1, prepared in June 1988, had stated that Tricontinental held more than 17m shares in Pro-image, plus 500,000 shares in Battery Group Limited, as security. At the time facility 3 was approved, the security was stated as being 3m shares in Pro-image and more than 73m shares in Disctronics. It was not proposed in the submission that any additional security be obtained in support of the increase of facility 1.

The security over the shares in Battery Group Limited was apparently released. Mr Atlas acknowledged that he was aware of occasions when security was returned to the Quatro group and that he assumed that he was involved on those occasions. He was unable specifically to recall the release of the security over the shares in Battery Group Ltd.

(e) Variation to facility 3

In March 1989 Quatro requested variations to Tricontinental’s security and preconditions, in order to enable the immediate drawdown of facility 3. The variations of security requested included the deletion of the requirement for the taking of an irrevocable assignment over the proceeds of the facility to be provided by BNZ to Mr Kavanagh. Quatro also requested that Tricontinental accept the ANZ McCaughan placement agreement rather than a firm
placement agreement drawn up by Tricontinental's solicitors, and waive the requirement of an independent expert's report on the fairness of Mr Kavanagh's bid for Quatro's shares in Pro-image.

Wigginton, in a memorandum to Johns dated 10 March 1989, conveyed Quatro's requests for a variation to security. The memorandum stated, "The BNZ letter has a plethora of preconditions such that it is virtually worthless..., and recommended that Tricontinental consent to the deletion of the BNZ assignment. Wigginton also referred to Tricontinental's solicitors' opinion that ANZ McCaughan's placement agreement was not binding. The memorandum noted that the expert's report could not be completed until further information was supplied by Pro-image and that Quatro could not call the extraordinary general meeting before Corporate Services released its report, which would not be ready until 16 March 1989. Wigginton expressed the view that he could not recommend that the preconditions be waived. Mountford added a handwritten comment on the memorandum that the ANZ McCaughan placement agreement was "totally unacceptable". Mr Mountford said that he believed the word "agreed" which was initialled and dated "10/3" was that of Mr Johns.

In a memorandum to Wigginton dated 16 March 1989, Mountford stated that he had discussed with Johns the need for an "undoubted takeout" and in the absence of a firm underwriting/placement commitment from a reputable broker, Tricontinental was not to provide the facility to Quatro.

In a further memorandum dated 20 March 1989, Wigginton asked Mountford to approve the following amendments to the facility originally approved:

(i) reduce amount of facility to $10m;
(ii) reduce establishment fee;
(iii) accept present placement/underwriting letter from ANZ McCaughan rather than that proposed by Tricontinental's solicitors;
(iv) delete all reference to the facility Mr Kavanagh has arranged with BNZ; and
(v) accept additional shares in Pro-image to the value of 1.5m times the amount drawn down under the facility. The initial drawing was to be in the vicinity of $6.3m.

The memorandum bears Mountford's signature with the word "approved" and the date "20/3/89". On the same day a letter of offer was issued to Quatro offering the varied facility.

Although the varied facility was substantially different from the facility initially approved by directors, no fresh credit submission was drawn up. Mr Moyle and Mr Ryan both said they would have expected that, in these circumstances, a fresh credit submission would have been prepared.

Mr Mountford said that he was aware that the only prospect of Tricontinental being repaid a substantial amount of the Quatro debt was for Peperback's acquisition of Quatro's Pro-image shares to proceed. He said that he altered his opinion concerning the need to have the firm placement agreement and the irrevocable order sought under the approved facility, because the source of repayment was no longer to be the BNZ facility. On this basis Mr Mountford asserted that he was satisfied that the varied facility provided a source of repayment of Tricontinental's debt and it was in Tricontinental's best interests to extend the varied facility to Quatro. He also said that the varied facility accorded with the purpose for which the board had approved the proposed facility and, on this basis, he was willing to recommend the varied facility.

In April 1989, Quatro defaulted on payment of interest to Tricontinental. Tricontinental later consented to the sale of most of Quatro's shares in Pro-image to Peperback, a company controlled by Mr Kavanagh. The purchase price of $12m was used to reduce Quatro's exposure to Tricontinental.
Tricontinental's loss was $7.984m, of which $4.7m related to facility 3 approved in March 1989. The loss was written off in 1991.

D. Narrative - the Disctronics Facility

A credit submission dated 14 April 1987 was prepared by Maddison on instructions from Atlas to provide a facility to Disctronics to be used to construct a compact disc manufacturing plant in Australia. The amount of the facility was $33m, together with a foreign exchange forward dealing limit of $5m.

The security for the facility was a registered debenture mortgage over the whole of the assets of Disctronics and Disctronics Manufacturing Pty Ltd, together with guarantees from Pro-image and Quatro to the extent of their shareholdings in Disctronics, and a deed of subordination over loans to Disctronics from Pro-image and Quatro. The drawdown of the approved facility was to be in stages, each stage requiring a 25% equity contribution by Disctronics over the period April 1987 to October 1987.

Disctronics was to service the facility from cash flow, which was estimated to be 9.12 times the projected interest expense. Repayment was to come from refinance at the expiration of the facility, or from the proceeds of a "public flotation of Disctronics Ltd".

The submission was approved by Johns, Ryan, Carr and Smith.

Disctronics paid all interest payments and foreign exchange losses until May 1989, when it defaulted in the repayment of a foreign exchange loss.

Mr Atlas, the account manager, said that there were four matters relevant to Tricontinental's risk in granting the Disctronics facility, namely:

(i) Exclusivity - Disctronics had apparently obtained the provision and installation of the most efficient equipment available for the
manufacture of compact discs. Both Mr Atlas and Mr Donovan confirmed that Disctronics was the only manufacturer to be provided with this equipment in either Australia or New Zealand;

(ii) Competitors - there were no competitors in Australia to Disctronics. The analysis undertaken by Disctronics management suggested that manufacturers were unable to import compact discs at or about the costs of a local manufacturer;

(iii) Sponsors - Quatro and Pro-image were guarantors. At the time of this facility they were both successful public listed companies;

(iv) Expertise - whilst the industry was a new industry, it was apparent that Disctronics had secured training from Japan’s leading executives in compact disc manufacturing. Further, Atlas observed that the video and compact disc markets were similar in terms of production, distribution and marketing and Pro-image’s management had been successful in marketing videos.

Mr Atlas was particularly taken with what he saw as a unique opportunity for Disctronics within Australia. He said on more than one occasion that the facility did not give him any cause for concern in all the time he was involved with it and that he thought it was a good solid manufacturing business in a very solid industry. He now realised, with hindsight, that unless Disctronics succeeded the entire Quatro group was likely to fall.

Price Waterhouse prepared a valuation report for Disctronics, dated 9 February 1987, which was made available to Tricontinental before the preparation of the credit submission. The report valued Disctronics at approximately $118m. It was based on assumptions provided by the directors of Disctronics.
Mr Donovan said that the Price Waterhouse report examined and accepted the management's view regarding projected earnings for Disctronics. He said that at no time did Price Waterhouse indicate that it felt the projections were unachievable, or that there was anything about the formulation of those projections which was incorrect or unacceptable.

Mr Atlas acknowledged that the figures in the credit submission for projected earnings of $57.3m did not reconcile with the figures used in the Price Waterhouse report, which were considerably lower.

The credit submission stated that Disctronics would be making payments under its construction contract which were some 25% greater than the drawdowns schedule. Counsel assisting submit that there was in fact no equity contribution by Disctronics when its use of funds was properly analysed. The result was that Tricontinental funded 100% of the cost of establishing Disctronics' business.

Mr Moyle said that he was not aware from examining the submissions that the purpose was for Tricontinental to provide 100% of the start-up finance for Disctronics. He said he would have had reservations about that, unless the security was something other than the business itself. Mr Moyle also was not aware of the reliance by the Quatro group, as a whole, on capital raisings from the public to provide equity and repay loans.

The $33m facility represented 75.17% of the cost of the equipment over which a debenture mortgage was to be provided as security. The guidelines stated that a facility secured by a debenture charge was not to exceed 70% of the written down value of the assets; plant and equipment were to be credited with their depreciated value before the 70% discount was applied. On the other hand, the credit procedures manual indicated that, when the assets were plant and equipment, their value should be written down to 20-30%. Whichever approach was used, the resulting figure would be less than 75%.
Mr Atlas acknowledged that he was aware that the guidelines had been exceeded, and sought to justify this by referring to factors such as the highly technical nature of the equipment, the fact that the equipment was available exclusively to Disctronics in Australia and that it was "state of the art" equipment.

Substantial plant and equipment, subject to Tricontinental's debenture charge, was transferred to Disctronics' United States and United Kingdom operations. The transfer of this plant and equipment was undertaken in apparent breach of the debenture charge deed executed in favour of Tricontinental. The value of the plant and equipment transferred to the United Kingdom was approximately $4.5m. Mr Donovan said that the transfer was undertaken with Tricontinental's knowledge. He did not provide any documentary evidence to support this assertion, other than the contents of a letter he himself wrote to the receiver and manager on 7 June 1991. Tricontinental did not conduct "spot audits" of Disctronics' premises.

During the Commission's hearings a comparison was made between a cashflow projection and the audited accounts of Disctronics. The projections stated that the total revenue to June 1988 was to be $81.5m, whereas the actual revenue was approximately $33m. This shortfall of revenue was explained by Mr Atlas and Mr Donovan by saying that Disctronics experienced considerable "teething problems". Mr Atlas also said that there was substantial room for such a contingency in the cashflow projections to June 1988, which was reflected in the interest coverage of 9.12 times.

Mr Donovan agreed that there was a substantial shortfall on the actual production compared to the projected production, and said that external economic factors affected Disctronics' performance. He said:

"I think in the period from mid 87 through to mid 88 there is clear evidence that the industry started to suffer a fairly massive decline in price."

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Plants did come on stream in 1987 in Europe and there was a lot of activity in competition around in the latter part of 1987 which was causing a serious erosion to the price. It also caused, by definition, an erosion to the available volume, so what happened is that there was a large number of - there was a productive capacity that suddenly came on stream that meant the prices were being eroded and it was more difficult to in fact get volume. 

Mr Donovan also said that the difficulties facing Discronics principally related to its inability to generate sufficient cash to service its debt requirements, and that this arose from Discronics' expansion of its compact disc manufacturing business in the United States.

In 1987, Discronics acquired a compact disc manufacturing plant in the United Kingdom and signed a contract to acquire "Laser Video", from Quixote Corporation, in the United States. This raised a question whether the acquisition of overseas compact disc manufacturing plants necessarily impacted upon the ability of Discronics to export 85% of its product, as had been suggested in the initial projections provided to Tricontinental. Mr Atlas said that the prospect of exporting 85% was still viable, given that both the UK plant and "Laser Video" were existing plants which Discronics' management had already taken into account when developing its projections regarding export.

In June 1988, Discronics was floated by way of a takeover of Discronics by BGL International Limited, which then changed its name to Discronics Ltd. Instead of achieving the $200m capital raising which had been expected, at least by Tricontinental's management, in 1987, less than $25m was raised by the float. The funds that were generated by the float were used to repay inter-company debt to Quatro and Pro-image and not to repay the Tricontinental facility to Discronics, as had been at least contemplated in the original submission.

The documentation prepared for the float of Discronics in June 1988 included a reference to the repayment of inter-company loans of approximately $50m
to Quatro and $65m to Pro-image. Mr Atlas agreed that the repayment of inter-company loans in this fashion would have breached the terms of the deed of subordination in favour of Tricontinental, but this was apparently not noticed at the time.

An internal review of the Disctronics facility was conducted in August 1988, shortly after Mr Atlas ceased to have responsibility for the Quatro group. The review included reference to the acquisition of both the UK and US operations, but did not attempt any analysis of their impact upon the Tricontinental facility, nor did it detail in any way the terms of those acquisitions. The review was based upon financial data for Pro-image, which was guaranteeing the facility, it being stated that current data for Disctronics was unavailable. In fact, unaudited accounts had been published with its prospectus in July. The review was prepared by Ms Zulal Rogers and recommended the continuation of the facility in view of "the adequate security cover, sound financial position, long standing and satisfactory relationship between TCL and the companies within the Quatro group". The substantial failure of the July float was not mentioned. There were also some suspect valuations of plant and equipment and of goodwill.

Disctronics defaulted under the facility in or about May 1989. Mr Hunter instructed Tricontinental's solicitors to prepare notices of demand.

A debt and moratorium agreement was entered into between Disctronics and its lenders in June 1989.

On 21 February 1991 a receiver and manager was appointed to Disctronics by Disctronics' lenders.

Mr Donovan would not accept that Tricontinental had suffered a loss on its facility to Disctronics and said that, during the period April 1989 to March 1991, the Disctronics business generated approximately $8m operating cash,
and that it was projected that the profit would increase to $10m per annum in
the 12 months following March 1991. He said that, in the previous two
years, Disctronics' projections accorded closely with those of the receiver.
On this basis Mr Donovan asserted that the Tricontinental facility could be
repaid within 5 years.

Recent public statements suggest that Mr Donovan’s confidence was not
misplaced. The receiver has invited tenders for the business, which is trading
profitably, and it is hoped that Tricontinental’s facility will eventually be
repaid in full.

E. **Narrative - the Pro-image Facility**

Between August 1984 and September 1988, Tricontinental provided several
facilities to Pro-image. During this period, Pro-image developed from a
company with a small interest in the production of television commercials to
a market leader in video and closed circuit television, specialising in the
production of television commercials, corporate and music videos and sporting
broadcasts.

In 1988 Pro-image, together with Quatro and Disctronics, were part of a
restructuring process by which the ownership of Communications
Entertainment Limited was transferred from Quatro to Pro-image. Pro-image,
as part of the restructure, transferred its interest in Disctronics to Quatro.

At a meeting between Kavanagh and Johns, in or about August 1988,
Kavanagh requested a $50m loan from Tricontinental. Johns suggested that
the facility be provided to Pro-image by a syndicate, although no mention was
made of the level of Tricontinental’s participation in the syndicate.

A syndicate memorandum was later prepared by Mr Waldron. The
memorandum contained details of the proposed facility to be provided to Pro-
image and was sent to lenders by way of invitation to participate in the
syndicate. Three financial institutions accepted Tricontinental's offer to participate in the syndicate: Australian European Finance Corporation, State Bank of South Australia and NatWest Australia Bank Limited, in the proportions of 10%, 30% and 20% respectively.

Tricontinental was a 40% participant in the syndicate and was its manager.

The syndicate memorandum was used as the basis for the compilation of a credit submission, dated 21 September 1988, for Tricontinental's 40% participation in the syndicate.

The submission was approved by Johns, Carr and Morton.

During the Commission's hearings, it was put to Mr Waldron by counsel assisting that the financial analysis in the syndicate memorandum was misleading, in so far as the operating profit before tax for the year 1987/88 was stated to be approximately $31m. This profit was based on sales of approximately $79.8m. Counsel assisting suggested that the failure to identify that part of the profit attributable to Disctronics' sales was misleading. Mr Waldron responded by saying that the syndicate memorandum made clear that the movement of Disctronics' business into a separately listed vehicle had a direct result on the financial statements of Pro-image. He said it was obvious from the syndicate memorandum that the Disctronics' operation was to be separated from Pro-image and that would have an effect on its accounts in the coming financial year. On this basis, Mr Waldron said there was no need for a further warning about Disctronics' transfer of ownership to be included in the syndicate memorandum.

Mr Hue, a credit analyst, prepared the credit submission for the proposed syndicated loan. Mr Hue said that, when preparing the submission, he was aware of the considerable work undertaken by Mr Waldron in preparing the syndicate memorandum, and said that he relied heavily upon the memorandum
when drafting the submission and made no attempt to verify the unaudited figures in the memorandum. Mr Waldron, in turn, relied on figures and projections provided by Pro-image when preparing the syndicate memorandum.

Security for the syndicated loan was a first registered debenture mortgage over the assets and undertaking of Pro-image, and a first registered mortgage over Willoughby Road and McCabe Place properties. Valuations were obtained by Tricontinental for both the plant and equipment and the mortgaged property.

The audited accounts of Pro-image for the year ended 30 June 1988 were received by Tricontinental in or about October 1988. Discrepancies clearly existed between the management accounts set out in the syndicate memorandum, and the audited accounts to 30 June 1988 once they were received. For example, the management accounts stated that the shareholders' funds to 30 June 1988 were $95.7m. The audited accounts showed the shareholders' funds to be $64.2m. Mr Kavanagh said that there was an attempt to integrate the two accounting systems of CEL and Pro-image which may well have resulted in the discrepancy.

A further discrepancy related to the net profit before tax. The management accounts provided for a net profit before tax of $31.2m, whereas the audited accounts provided for a net profit before tax of $19.8m. Mr Kavanagh said that the discrepancy related to the obtaining of a profit by Pro-image on the Discronics float, which had been "grossed into" the total profit figure which was provided to Tricontinental.

Mr Morton said that he expected that the board would have been informed by Johns of the changes in financial position as shown in the audited accounts, once they were received. Mr Morton had no recollection of that happening on this occasion, and thought that there was a duty on Mr Johns to do so.
Mr Moyle said that he would have expected the audited accounts, when provided to Tricontinental, to be monitored by the analyst and the account manager, so that any significant deterioration could be brought to the board’s attention. Equally, if projections were shown to be wildly optimistic in the light of performance, the board should have been told.

Mr Ryan said that he could not imagine that Tricontinental could have been in any better position to know what was happening in the Quatro group. He said that, if it was not possible to keep tabs on a company to which Tricontinental was financial adviser, and had the right to attend board meetings, there was not much hope in other cases. Tricontinental should have been able to pick up any trend that became obvious within a 3-month period. Mr Ryan said that he would then expect the information to be put to the board to do something about it.

Mr Carr did not recall being told that Discronics’ actual sales were well below projections for the first year. He expected this sort of thing to be brought to his attention, especially where Tricontinental was financial adviser to the group. He said it should have been referred to the board unless the financial advisers thought it was within acceptable parameters. If the matters were significant, Mr Carr said he expected them to be referred back to the board as they occurred, even if just by way of mention by Johns. Mr Carr placed confidence in the fact that Tricontinental was the financial adviser to the Quatro group. He said he thought this meant Tricontinental would get the earliest possible signals about anything going wrong, and would be able to keep matters such as security under review.

In March 1989 Pro-image had a rights issue underwritten by Quatro. The issue was unsuccessful and Quatro was required to take up most of the issue. Pro-image used these funds to repay approximately $33m of inter-company debt to Quatro Finance Limited and not Tricontinental.
In December 1989 Pro-image defaulted on its interest payments. Interest was
capitalised by Tricontinental from 20 December 1989 to 25 February 1990.

In June 1990 State Bank Victoria and Bank of New Zealand, both participants
in the syndicated loan to Pro-image, assumed that loan in its entirety, making
a payment to the other lenders of 23 cents in the dollar. Tricontinental
received $4.6m. The balance of the funds provided to Pro-image as part of
Tricontinental's participation in the syndicated loan is a total loss. $15.4m
was written off in 1990.

F. Role of Mr Johns in the Quatro Group Transactions

Mr Hunter and Mr Waldron both said that Mr Johns maintained an active
involvement with the Quatro group facilities and that he was, in effect, the
account manager. Mr Wigginton, who was the account manager for Quatro
from February 1989, said that Mr Johns had a large involvement in the actual
control of the account and had regular contact with Quatro executives.

Mr Johns (together with an alternate for Mr Ryan) approved Quatro facility
1 in January 1986. The facility was within his discretion as managing
director. Mr Johns' approval of the increase in facility 1 and the grant of
facility 3 in March 1989 was endorsed: "No further extensions". He also
approved the variation to the security for Quatro facility 3.

Mr Johns reviewed and approved the final version of the syndicate
memorandum prepared by Tricontinental for the Pro-image syndicated loan.
Mr Paul Hue, credit analyst, said that he treated the preparation of the credit
submission for Tricontinental's participation in the Pro-image syndicated loan
as if Johns were the account manager and that any submission for Johns was
considered as urgent. Mr Waldron said that he viewed Johns as the account
manager for Pro-image, as the directors of Pro-image would conduct most of
their discussions with him and Johns would then structure the loans and have
them carried out accordingly.
Kavanagh met Johns on two or three occasions to arrange the Pro-image syndicated loan. Mr Kavanagh said that he thought Johns had a good understanding of the business and of the plans for Pro-image.

G. Role of Directors in the Quatro Group Transactions

(a) The Quatro facilities

An extension of facility 1 was approved on or before 27 June 1988 by Johns, Ryan, Carr and Moyle.

Facility 2 was approved on or before 24 February 1987 by Johns, Moyle and Ryan.

Approval for the grant of facility 3, and the increase of facility 1, was given between 5 and 7 March 1989 by Johns, Moyle, Smith, Carr, Ryan and Morton.

(b) The Disctronics facility

The credit submission for the Disctronics facility was approved on or before 28 April 1987 by Johns, Ryan, Carr and Smith. An amendment to the foreign exchange dealing limit was approved by Johns, Ryan, Moyle and Rawlins in July 1989.

(c) The Pro-image facility

The syndicated loan was approved by Johns, Morton and Carr on 29 September 1988. Ryan, Carr and Smith were noted as unavailable, but it was Moyle, for whom Carr was an alternate, who was not available. Mr Carr did not recollect approving the facility.

Mr Morton gave evidence that he had some doubt about his approval as he had a number of other engagements on 28 September 1988. He also said that he found it strange that other directors were unavailable as there was a Tricontinental board meeting the day before and a SBV meeting the next day.
H. Role of Management and Staff in the Quatro Group Transactions

(a) Mr Atlas
123 Mr Warren Atlas was the account manager for the Quatro group, reporting directly to Mr Johns, for a period commencing before July 1985 to mid-1988. Mr Mountford said that he assumed control of the day-to-day operation of the account in or about November 1988, although his involvement may have begun earlier.

124 In his role as account manager, Atlas gave informal advice on the proposed restructure of the Quatro group.

125 The credit submissions for Quatro facility 1 and facility 2 and for the Disctronics facility were prepared on the instructions of Atlas. He agreed that he had a substantial input into the content of the credit submissions, even though he was not directly involved in their actual preparation.

126 Mr Atlas acknowledged that the credit submissions for the Quatro facilities and the Disctronics facility were deficient. He said that he did not deliberately or in bad faith mislead the board, or leave anything out of the credit submission just because it went contrary to the recommendation he was making.

(b) Mr Mountford
127 Mr Mountford assumed responsibility as account manager for the Quatro group from about November 1988 to February 1989. He said that there was no formal hand-over of responsibility and that he did not recall Atlas briefing him about the facilities.

128 In March 1989, Mountford notified Wigginton of a variation to the amount of and the security for Quatro facility 3, which had been agreed by Johns.
(c) Mr Wigginton

Mr Wigginton assumed responsibility as account manager for the Quatro group in January 1989 at the request of Mountford, although Mountford maintained a supervisory role in his capacity as general manager lending. The credit submission for Quatro facility 3 was prepared by the credit department on instructions from Wigginton.

130 Wigginton asked Mountford to approve amendments to the terms of facility 3 which are set out at para 64 above. Wigginton gave evidence that he recommended that Tricontinental should agree to Quatro’s request to delete from Tricontinental’s security the assignment of the proceeds of the facility to be provided by BNZ, because he thought that the preconditions attached to it rendered it worthless.

(d) Mr Waldron

Mr Waldron was appointed as special projects manager for Tricontinental in mid-1988 with responsibility for syndicated loans. He was directed by Johns to meet Kavanagh and prepare a syndicate memorandum for the Pro-image syndicated loan, under the supervision of Mountford. The Pro-image syndicated loan was the first syndication on which Mr Waldron had worked. This was the first contact he had with any persons from the Quatro group.

132 Mr Waldron said that Mr Johns was actively concerned in the preparation of the syndicate memorandum, being involved in discussion as to security, covenants and other matters.

(e) Mr Hue

Mr Hue prepared the September 1988 credit submission for the Pro-image syndicated loan. He had no previous knowledge of the Quatro group. Mr Hue said that he expected the credit manager to inform him as to related exposures or inter-company borrowings. He acknowledged that he relied heavily on the syndicate memorandum when preparing the credit submission.
He conceded that he had accepted the information at face value and did the best he could with it. He had assumed that the terms and covenants had been negotiated with the client by Mr Waldron and Mr Johns.

I.

**Expert Witnesses**

**Mr Perry**

Mr Perry gave evidence as to the somewhat speculative nature of Pro-image and Disctronics shares. He also gave evidence as to the problems associated with the disposal of a strategic parcel of shares, and said that low turnover would tend to indicate that it would be more difficult to dispose of a larger parcel of shares.

**Mr Weaving**

Mr Weaving commented on the taking of 40% of the issued capital of Pro-image as security for the loan to Quatro. He described 40% as a "large shareholding to hold as security", and pointed out that it was outside Tricontinental’s guidelines which stipulated a 5% maximum. He also said that such a holding was beyond the threshold 19.9% which would otherwise trigger a takeover, and expressed the further opinion that such a large shareholding would involve "all sorts of problems if you wanted to realise on that security, including finding a buyer...".

Mr Weaving further said that he would have expected to find equity participation of between 35 and 50% in a start-up venture. He went on to say that he believed the Disctronics venture was ill-conceived from the outset. Tricontinental should have investigated the project thoroughly through a feasibility study rather than relying on management figures, especially as management were themselves new to the industry.

He was also of the opinion that the main problem of the Quatro group facilities was the lack of monitoring, coupled with the rapid and unchecked expansion which was permitted.
J. Significant Issues Arising - the Quatro Facilities

Counsel assisting submit that the approving directors had insufficient information to assess the adequacy of the proposed security for the Quatro facilities. They further submit that a prudent director of a merchant bank would have required independent verification that the proposed security was adequate and likely at least to maintain its value. This is particularly so, they contend, in circumstances where the board had not formulated any appropriate policy and guidelines relating to margin lending or lending with shares as security. In this respect they submit that the approving directors failed to exercise the degree of care and diligence required by s229(2) of the Companies Code. They submit that the acceptance of shares in Pro-image and Discronics, as security for its advances to Quatro, substantially contributed to the loss suffered by Tricontinental. They argue that, although Tricontinental made considerable efforts to obtain top-up security after Quatro defaulted in relation to security covenants in November 1988, the size of the holding of shares in Pro-image substantially reduced the value of the shares as effective security for Tricontinental. They submit that a strategic parcel only attracts a premium if the underlying business is a going concern and has assets to support it.

Counsel for the directors submit that the directors would expect that management would use outside experts (including international investment bankers, lawyers, accountants, valuers, quantity surveyors, geologists) and have access to outside research (including stock exchange reports, annual reports, directors’ and audit reports and Australian Ratings Reports). They further contend that the directors were well aware that a panel of experts were used by management, and they could properly assume that such experts were employed and could be relied upon. They say that there is no evidence that members sought from the Pro-image syndicate leader (Tricontinental) any verification. For these reasons they submit it cannot be suggested that the directors, in approving the Quatro facilities, failed to exercise the degree of care and diligence required by s229 of the Code.
Counsel assisting further submit that Mr Mountford failed to exercise the degree of care and diligence required by s229(2) in agreeing to the variation of security for facility 3 by the deletion of the irrevocable order to BNZ.

Counsel for Mr Mountford submit in reply that the deletion of the irrevocable authority was done with the approval of Mr Johns and that, on the basis of the information available to the Commission, it is not possible to say that Mr Mountford had no basis and did not exercise care in agreeing to the variation of security, even if it be accepted now, with the benefit of hindsight, that it may not have been prudent to do so. They further submit that Mr Mountford was not "an executive officer" within the meaning of s229(5) of the Code.

Counsel assisting submit that Mr Johns also failed to exercise the degree of care and diligence required by s229(2) in agreeing to the variation of security for Quatro facility 3 without obtaining the approval of the board.

Counsel assisting also submit that the credit submissions prepared for the Quatro facilities were deficient in a number of respects and that when considering the quality of the various credit submissions, it is also necessary to ask whether the directors had other information available to them. They submit that there is no evidence to suggest that any such additional information was available to, or requested by, the directors.

On the other hand, counsel for the directors submit that there is no evidence to suggest that any additional information was not available to the directors, and they argue that it is more likely, having regard to the involvement of Mr Johns and the interaction between him and the other directors, that discussion did take place about whether approval should be given to particular credit submissions. They submit further that, even if one accepts that there were deficiencies in the credit submissions as alleged by counsel assisting, it cannot be concluded that the deficiencies referred to were as a consequence of the absence of appropriate policies or guidelines, formulated and implemented by
the board, relating to margin lending and lending secured by shares. They submit each is a matter to be determined on a case-by-case basis and the preparation of a credit submission is in the domain of the analyst, the account manager or the managing director and the credit committee.

Counsel assisting further submit that the absence of any monitoring procedures enabled the funds advanced for facility 2 to be applied for a different purpose from that approved in the credit submission. But it must, of course, be remembered that the use of facility 2 was subject to the approval of Mr Johns. The shares purchased had to be "acceptable" to him. This hardly seems to raise questions of monitoring.

K. Significant Issues Arising - the Disctronics Facility

Counsel assisting submit that it is open to the Commissioners to find that no prudent director of a merchant bank would have approved a facility which involved funding a "start up" business to the extent of 100%, especially in circumstances where no independent assessments were obtained of the financial information and projections provided by the borrower.

Counsel for the directors submit that it is not a question of whether a prudent director would have approved a facility, but a question of whether the directors at the relevant time, having regard to the information they had, took care within the meaning of s229(2). They submit that the evidence indicates that the directors took into account relevant matters including the Price Waterhouse valuation. Criticism may be levelled at the directors now with the benefit of hindsight, but the directors were entitled to rely upon the Price Waterhouse valuation at the time. They submit further that, just because a view may have been taken which was overly optimistic (if this be the case), that does not mean that the approving directors failed to exercise the degree of care and diligence required by s229(2) of the Code.
Counsel assisting further submit that the pattern of tolerating departures from guidelines constituted a failure by the approving directors to exercise the degree of care and diligence required by s229(2). They submit that the directors had a positive obligation to ensure the observance and maintenance of the guidelines.

Counsel for the directors submit that it is not a question of looking at prudence or reasonableness or making generalised comments about tolerating departures from guidelines. They submit there is no evidence of any toleration of departure, and the board was not aware of any departures, except those which it approved.

They further submit that the justification for Mr Atlas agreeing to the lending security ratio guidelines being exceeded comes from taking into account factors such as the highly technical nature of the equipment, the fact that the equipment was available exclusively to Disctronics in Australia and the fact that it was "state of the art" equipment.

**L. Significant Issues Arising - the Pro-image Facility**

Counsel assisting submit that the approving directors had insufficient information to assess the adequacy of the proposed security for the Pro-image syndicated loan, the financial analysis in the submission being based on management figures rather than audited figures.

Counsel for the directors submit that the approving directors had ample evidence that Pro-image had an adequate servicing capacity at the time the credit submission was approved, and they say that the cash flow projections indicated that adequate provision had been made for interest expense in the next 12 months. They submit that the syndicated loan was a commercial transaction for a number of reasons including the adequacy of the security and the servicing capacity of the borrower.
Counsel assisting submit further that the substantial differences between the management accounts and the audited accounts, once known to management, ought to have been reported to the board by Mr Johns and that in failing to do so, he did not exercise the degree of care and diligence required by s229(2) of the Code.

M. Conclusions and Findings

This case is by no means one of the worst that the Commission has had to consider. The two operating businesses concerned, Pro-image and Disctronics, were both worthwhile initiatives. In the case of Pro-image, the business had been running for some time and was successful; Disctronics was a new venture, but it seemed to have good prospects of success. The holding company, Quatro, appeared to deserve, and certainly received, support from a number of leading Banks.

However the Quatro and Pro-image transactions failed, leaving Tricontinental with total debts exceeding $23m. An analysis of how that failure came about serves to illustrate many of the weaknesses in Tricontinental’s procedures and practices. The Disctronics facility appears to have survived a period of receivership, but here too there are lessons to be learned.

The Quatro facilities

Quatro was a holding company with no substantial assets of its own. Its cash flow came from the earnings of its subsidiaries. In those circumstances there was little comfort to be had from security in the form of shares in those subsidiaries. It was obvious that, if Quatro was unable to service the loans, it would be because the subsidiaries were in difficulties. If that were so, then their shares would be of doubtful value. This rather obvious result was particularly true in Quatro’s case, because the shares were not traded regularly on the Stock Exchange and Tricontinental held very large parcels.
In fairness to the directors, it must be said that they were only responsible for the taking of Pro-image shares as security for facility 1. It was Mr Johns who was responsible for accepting them for facility 2, and Mr Mountford for facility 3.

The credit submissions for these three facilities were deficient in a number of ways; see paragraphs 38, 46, 51 and 58 above. In particular, there was an uncritical acceptance of the borrower’s estimates of future earnings, and an absence of much relevant information. There was no attempt to analyse carefully Quatro’s ability to service and repay the particular facilities.

Inadequate monitoring of these facilities was also apparent. Although Tricontinental was appointed as financial adviser to the group, it was not aware of the fact that, within five months of the approval of the first facility, Quatro’s debt had increased by $14m. No covenant had been taken to prevent this situation occurring without agreement.

The second facility, like others the Commission has reviewed, was to enable the borrower to "take positions in publicly listed companies or allow the group to undertake a takeover of a listed/or private company." Any shares purchased or lodged as security were to be acceptable to Tricontinental. As usual, the directors were prepared to allow Mr Johns to determine acceptability. In fact the funds were used to take up rights in Pro-image. The directors, in their evidence, saw this as a departure from the purpose specified, and said that it should have been reported back to the board. The Commission agrees that there was a departure from the spirit of the submission, if not from the letter, and the directors should have been consulted. However the Commission also believes that it was an abdication of responsibility by the directors that they approved such a vaguely worded submission, enabling the managing director, in effect, to approve both the purpose of the facility and the security.
Counsel for the directors have argued that they were entitled to rely on management to provide full and accurate information in the first place, to inform them if there were important changes in the information which they had been given, and to observe faithfully the conditions of any submissions which they had approved. There is substance in this submission, but the example in the last paragraph illustrates one of the ways in which the directors brought upon themselves a decline in management standards, by approving submissions which were expressed in vague terms, or inadequately supported by financial details, in the first place.

Another illustration of the way in which management could let down the directors is to be found in the absence from the credit submission for the third facility of any information about recent breaches of security covenants.

So far as the variation to facility 3, approved by Mr Mountford, is concerned, the Commission is clear that this should have been reported back to the approving directors or the board. Although no guidelines had been established to define the entitlement of management to make variations in cases such as this, and Mr Mountford believed that what he was doing was within the purpose of the facility and in Tricontinental’s best interests, this was clearly such a major change from the proposal as approved that it should have been taken back to directors.

However the Commission is certainly not able to say that the decision to make the variations, including omitting reference to the irrevocable order to BNZ, was a negligent act on Mr Mountford’s part. He had advice about the doubtful value of that provision from an experienced subordinate, Mr Wigginton, which he no doubt accepted. The Commission is unable to say that Mr Wigginton’s advice was unsound. Mr Mountford also had positive reasons for agreeing to a reduced facility and an alternative source of repayment.
Disctronics

The most obvious criticism of this facility was that it was granted to a start-up business for which no equity was being provided by the owners. An elementary precaution would have been to obtain some independent advice. All that Price Waterhouse had been asked to do was to put a value on projections supplied to them by the owners themselves; and even that valuation was not reflected in the credit submission.

Mr Atlas, and later Mr Mountford, were both understandably impressed by the prospects for success of a compact disc manufacturer in Australia. Mr Atlas did not, however, investigate the possibility of new competition opening up in Australia nor, perhaps more significantly, the ability of the new venture to compete in overseas markets. He simply accepted, at face value, what he was told by the borrower.

Of course, if an independent review had been sought, the advice received might well have been to go ahead. This does seem to have been a worthwhile venture, which ran into difficulties partly because the company over-reached itself in commitments overseas, and partly because it was unable to meet projected sales levels in its first few years.

This tends to highlight the question of monitoring. One of the conditions of the credit submission was that each stage of the facility called for an expenditure of funds by the borrower at a rate some 25% greater than the periodic drawdown. This gave the appearance of an equity contribution by the borrower. In fact, the only equity contribution received came from inter-company loans from Quatro and Pro-image, which were themselves funded by Tricontinental. Directors were entitled to feel let down by this arrangement. If Tricontinental's management knew of it from the outset, the credit submission was deceptive. If they did not, monitoring should have brought it to light and action should have been taken, either to avoid 100% funding by Tricontinental or to bring it to the notice of directors.
The credit submission stated that the lending/security ratio was 75.17%. This ratio alone showed a departure from the lending guidelines, which provided that a facility secured by a debenture charge was not to exceed 70% of the written down value of the assets. Plant and equipment were to be written down either to their depreciated value (guidelines) or to 20-30% of cost (credit procedures manual). In fact, as indicated on the face sheet of the credit submission, this ratio was calculated on the basis of the actual cost of the equipment provided as security. In the view of the Commission this, like all other departures, should have been highlighted in the submission, so that directors would realise that the guideline was being departed from. However there was no such requirement from directors although they must, on many occasions, have noticed that variations from guidelines were being proposed without being emphasised.

In fact some $4.5m worth of plant and equipment was transferred to the United Kingdom and USA. This was probably done in breach of Disctronics' contract with Tricontinental, but that is contested by Disctronics' management who claim that Tricontinental was informed and consented. There is no contemporary evidence of this, and the Commission believes it is more likely that Tricontinental remained in ignorance of the transfer.

On the assumption that Tricontinental was not aware of this move of plant and equipment, counsel assisting argue that Mr Mountford's monitoring must have been deficient. They suggest that spot audits would have discovered the breach of covenant. The Commission is not satisfied that there was any obligation on Mr Mountford to institute such surveillance of Disctronics when he had no reason to doubt the integrity of its management.

A more serious failure of monitoring is to be found in paragraphs 87 and 88 above, which show that Tricontinental failed to get any benefit from the $25m which was raised by Disctronics in the middle of 1988.
The poor quality of monitoring was emphasised soon afterwards by the deficiencies of the internal review carried out in August 1988; see para 89 above.

**Pro-image**

The credit submission for this facility provides yet another example of poor analysis. It was probably clear enough to a careful reader of the submission that the recent figures shown for Pro-image included profits from its part ownership of Disctronics. However no attempt was made to calculate what cash flow could be expected from it after Disctronics had been hived off.

The figures and projections supplied by Pro-image management for purposes of the syndicate memorandum (see paras 97 and 101-102 above) were shown to be inaccurate when audited figures became available a few weeks after the credit submission had been approved. The discrepancies are set out in paras 104-105 above. No effort had been made to obtain more recent management figures for purposes of the credit submission. At the least, the latest figures should have brought to the attention of the board when they became available.

Although the primary responsibility for initial lack of diligence and later lack of frankness in such matters must lie with the management of Tricontinental, the directors themselves must accept some share of the blame, because they regularly accepted out-of-date financial information without demur, and seem never to have suggested that they required formal notification of any significant change in circumstance of a loan already granted - apart from Mr Rawlins who raised the issue just before resigning.
TRANSACTION REPORT 3
THE ESSINGTON GROUP - TIBHAM PTY. LTD.
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A. **Background and Summary**

(a) **The Essington group**

1 The business of the Essington group was to arrange and market property development schemes. The group consisted of a complex web of more than eighty companies. Its chief executive was Mr Malcolm Leslie Edwards.

2 The group’s cash flow was irregular, principally based on the sale of large property developments.

3 The parent company of the group was Essington Limited ('Essington'), a public entity (incorporated in 1960) which operated as an investment vehicle. Its major shareholders were:

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4 By April 1989 Tricontinental had exposures to the Essington group which totalled more than $146m. The Commission has examined in detail the provision of loans to three group entities, namely:

- Tibham Pty Limited ('Tibham');
- Mainsel Investments Pty Limited ('Mainsel'); and
- Essington Developments Limited ('EDL').

(b) **Tibham**

5 EDL was an investment company and property developer ultimately owned by Essington (70%) and EIE Japan Ltd ('EIE') (30%). Mr Edwards was EDL’s chief executive officer.
Tibham was incorporated on 19 May 1988 in New South Wales. It was a wholly-owned subsidiary of EDL, formed to acquire and develop the Bondi Junction bus/rail interchange site ('the interchange site') in Sydney.

In June 1988, Tibham contracted with the State Rail Authority of New South Wales ('SRA') to acquire a 99 year lease of airspace over the interchange site for $28.5m. It also purchased two adjacent freehold properties, for $8m, from SBNSW and Australian Gas Light Company ('AGL'). EDL's intention was to carry the project through to development approval stage, while securing the involvement of a joint venture partner to develop a combined retail and residential complex on the site, estimated to cost in the order of $219m. The lease payment to SRA of $28.5m was payable on 27 October 1988.

On 23 September 1988, Mr Edwards sought finance from Tricontinental, possibly to meet Tibham's commitment to SRA. He talked to Mr David Hadley (Tricontinental's regional manager in Sydney). His request for finance met with the reply from Hadley that Tricontinental could not provide further funds to Essington due to "prudential limits". Edwards was upset at this response and complained to Mr Ian Johns. At this time Tricontinental had significant exposures to the Essington group, namely:

- $42m to Mainsel;
- $10m to Magic Millions (Holdings) Pty Limited ('Magic Millions'), (Essington had a 44% interest); and
- $30m to Magnetic Keys Limited (EDL had a 70% interest).

On 26 September 1988, Johns wrote to Hadley rebuking him for his comments and informing him that it was incorrect to say that Essington was subject to "prudential limits". Johns told Hadley he had no right to make this statement as "one of the major reasons for TCL's success and continued success is our ability to handle volume".
Mr Hadley could not recall the specific proposal he was discussing with Edwards, although he thought it would have been connected with the loan ultimately extended by Tricontinental to Tibham. Mr Hadley told the Commission he referred to "prudential limits" as an excuse, because he was not impressed with the proposal put forward by Edwards.

(c) Summary

The Tibham transaction may be shortly summarised. In October 1988, the Essington group initially sought a loan of $41.65m to fund acquisition and development costs for the interchange site. Shortly afterwards, a request was made by Essington to increase the facility to $65m. Although not mentioned in the written request, the $65m was to be used for two purposes, namely, $20m to assist Essington in purchasing a parcel of Ariadne shares and $45m for the settlement and holding costs of the interchange site.

Approvals for these facilities were given by directors in circumstances of extreme urgency, without the support of the usual detailed credit submission or any previous recommendation from the credit committee.

Drawdown of a substantial portion of the funds occurred, in spite of the fact that senior executives at Tricontinental were informed of the potential inadequacy of the security held by Tricontinental for the $45m facility.

Tibham failed to repay the $20m on the due date in February 1989. Without reference to the board, senior management approved of a number of extensions for this repayment. In September 1989 (following integration) the facilities were increased to a total of $66.5m and further extended to March 1990. This date passed without repayment and the facilities were placed in default. Tricontinental only recovered security of $15m and $46.5m has been written off.
B. **Chronology**

The chronology of relevant events is as follows:

1988

9 September  At EDL’s request, Richard Ellis valued the leasehold interest in the site at $44m, assuming development approval had been granted.

21 September  At EDL’s request, Raine & Horne valued the freehold land (to be acquired from SBNSW and AGL) at $8m.

28 October  Edwards wrote to Johns outlining details of project and funding requirements.

2 November  A credit memorandum from Mountford and Johns was sent to Smith, Ryan and Carr, outlining the proposed facilities to Tibham for $65m. Ryan approved the facilities.

3 November  Smith & Carr approved the facilities.

8 November  Corr Pavey Whiting and Byrne (‘Corrs’) advised Tricontinental that the absence of council development/building approval could have a detrimental effect on the value to Tricontinental of its security.

10 November  Formal credit submission for the Tibham facilities prepared.

11 November  Drawdown of $51.36m.

14 November  Hunter prepared a file note specifying his concerns, which had been referred to Mountford before drawdown.

8 December  Drawdown of $6.7m.

12 December  EDL lodged development applications with Woollahra Council.

1989

17 February  Due date for repayment of $20m.

21 February  )

16 March  )

13 April  )

23 May  )  Extensions of amortisation and expiry dates, for which no credit submissions were compiled.

28 June  )

27 July  )

30 August  )
1989
14 March  EDL informed Tricontinental that development approval was expected in May 1989. (EDL later notified Tricontinental of revised estimates on grant of approval as follows:
22 May 1989 - not before June 1989
20 June 1989 - not before August 1989
27 October 1989 - not before December 1989
20 February 1990 - expected August 1990.
9 August 1990 - expected in December 1990.)

18 April  Drawdown of $1.4m.

7 June  Drawdown of $1.3m.

30 June  Expiry date of $45m facility and $1m penalty fee payable; no repayment or payment of fee.

5 September  Credit submission, recommending total facility be increased by $1.5m to $66.5m and extended to 30 March 1990, approved by SBV credit committee "due to urgency". Submission signed by Dawkins, Baker, Carr, Morton, Moyle and Hancock.

7 November  Default interest paid on a weekly basis.

1990
8 January  $1.759m draw down. Of this Tricontinental retained $1.632m ($1m - penalty fee, $332,550 - increase/extension fee, $218,083 - discount on bills, and $82,762 - interest outstanding).

31 March  Expiry date of facilities. Facilities placed in default.

18 May  Weekly interest payments ceased.

26 June  Notice of Demand served on Tibharn.

29 June  Tricontinental received payment of $15m pursuant to exercise of rights under BNZ Letter of Credit.
C. Narrative

16 Following a discussion between Mr Johns and Mr Edwards shortly before 28 October 1988, it was proposed that Tricontinental fund acquisition and development costs for the interchange site. Edwards wrote to Johns on 28 October seeking a loan of $41.65m for this purpose until 30 June 1989. Edwards proposed, as an alternative to funding until June 1989, "... a shorter term facility whilst construction or other funding is put in place". On 31 October, in another letter to Johns, EDL requested an increase in the facility to $65m. An additional $20m was required to fund part of EDL's purchase of shares in Ariadne Corporation Limited ('Ariadne') (although this was not stated in the letter).

17 On the same day, 31 October 1988, there was a discussion between Johns and Mr Leigh Scott-Kemmis, chief executive in Australia of the Bank of New Zealand ('BNZ'). BNZ agreed to provide a $15m letter of credit ('LC') facility to Tricontinental as security for the $20m share financing.

18 On 2 November, Mountford and Johns sent a three page credit memorandum to Smith, Ryan and Carr. The memorandum was signed by Johns' secretary. It requested these directors to give urgent consideration to a proposal having a dual purpose, namely to provide EDL, or a wholly owned subsidiary, with facilities of:

- $20m (repayable in 3 months) to "assist with undisclosed share purchases being undertaken in conjunction with Essington Developments Limited 48% shareholder Axis Pty Ltd (W/O by EIE Japan)"; and
- $45m (repayable by 30 June 1989) "towards total settlement and holding costs for purchase of Bus/Rail Interchange Site at Bondi Junction".

19 The credit memorandum did not:

- name Ariadne shares as those to be purchased;
- indicate that $28.5m of the $45m facility, expressed to be for "Site Acquisition Costs", was for the acquisition of a leasehold over air space; or
make any reference to the development or building approvals required.

The accompanying papers did refer to EDL having acquired "a 99 year lease" from SRA in June 1988, and they provided a list of time estimates which showed the development application was to be lodged in September 1988 and that development approval was anticipated in January 1989. However, it was not until 12 December 1988 that applications for development approval were in fact lodged with Woollahra Municipal Council. To date, no development approvals have been granted.

The security offered was the BNZ letter of credit for $15m and a "1st Registered Mortgage over the Bus/Rail Interchange site - minimum valuation for [Tricontinental's] purposes $49 million...". The total security was incorrectly stated as amounting to $69m. It should have been recorded as $64m.

The credit memorandum stated that Edwards had:

"... advised BNZ in conjunction with EIE is arranging introduction of Japanese [joint venture] partner to proceed with site development to estimated total cost $218.9m. BNZ has been awarded mandate to arrange project finance and there is no undertaking from Tricontinental to participate in any syndication".

Although not expressly stated in the credit memorandum, it was apparent that repayment of the $45m was intended to come from takeout or refinance. Takeout finance was a crucial aspect of this transaction, as the borrower, Tibham, had no cash flow and all interest payments were to be capitalised. A precondition to drawdown was that Tricontinental should sight and find acceptable a Richard Ellis mortgage valuation of the site (but not the freehold properties) for $49m. Feasibility details of the proposed development were included, along with a schedule as to EDL's financial position. Unaudited 1988 figures were the latest provided. They suggested that the operating profit before tax for that financial year was $480,000. The tax figure was not available. In fact, in 1988 the company recorded a net loss after tax of $3.83m.
The proposal was recommended by Johns and Mountford "given the short
term nature of the facility requested, the prime site (notwithstanding high
loan/security ratio) [said to be 94%] and the active role of BNZ...".

Directors were requested to provide their decision on 2 November 1988,
which was the day they received the memorandum. Ryan approved the
proposal on the same day by writing "approved" and signing his name on the
memorandum. Smith and Carr approved the next day, 3 November. These
approvals were noted in a later credit submission as having been provided to
Mountford. The board noted the approvals on 22 December 1988. None of
the directors' approvals were shown as being subject to any conditions.

On 2 November 1988, Mountford wrote to Edwards saying that the internal
credit committee of Tricontinental had that day "supported a $65m
Commercial Bill Facility for the consideration and approval by
Tricontinental's board". In fact the credit committee had not considered the
proposal at that time and did not do so until 16-18 November 1988, by which
time a total amount of $53,967,689 (including capitalised interest) had been
drawn down. In the same letter Mountford stated, "The purpose of the facility
is to assist with acquisition of the Bus/Rail Interchange site, Bondi Junction".
No mention was made of the share purchase.

On 3 November 1988, a letter of offer was sent to Tibham. It was prepared
by Mr David Dyring (a Tricontinental securities officer) and signed by him
and Mr Mountford. Under paragraph (B) a single purpose for the facility was
stated, namely:

"To assist your company with the following:-

(1) $59,275,000 for the acquisition of the Bus/Rail Interchange site
situated at Bondi Junction, NSW and associated Pre-development
costs...

(2) $5,725,000 for capitalised interest and financing costs."

No reference was made to the financing of the Ariadne share purchase
although the letter noted that, subject to obtaining BNZ's letter of credit for
$15m and a guarantee from EDL, $20m could be drawn down. The balance
would be made available subject to obtaining the mortgage over the interchange site. The $20m was to be repaid by 18 February 1989. The balance was to be repaid by 30 June 1989 or a penalty fee of $1m was to be paid.

Although the letter of offer was signed by Mr Mountford, in evidence before the Commission he claimed he had nothing to do with drafting the letter so as to reflect only the single purpose stated. Mr Edwards also claimed he was not instrumental in concealing any reference to the Ariadne share purchase.

On or about 2 November 1988, Hadley was told he'd "... be better off not knowing what the share purchases were". He thinks it was Mountford who said this to him. In evidence, Mr Mountford initially said he thought that he may have disclosed to Hadley that the shares were Ariadne shares, and when questioned about Hadley's allegation as to what was said to him, Mr Mountford said he couldn't recall saying that.

On 4 November, Edwards wrote to Hadley informing him, among other things, that "Development Approval is expected by the end of May 1989".

Corrs, solicitors to Tricontinental, wrote to Mr Neil Hunter on 8 November drawing his attention to:

- the detrimental effect on Tricontinental's security which was occasioned by the absence of development approval (in response to this comment Hunter noted on the letter - "very true");
- a prohibition on Tricontinental's exercise of a power of sale except in favour of a purchaser approved by the State Rail Authority; and
- the fact that Tricontinental might be obliged actually to complete development works in order to perfect its security position.

Hunter warned Mountford of these matters before drawdown. Hunter's file note of 14 November stated:

"(1) Valuation by Raine & Horne (not panel valuers) of small properties not for mortgage purposes. Acceptable subject to receiving
assignment thereof for mortgage purposes.

(2) No Development Approval in place.

(3) Under lease agreement a sale cannot be effected without State Rail approving purchaser, thereof [sic] Mortgagees auction would be most difficult.

(4) In regard to smaller properties Tricontinental is limited by priority to $5.4m until second mortgagees are paid out. Advised in order to effect drawdown".

In evidence, Mr Mountford did not dispute that he was so informed by Hunter.

33 Over the names of Johns, Mountford and P Watkin, a formal credit submission was prepared, dated 10 November 1988. This submission disclosed the separate purposes for which the facilities were to be made available. The lending/security ratio was correctly stated to be 101.6%. This was said to be a "notional" ratio only as the second facility of $45m was not expected to be fully drawn before the first facility of $20m expired and was paid out. In fact, $33.07m of the $45m facility was drawn down the next day. The submission failed to mention a related exposure of $10m to Magic Millions.

34 A total of $51.36m was drawn down on 11 November 1988. Of this, $25.64m was paid to the SRA (being the balance of the belated lease payment due on 27 October 1988) and $19.29m was paid to Tibham. This latter amount was placed on deposit with Tricontinental until the end of November 1988. On 30 November 1988, Tibham lent $19.3m to EDL. This sum was onlent to Grylis Pty Limited ('Grylis') (an Essington subsidiary), which on the same day lodged $20m with FAI Insurances Limited ('FAI') for the purchase by Grylis of a 19.68% parcel of Ariadne shares.

35 A further drawdown of $6.7m took place on 8 December 1988. Two further drawdowns under the original facility were made, namely $1.4m on 21 April 1989 and $1.3m on 7 June 1989. The total facility was increased by $1.5m on 7 September 1989. Most of these additional funds were used to pay fees and other expenses owing to Tricontinental, including the $1m penalty fee for failure to repay the $45m by 30 June 1989.
The $20m component of the loan was not repaid on the due date, 18 February 1989. On 20 February 1989, Mountford requested Hunter to arrange a letter of variation extending the date for repayment of $20m to 13 March 1989. A letter of variation was sent to Tibham on 21 February. The repayment date for the $20m was extended four more times before 30 June 1989. Directors' approvals were not sought for any of these extensions. Further monthly extensions of the repayment date were granted from June to September 1989. The BNZ letter of credit was extended to coincide with each extension of the repayment date for the $20m. On 31 March 1990 the facility was placed in default.

The BNZ letter of credit facility was called up and the $15m paid to Tricontinental in June 1990. The anticipated loss in respect of the Tibham facility is $46.5m.

**D. Role of Mr. Johns**

Mr Johns had extensive involvement in negotiating and approving this facility. In particular:

(i) He had the initial discussions with Edwards leading to EDL's request for $41.65m on 28 October 1988.

(ii) He had a further discussion with Edwards before EDL requested an additional $20m on 31 October 1988, which was eventually used to assist with the Ariadne share purchase.

(iii) He had a conversation with Mr Scott-Kemmis to discuss the nature of BNZ's letter of credit facility and a common approach to fee pricing.

(iv) On 2 November 1988 he gave Mountford "the broad bones of the credit proposal", and requested him to prepare urgently a credit submission. He told Mountford he had discussed the proposal with both Scott-Kemmis and Edwards.

(v) On his behalf his secretary, Marisa Furno, signed the credit memorandum.
(vi) He provided Mountford with some of the information in the memorandum. Other information was obtained by Mountford from the EDL letters to Tricontinental of 28, 31 October and 1 November 1988 and the feasibility and cash flow summary attached to the memorandum.

(vii) According to Mr Ryan, Johns spoke to him about a number of Ryan's queries concerning the proposal outlined in the memorandum.

(viii) Johns approved the facility on 2 November 1988 and signed the credit submission dated 10 November 1988.

(ix) Mr Smith believes he also spoke with Johns, although he doesn't have a direct recollection of having done so.

E. Role of Other Managers and Staff

(a) Mr Mountford

Mr Mountford was involved in a number of important aspects of the facility. His evidence disclosed that:

(i) He had previous dealings with the Essington group, particularly concerning the Mainsel facility (TR4, below).

(ii) On 2 November 1988, on instructions from Johns, he prepared the urgent credit submission in the form of the memorandum addressed to Smith, Ryan and Carr. In doing so he relied on the sources referred to in sub-para (vi) of the previous paragraph. He did not know the Bondi Junction site, nor much about the proposed development. He did know it was primarily leasehold, but cannot recall whether he then knew it was a lease of airspace. He knew that development approval for the project had not yet been granted. He conceded that obtaining the development approval was crucial to securing a joint venturer and, without it, the project was doomed.

(iii) Johns told him that he had had discussions with Edwards and Scott-Kemmis. He (Mountford) did not have discussions with the client; he just did the work in relation to the proposal.
He understood the urgency was to do with the share transaction. But he did not specifically know the identity of the shares although, from what Mr Johns had told him, he assumed they were Ariadne shares. He said he did not mention Ariadne in the memorandum of 2 November for confidentiality reasons. This might have been conveyed to him by Johns.

He knew there were gaps in the submission and decided to leave it brief and wait for questions from directors. He did not recall seeking EDL's audited figures for 1988.

He was uncertain about the valuation of the site, hence the insertion of the phrase "subject to valuation" in the memorandum.

He agreed that the loan amount exceeded the security value but, he said, there were no relevant guidelines (as it was neither a true construction facility nor lending against real property).

He agreed that his letter to Edwards of 2 November 1988 contained two false statements. He explained that, leaving aside the silence on the Ariadne facility, the comment as to the credit committee's approval was a "tactic" to keep Mr Edwards enthusiastic.

As to the letter of offer, this was signed by him but he denied instructing Dyring to refer to the sole purpose of the facility as it appears in the letter of offer. It was unusual to draft the letter in this way and he believed this was the result of discussions Dyring had with Johns or Edwards or both.

He met Edwards shortly before 20 February 1989, when the $20m was due to be repaid. He arranged for a repayment extension, initially for one month, then for further monthly extensions. He did not consider directors' approvals were required for these extensions. Because $15m was guaranteed, he felt they were within his discretion. He was also under great pressure at the time due to the problems being faced by Tricontinental.

His role was that of general manager lending and Hadley's was as regional manager in Sydney, responsible to him. After May 1989 (post integration) he had little to do with the file.
(b) Mr Hadley

Mr Hadley was regional manager lending in New South Wales. His role was in the implementation and administration of the facilities. His evidence disclosed that:

(i) He was involved in the arrangements for the $15m letter of credit facility from BNZ and the later extensions of that facility.

(ii) He was the account manager for the facilities, but his role was administrative in nature.

(iii) He had an earlier involvement with the Magic Millions facility, but not with Mainsel. His relationship with Johns was strained at times (as evidenced by Johns' memorandum of 26 September 1988 referring to "prudential limits", see para 9 above).

(iv) He could not specifically recall sending a copy of the EDL letter of 4 November 1988 to Melbourne, but it would be his usual practice to do so. This was the letter which stated that development approval was expected in May 1989.

(v) He did not know whether the directors knew of the four extensions between February and June 1988.

(vi) He would not have approved the credit proposal himself, wanting better evidence of the borrower's ability to repay, as EDL had considerable contingent liabilities and very little, if any, recurring income. He appreciated that the proposal involved a leasehold over airspace and understood also that the development approval had not been obtained, although he believed it had been applied for.

(c) Mr Hunter

Mr Hunter was responsible for implementing security arrangements; in particular he instructed Corrs (in Sydney), to act on behalf of Tricontinental. His evidence disclosed that:

(i) He did not recall the letter of offer or memorandum of 2 November 1988. He assumed his department was instructed to express the purpose of the facility as it was set out in the letter of offer.

(ii) He did not remember Corrs' letter to him of 8 November 1988, but
he prepared his file note of 14 November as a result of his concerns arising from this correspondence.

(iii) The fact that the Raine & Horne valuation of the freehold property had not been prepared for mortgage purposes, that no development approval had been granted, and that State Rail Authority approval was required for sale by a mortgagee, amounted, in his view, to a serious waiver of preconditions to drawdown; but later he accepted no such preconditions were set out in the letter of offer.

(iv) Before drawdown on 11 November 1988, he believed he would have spoken to Mountford of his concerns (as later expressed in his memorandum of 14 November 1988).

(d) Mr Dyring

(i) Mr Dyring was involved in preparing the letter of offer of 3 November 1988, but had no recollection of the basis on which it was prepared or who instructed him to prepare it in the way he did. He said that ordinarily the letter of offer would reflect the terms and conditions set out in the credit memorandum.

(ii) He believed he must have been directed to prepare the letter of offer so as to refer to only one purpose.

F. Role of Directors

The directors who approved the proposal set out in the memorandum of 2 November 1988 were Johns and Ryan (on 2 November) and Smith and Carr (on 3 November). The facility was ratified at a board meeting on 22 December. The evidence of approving directors (other than Johns) is outlined below.

(a) Mr Smith

(i) Mr Smith had no distinct recollection of the proposal and remembers it only "in general terms".

(ii) He said there were no guidelines which applied to this transaction
as it was not finance for construction.

(iii) He was not concerned that he did not know the identity of the shares the purchase of which was being financed, as the question of the acceptability of the shares was within Johns' prerogative.

(b) Mr Ryan

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(i) Mr Ryan approved the credit proposal on 2 November 1988, adding his signature to a copy of the memorandum. He conceded the memorandum did not contain sufficient information to give an approval. He said further information was required.

(ii) He recalled speaking to Johns, probably during the afternoon of 2 November 1988, about the memorandum and said he obtained additional information from him.

(iii) However, when earlier examined under ASC powers, he said that he had no recollection of the facility at all, nor of talking to either Johns or Mountford.

(iv) He said that, during his discussion with Johns, he received certain assurances upon which he based his approval. These were:

• the memorandum recommended no charge over the shares to be acquired, and he required Johns to ensure such a charge would be taken before drawdown;

• he was given to understand by Johns that take-out finance arranged by BNZ would be in place before drawdown;

• Johns gave him a very clear indication that the development approval would be obtained before drawdown;

• he raised the issue as to whether a joint venture partner had been arranged, and his recollection was that Kumagai (a major developer) was mentioned by Johns as a very likely joint venture party; and

• he discussed the proposed $1m penalty for non-payment by June 1989, which Johns said was imposed to ensure the borrower understood its obligations.

He took no note of his conversation with Johns and didn't follow
these matters up at any later date.

(v) He did not know the identity of the shares to be purchased. It was, he said, satisfactory if the shares were acceptable to the managing director, although he said he was cautious of Mr Bruce Judge (Ariadne), and if he had been told on 2 November that it was proposed to use the $20m to purchase Ariadne shares, he most likely would have declined that part of the proposal.

(vi) The guidelines did not apply to this facility; it was special, being in the nature of bridging finance.

(vii) He was unaware that Tibham was acquiring a leasehold interest over airspace. He believed the security was over freehold land and buildings. Had he realised the position was otherwise, he was sure that this factor would have altered his opinion of the proposal, and he probably would have asked a lot more questions and wanted to understand a lot more about it.

(viii) He did not follow up the proposal at a later date and was unaware of actual drawdowns under the facility.

(ix) He was present at the 22 December 1988 board meeting when the facilities were noted.

(x) He was unaware of extensions being granted by Mountford in 1989.

(c) Mr Carr

(i) Mr Carr had no independent recollection of the memorandum of 2 November 1988. He thought the security was a mortgage over the freehold site and not over airspace. He conceded that obtaining the development approval was critical to the success of the whole project.

(ii) He approved the proposal on 3 November.

(iii) He did not know that the proposed share purchase was of Ariadne shares. He was willing to rely on Johns in such matters.

(iv) He was present at the 22 December 1988 board meeting when the facility was noted.

(v) He said that proposals for extension of the facility should have been
returned to directors for their consideration and approval.

G. Significant Issues Arising

The Commission's examination of this transaction has involved consideration of a number of significant matters. These include:

- procedures for the approval of such facilities, particularly in the absence of guidelines and with no real circumstances of urgency;
- the adequacy of the information provided to the directors;
- Mr Ryan's claim to have given conditional approval;
- the adequacy of security and provisions for repayment;
- the Ariadne share purchase;
- the conduct of management in response to warnings received, after approval and before drawdown, as to Tricontinental's position;
- the extensions granted for repayment of the $20m without reference to the board; and
- the submission that approving directors and Mr Mountford have breached the Companies (Victoria) Code ('the Code').

(a) Procedures for the approval of the facilities - absence of guidelines and circumstances of urgency

It was freely acknowledged by directors and management that there were no existing guidelines governing this application for finance. Counsel assisting submit there was a failure by the Tricontinental board in not having clearly defined, pre-existing policies and guidelines which would have provided a proper framework within which directors could make a decision on each of these facilities, especially in circumstances where a decision was required as a matter of urgency.

The usual procedures for obtaining credit approval were not followed. A credit submission in usual form was not prepared until after the letter of offer had been sent and accepted. The credit memorandum of 2 November 1988 was limited in information and the credit committee did not consider the
proposal until after a decision to lend had already been taken and an amount of $53,967,689 had been drawn down. In this case its role was no more than that of a rubber stamp. These omissions were said to be justified on the ground of urgency.

There can be no doubt that Smith, Ryan, Carr and Mountford believed that the matter was extremely urgent. Indeed Mountford described the haste in which the memorandum of 2 November was prepared as "extraordinary". However, the reason for urgency was not the one which Mountford believed, namely an urgent need to fund the share purchase, but rather because the due date for payment of the lease premium to the State Rail Authority had already passed. This was confirmed by Mr Edwards and the fact that, following drawdown on 11 November 1988, the moneys ultimately used by Tibham to fund the Ariadne share purchase were placed back on deposit with Tricontinental until 30 November 1988.

Counsel assisting submit that the mere fact that a matter is stated to be urgent cannot, of itself, justify departure from normal procedures for credit assessment. It is argued that a distinction could perhaps be drawn where there is an existing exposure to a borrower and urgent consideration must be given to whether additional funds should be provided in order to prevent the borrower's collapse. In such a case Tricontinental's interest would be paramount and served by an urgent response. But, it is submitted, in this case urgency arose due to the need for lease premium moneys by a client to whom Tricontinental had no obligations, either in relation to the interchange project or the share purchase. It was the borrower's urgency to which Tricontinental was responding, not its own. Counsel assisting also raise the possibility that the urgency may have arisen because the borrower had been refused funds by some other financier. Otherwise it seems strange that funding should have been left to the last minute. If it had been refused, this may have been for good reason. Tricontinental should have considered this possibility and its significance for the viability of any proposed Tricontinental loan. It is to be noted there is evidence that BNZ withdrew from the project partly because of
its concerns as to Essington’s cash flow and ability to support the project in a difficult market, given its other projects already in train.

As to the absence of guidelines, counsel for the directors (other than Johns) and Tricontinental staff, submit that whilst guidelines were relevant for loans initiated by management, as a guide to what the board would find acceptable, this was an example of a loan initiated solely by Mr Johns, himself a director, and thus it is said the board was not bound by guidelines and could consider the proposal on its merits. In this context they submit that a special relationship existed between Johns and Edwards, that Johns had a close ‘hands on’ relationship with all the Essington facilities and had decided to grant this facility because he wanted to promote the Essington group as a client of Tricontinental.

As to the question of urgency, counsel for the directors submit that Mountford and approving directors believed the urgency was due to the need to fund the share purchase. Further, they argue that there is no evidence to support counsel assisting’s suggestion that EDL was refused finance by some other financier.

(b) Adequacy of information provided to directors

Counsel assisting submit that the information provided in the credit memorandum of 2 November 1988 was grossly inadequate. In particular, the memorandum made no reference to the lack of development approval, without which it would be almost impossible to attract a joint venture partner or other investors (which Tricontinental was relying upon for repayment); nor did it identify Ariadne shares as those to be purchased. As well, the information relating to the proposed joint venture partner and to take-out construction finance was inadequate and vague (if not positively misleading - see the evidence of Mr Edwards and Mr Scott-Kemmis referred to in para. 60 below); the memorandum failed to highlight deficiencies in the proposed security; and its support for the proposal suffered from an insufficient investigation of the borrower’s capacity to repay the loans. Counsel assisting submit that it came
as no surprise that Mr Mountford should concede that a lot of information relevant to directors’ approval was missing from the material provided to them.

Counsel assisting go on to submit that directors would have been failing in their responsibilities to exercise a reasonable degree of care and diligence, within the meaning of s229(2) of the Code, if they made a decision to approve the proposal based solely on the information in the memorandum of 2 November 1988. The issue of what other information may have been known to the directors therefore becomes relevant.

Mr Smith had no distinct recollection of the facility, although he had some memory of it in "general terms". He believed he spoke to Johns or Mountford, but had no recollection of actually doing so, basing his belief on what he said was his custom in relation to large facilities. Mr Smith said that the two things which he would have wanted to have found out about were:

- the reason for urgency; and
- the particular role which Tricontinental was expected to play in respect of the $20m for the share facility - that is, "whether we were was taking security on the shares or was it merely a friendly holding place for them".

Nevertheless he did not stipulate any conditions to his approval.

Mr Carr had no independent recollection of the memorandum of 2 November 1988 or of approving the facility, nor did he recall having any discussions with Johns or Mountford, although there must have been some communication with one or other of them when notifying his approval. Mr Carr did not claim to have had any additional information, beyond that contained in the memorandum, which would have helped to justify his decision to approve the facility.

Counsel assisting submit it could not be concluded that Mr Smith or Mr Carr had any additional information about the proposal, beyond that contained in
the memorandum, such as would or might justify their decisions to approve the two facilities. Accordingly, counsel assisting submit that Mr Smith and Mr Carr breached s229(2) of the Code in approving the proposal.

Counsel for the directors submit that, whilst Smith and Carr could not recall the circumstances surrounding their approval of the facility, it is probable they would have discussed their approval with Ryan and Johns. General evidence to the effect that it was common for directors to discuss approvals between themselves, and to discuss with him the terms of loan proposals initiated by Johns, is referred to in this context.

As to Mr Johns, counsel assisting submit he was closely involved in the negotiations with Edwards and Scott-Kemmis and it must be inferred that he had a clear understanding of all relevant matters. Counsel assisting note that the statement in the credit memorandum, to the effect that Edwards had advised that BNZ, in conjunction with EIE, was arranging the introduction of a Japanese joint venture partner to proceed with the site development, was not accurate - according to Mr Edwards and Mr Scott-Kemmis - certainly in so far as it referred to BNZ. Nor was it correct that BNZ had been awarded a mandate to arrange project finance. Both Mr Scott-Kemmis and Mr Edwards said they were not aware of any firm undertaking being given about take-out finance. Counsel assisting argue it is probable that Mr Johns knew the reason for urgency was the overdue lease payment to the State Rail Authority and, so far as the shares were concerned, that Mr Johns did know the shares to be purchased were Ariadne.

In these circumstances, counsel assisting submit Mr Johns must have appreciated the deficiencies inherent in the credit submission of 2 November 1988 and that, by approving the proposal, he breached s229(2) of the Code.

(c) Ryan's claim to have given conditional approval

Mr Ryan said in evidence that he could not justify approving the facilities proposed on the basis of the memorandum and the material provided. He said
he received additional information and assurances from Johns (outlined at para 45(iv) above) upon which he conditioned his approval. Counsel assisting submit that the Commission should not be satisfied that Mr Ryan received the additional information and assurances from Johns (even though he may have had a general discussion with him), and they submit that Mr Ryan did not give a conditional approval.

Counsel assisting rely, in particular, on the alleged conflict between the evidence which Mr Ryan gave at his ASC examination and his evidence before the Commission. At his ASC examination, Mr Ryan said he had no recollection of the facility or of talking to either Mr Mountford or Mr Johns, although he felt that he would have spoken to Mountford and have got some further information from him. In their submission, counsel assisting also rely on a number of other matters. Some of these include:

(i) Mr Ryan’s failure to specify his conditions in writing, particularly as his stated reason for not doing so (Johns’ request in 1986 not to undermine his authority with junior staff), was no longer valid;

(ii) the fact that, in his own statement to the Royal Commission, Mr Ryan did not suggest he had received these assurances and specifically asserted that he based his approval on the memorandum provided by Mountford;

(iii) Mr Ryan’s failure to check or question Johns following approval, particularly as only five months earlier he had developed grave concerns after learning that Johns had failed to implement a precondition to approval regarding Mr Minuzzo’s removal from the Mainsel project. Mr Ryan said that, following this revelation, he had vigorously quizzed and cross-examined Johns at the board meetings;

(iv) the absence of any documentation which supports Mr Ryan’s contention, and the fact that Johns did not inform others at Tricontinental of these alleged conditions;

(v) the fact that it was highly unlikely Mr Johns would have agreed to obtaining development approval before drawdown, given the
urgency of the situation and the fact that, on any view, development approval was unlikely to be obtained for some months at the earliest; and

(vi) the improbability that Mr Ryan would recall these matters so clearly when generally his recollection has not been very strong.

Accordingly, counsel assisting submit that Mr Ryan breached s229(2) of the Code in approving this proposal.

Counsel for the directors submit that Mr Ryan's evidence should be accepted. The ASC procedure was criticised as not enabling Mr Ryan to do himself justice and, it is argued, the lapse of further time enabled Mr Ryan to recall more details. Counsel submit that the assurances provided by Mr Johns to Mr Ryan were not so much preconditions to Mr Ryan's approval, but rather matters which provided a level of comfort to Mr Ryan in giving his approval. It is argued that Mr Ryan's original reason for not noting conditions to his approval above his signature would continue to apply. Further, they contend that his recollection has not been faulty. They submit that, as Mr Johns has refused to give evidence on the matter, it is not open to the Commission to decide one way or the other whether it was unlikely that Mr Johns would have agreed to obtaining development approval before drawdown. It is further argued that the absence of internal documentation, or Johns' failure to inform management of Ryan's stipulations, do not enable one to conclude that Mr Ryan did not speak to Johns and receive assurances from him. It is suggested that Mr Johns' motive in misleading the board (by the false attribution of directors' unqualified approvals) lies in the fact that he wanted to get the deal completed.

(d) Security and repayment

Total security was said to have amounted to $64m, made up of the $15m BNZ letter of credit facility and an anticipated $49m valuation of the interchange site. The only precondition proposed in the credit memorandum was that there be a valuation for $49m for mortgage purposes from Richard Ellis, to
be assigned to Tricontinental. The proposal amounted to more than 100% funding and thus counsel assisting submit security was inadequate. They further submit there were two major risks. First, development approval would not be available before drawdown, and second (consequent upon the first), no firm arrangement would be in place for construction finance. This was critical as Tricontinental was relying on takeout or refinancing for repayment of the $45m and possibly the $5m not secured by the BNZ letter of credit. The solution, it was suggested by counsel assisting, was for directors to condition their approval on the borrower first obtaining development approval and a firm commitment for take-out finance. In these circumstances, it would be up to the borrower to make its own arrangements to defer the lease premium payment.

Counsel for the directors submit that security and repayment provisions, as understood by the directors at the time they gave their approval, were appropriate. This is so because directors were led to believe that security consisted of a mortgage over freehold property rather than over leasehold airspace. It is further argued that, although the loan/security ratio was in excess of 100%, the directors were informed that this would have been reduced somewhat with the repayment of the $20m facility in three months time. Thus counsel submit that the security that was ultimately obtained was not the security which was represented to the directors at the time they gave their approvals.

(e) Ariadne share purchase

Taken on its own, the financing of the share purchase was clearly undersecured by at least $5m. Given that there was no indication in the memorandum of any source for repayment of the $20m facility, counsel assisting submit that directors properly carrying out their duties should not have approved it.

There is the further question concerning the lack of knowledge on the part of directors (other than Johns) of the identity of the shares concerned. Smith,
Ryan and Carr each said they were not troubled by their ignorance in this matter. Each was willing to rely on the managing director.

Mr Edwards claimed there was no secret about the Ariadne share parcel and that the market already knew about Essington's proposals generally in respect of Ariadne. He thought Johns certainly knew that the parcel concerned was of Ariadne shares. However counsel assisting submit there was an obvious desire on the part of Johns and Mountford to keep the identity of the share parcel secret, as evidenced by Mountford's probable comment to Hadley that he was better off not knowing what the share purchase was and the letters from Tricontinental to EDL of 2 and 3 November 1988.

Counsel assisting submit that directors abdicated their responsibility in this regard, particularly where no security was to be taken over the shares themselves. Even if security were to be taken over the shares, as Mr Ryan said he requested, counsel assisting submit directors would be unable to assess the credit risk without knowing the identity of the shares. They draw attention to Mr Ryan's evidence that he probably would not have approved the $20m facility if he had known it was to be used to purchase Ariadne shares.

Counsel for the directors, however, argue that directors are entitled to rely upon management to make enquiries and to ascertain the appropriateness of shares to be purchased.

(f) Conduct of management following approval and before drawdown

Management was well aware before drawdown of a number of deficiencies in the security held by Tricontinental on the $45m facility. Hunter gave evidence that he had drawn them to Mountford's attention. Mr Mountford does not have a specific recollection of raising any of these matters with Johns, although he said that it would have been his normal practice to do so. He does not disagree with Mr Hunter's evidence that these matters were raised with him before drawdown on 11 November 1988.
Counsel assisting submit that Mr Hunter acted properly and responsibly in drawing Mr Mountford’s attention to each of these matters. It is submitted that, as general manager lending, Mr Mountford should not have permitted a drawdown to take place until each of these matters had been resolved or, alternatively, until they were referred back to the directors for their further consideration.

Counsel for the directors submit that, in addition to misleading terminology being used in the documentation, a number of significant events occurring before drawdown were not brought to the attention of directors. In particular, the concerns of Hunter, expressed in his file note, were not brought to the attention of directors (other than Johns).

(g) Extensions permitted without reference to the board

Counsel assisting submit the repayment date for the $20m, initially 18 February 1989, should not have been extended by management, but referred to directors (as was maintained by Mr Ryan and Mr Carr). Mr Mountford acknowledged responsibility in connection with these decisions. Counsel assisting accept that there is no basis for suggesting that Tricontinental suffered any greater loss by reason of these extensions than might otherwise have been the case. In fact further extensions were granted after SBV took control of Tricontinental, and payment of $15m was received from BNZ in June 1990.

Counsel for Mr Mountford submit that he was correct in maintaining there was no requirement for these proposed extensions to go to the board and that this matter was within his discretion. Counsel note that, over the period of time extensions were granted, Tricontinental received optimistic assurances from the Essington group that development approval was progressing well, as was the process of securing a joint venture partner.

(h) Alleged breaches of the Companies Code

Counsel assisting submit that approving directors breached s229(2) of the
Code. Their arguments in support have been canvassed above. Counsel for the directors submit that in all the circumstances this contention cannot be sustained.

Counsel assisting submit that Mr Mountford, as an officer of Tricontinental, breached s229(2) of the Code by the way in which he compiled and presented the credit memorandum of 2 November 1988. Counsel for Mr Mountford submit that he was acting under the express instructions of Mr Johns who directed him to prepare the credit submission and obtain directors' approval on the same day. They submit that it was not for Mountford to question an apparently lawful direction from Johns, for Mountford may not have known all the facts and circumstances surrounding the transaction, nor what Mr Johns may have already told directors about the proposed facility. Counsel also point to other circumstances, including the apparent urgency which prevailed, and Johns' desire to develop the Essington group as a valuable client which could introduce new business to Tricontinental.

Counsel assisting also submit that the letters from Mountford to Edwards of 2 November and 3 November 1988 contained false statements, principally as to the purpose for which the facility was to be used, but also as to the approval obtained from the internal credit committee. Mr Mountford signed both these letters. Counsel assisting submit that, as an officer of Tricontinental, he failed to act honestly in the exercise of his powers and the discharge of his duties contrary to s229(1)(a) of the Code. Counsel assisting submit also that Mr Mountford may possibly have acted contrary to s229(1)(b)), depending upon the result of any further inquiries concerning a previous NCSC investigation into the purchase of two parcels of Ariadne shares. In December 1988, the NCSC made declarations of unacceptable conduct by, among others, Edwards, Axis and certain Essington entities. It is not clear whether the contents of Mountford's letters to Edwards of 2 and 3 November 1988 were made known to the NCSC. They may be relevant to the previous NCSC enquiry. Thus counsel assisting submit it would be appropriate that this matter be referred to the ASC for its further enquiry.
Counsel for Mr Mountford oppose this contention and submit that the recipient of the letter, Mr Edwards, presumably knew the purpose for which funds were being sought from Tricontinental. Further, counsel submit that a breach of s229(1)(a) involves the concept of an officer acting dishonestly contrary to the interests of the relevant company. Counsel submit that it is quite clear that Mountford was acting in the interests of Tricontinental as a whole, subject to the direction of Johns. He was not acting for any collateral purpose. Thus, it is argued, he is not in breach of s229(1)(a). As to the suggestion that Mountford may be in breach of s229(1)(b), they submit that there is no evidence on which the Commission could be satisfied that Mountford acted for any fraudulent purpose. Further, they say that no useful purpose can be now served by referring this matter to the ASC.

H. Conclusions and Findings

This transaction provides another good example of many of the things which were wrong with the management and direction of Tricontinental.

Dealing first with the facility for the purchase of $20m worth of Ariadne shares, Mountford did not disclose to directors, in his credit memorandum, the identity of the shares to be purchased. In preparing the memorandum he was acting on the instructions of Johns. Either Johns or Mountford, probably the latter, told Hadley that it would be better if he was not aware of the shares being purchased.

However, the directors other than Johns showed no interest in the identity of this very large parcel of shares. They were content to leave such matters to the managing director, even when $20m was involved. On the other hand, Mr Ryan said in evidence that if he had known the shares concerned were in Ariadne, he might well have declined the facility. In the Commission’s view, it was an abrogation of responsibility by the directors to take no interest in the identity of the shares to be purchased, particularly since there would be security for only $15m. The Commission, having considered the respective
arguments of counsel, cannot feel confident that Mr Ryan made it a condition of his approval that a charge was to be taken over the shares in question.

The other transaction with which the Commission is concerned was a very large commitment to provide bridging finance for a major and complex development. At the time the commitment was entered into, the nature of the development was imperfectly understood by Mr Mountford, and may well have not been fully understood by Mr Johns. One thing which Johns would have been aware of, from his previous dealings with Essington, was that the group had a number of projects in hand and no source of regular income. For repayment of its bridging finance, Tricontinental was dependent on Essington finding a joint venture partner and this was, in turn, dependent on development approval by the local council. This had not even been sought at the time the transaction was entered into, and it could not be expected in a short space of time because the project was so complex.

The two facilities were entered into in great haste, which was apparently accepted by the directors although it was never explained to them. They seem to have been under the impression that the urgency related to the unspecified share transaction whereas, as events were to show, it arose because payment was overdue for the ninety-nine year lease of airspace from the State Rail Authority.

It is clear that the directors were not aware that a lease of airspace was involved. In fact there was nothing in the credit memorandum to tell them that the first registered mortgage offered by way of security related to anything other than freehold land. If they had had time to study the lengthy accompanying document carefully, they would have found a reference to a ninety-nine year lease, but no suggestion of airspace.

Another important consideration omitted from the memorandum put to directors was the SRA's right to approve any purchaser of the lease. This could seriously have inhibited Tricontinental's ability to dispose of the
leasehold by way of a mortgagee’s auction.

The Commission is satisfied, from the direct evidence about this transaction and from the picture which has emerged from all the evidence about the relationship between them, that Mountford consulted Johns at all important times before taking action concerning this transaction. The original arrangements were made between Johns and Edwards, Johns was very interested in the outcome of any dealings with Essington and, although he was very busy with negotiations for the merger with Australian Bank, the Commission believes nothing of importance would have happened in this matter without his knowledge and approval. This would apply particularly to the drawdown following the letter from Corrs drawing attention to the risks involved in the transaction, and the resulting note for file prepared by Hunter. Although Mountford does not have specific recollection of raising any of these matters with Johns, he said it would have been his normal practice to do so.

The Commission is of the opinion that the three directors who approved this transaction were too easily satisfied. It accepts that Mr Ryan probably had some discussions with either Johns or Mountford about the transaction, but it is not persuaded that these discussions resulted in a clear statement of conditions as described by Mr Ryan in his evidence.

So far as the granting of extensions by Mountford are concerned, the Commission believes that he clearly exceeded his authority by doing so. However, in view of the fact that he was working under extreme pressure at the time, and that SBV continued to grant extensions after integration, the Commission does not take as serious a view of his conduct as it otherwise might.

Although it believes that neither Mr Mountford nor the three directors concerned come well out of this transaction, the Commission does not believe that the case is an appropriate one for action under the Companies Code, even if it were generally disposed to make such recommendations. The reason for
this is that there can be no certainty as to just what the directors were told by Mountford or Johns at the time that they gave their approvals, and that Mountford was working under Johns’ direction.

Once again the major fault lies with a system and a policy which permitted complex transactions to be entered into upon such meagre and, to some extent, misleading material.
## TRANSACTION REPORT 4

**MAINSEL INVESTMENTS PTY LTD**

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A. **Background and Summary**

(a) **Essington Group**

An outline of the Essington group is provided at paragraphs 1 to 4 of the section dealing with the Tibham transaction (TR 3).

(b) **Mainsel**

Mainsel Investments Pty Ltd ('Mainsel') was incorporated in Queensland on 18 July 1985. Its first owners were Israel and Mary Herzog, John and Dawn Minuzzo. Mainsel was a single purpose entity which successfully tendered for a site in central Brisbane on which was to be constructed "Central Place", a multi-storey retail, office, hotel and car park complex.

Approximately 25% of the site was occupied by the Capital Hotel on Anne Street, Brisbane. The balance was land owned by the Commissioner of Railways, ('CR') with whom there was a development agreement. Part of this agreement stipulated that freehold title was only to pass to the developer upon the satisfactory construction of the building and of certain railway facilities, and after the CR had leased a substantial portion of the building.

On 19 February 1987, Mr Michael Lasky (Mr Herzog's partner) wrote to Ian Johns outlining the proposed development and seeking $25m from Tricontinental to acquire the Capital Hotel site and meet certain financial obligations to the CR in order to convert the combined site into a state where the project could be commenced. Mr Lasky's description of the project indicated that the building would reach a height of 345 metres above the Turbot Street level, making it the sixth tallest building in the world and the tallest in Australia. The total cost of development was to exceed $600m. It was said the project was being supported by the Queensland Government and the Brisbane City Council.

By April 1987, according to the relevant credit submission, the equity interests of the participants in the project had changed. The Herzog and
Lasky interests ('LOF') held 52% of Mainsel, Minuzzo interests ('Minfam') held 24% and Mr Anthony Nevins held 24%.

(c) Summary

In April 1987, Johns, Carr, Smith and Ryan approved a facility to Mainsel of $31m. This was increased to $42m in August 1988 and to $59.915m in March 1989. Following integration with SBV, a conditional development approval for a 78 storey building was granted in July 1989 and the facility was further increased in August 1989 to $65m (principally to allow for capitalisation of interest). In March 1990 the facility went into default and notices of demand were served in October of that year. Security proved to be valueless and the anticipated loss is $61.7m. $60m has already been written off.

B. Chronology

The chronology of relevant events is as follows:

1987

19 February Lasky requested $25m finance from Tricontinental for development of site.

15 April Credit submission prepared for $31m facility.

22-24 April Credit committee recommendation.

23-28 April Directors' approvals (Johns, Carr, Smith and Ryan).

1 May Richard Ellis provided a total site valuation of $45m, subject to the assumption that the site had been converted to full freehold title.

13 May Mountford informed Herzog that Tricontinental's offer of finance must await confirmation from Mr Russell Hinze (Queensland Minister) that the site had been totally rezoned.

19 May Letter from Mr Hinze confirming that he would be shortly initiating procedures to rezone the total site as a Special Uses Zone.
27 May Facility ratified by Tricontinental board.
29 May Letter of offer provided to Mainsel and accepted.

1987

Drawdown of $9.3m to settle Capital Hotel site and terminate existing leases.

31 July Mountford told Lasky that Tricontinental would not permit further drawdowns until the development agreement was executed and assigned to Tricontinental.

3 August Mountford informed Mainsel there was no objection to the commencement of demolition works on the former Capital Hotel site.

6 August Development agreement executed.

11 August Drawdown of $3.4m plus capitalised interest. Hunter told Mainsel that various preconditions were outstanding and that no further drawdowns would be permitted until they were met.

9 October - Drawdowns totalling over $3.7m plus capitalised interest.
2 December

10 December Mountford discussed the position with Lasky and Herzog, in particular his concerns that freehold title to the total site could pass to the developer only when the development was well on the way and CR had taken up 10 floors of the project.

14 - 21 December Drawdowns of over $1.3m plus interest.

1988

29 January -

29 April Drawdowns of over $8.8m plus interest.

9 May Essington Developments Limited ('EDL') offered to buy out all Mainsel shareholders other than Minuzzo.

1 June Mountford told Malcolm Edwards (managing director of Essington Limited) that Tricontinental was prepared
to provide finance of $42m to enable EDL to acquire 100% of Mainsel.

3 June -
1 December
6 June
7 June
8 June
9 June
10 June
4 July
20 July
2 August
3 August
19 December
22 December
23 December
1989
9 January
10 March
Drawdowns of over $8.8m.
EDL explained to Tricontinental possible problems with the removal of Minuzzo from the project.
Submission to increase facility to $42m recommended by credit committee (except Wigginton who recommended on 7 June).
Credit submission prepared to increase facility to $42m and extend to December 1988.
Ryan declined the submission (due to Minuzzo’s involvement), Carr approved. Mountford requested Ryan to reconsider.
Ryan approved the submission.
Moyle queried compliance with s129 of the Companies Code ('the Code') but approved, subject to legal confirmation that s129 would not be breached.
Letter of offer sent.
EDL informed Tricontinental that new shareholding in Mainsel - would be EDL 60%; Minfam (Minuzzo) 40%.
Queensland government agreed to Ministerial rezoning of railways land to central business zoning.
Letter of offer accepted.
Credit submission for extension to March 1989 - no indication of recommendation/approval
Letter of offer to extend facility to 31 March 1989.
Letter of offer accepted.
Drawdown of $100,994.
Drawdown of $135,506.
17 March  Urgent credit submission circulated to directors for increase in facility to $59.9m and extension to 30 September 1989; to be considered in conjunction with the submission regarding Intellect Electronics.

20 March  Submission approved by Moyle, Ryan and Smith.

21 March  Submission approved by Morton.

22 March  Submission approved by Carr.

31 March  Drawdown of $8.76m with provision for capitalisation of interest of $2.7m and further payment to the vendor shareholders of Mainsel.

19 May - 28 June  Drawdowns totalling over $0.5m.

28 July  Conditional development approval granted for a 78 storey building. Drawdown of $400,000 plus interest.

11 August  Drawdown of $350,000 plus interest.

25 August  Credit submission for cross-collateralisation of all Essington securities and an increase in the Mainsel facility to $65m.

5 September  Credit submission approved by credit committee.

7 September  Board approved credit committee approval. Letter of offer sent.

15 September  Letter of offer accepted.

1990

11 January  Drawdown of $1m.

19 January  Drawdown of $1.5m.

31 March  Facility went into default.

October  Notices of demand served.

C. Narrative

(a) The transaction

The first facility for $31m was approved in late April 1987. The credit submission dated 16 April 1987 informed directors that:
(i) the finance was to purchase and prepare the commercial site for future development;

(ii) repayment, which was to be on 31 May 1988, would be met either from the sale of the site to a developer/investor, from construction funding arranged in conjunction with a joint venturer, or from sale of the property and proposed development;

(iii) security was to be a first registered mortgage over 192 Anne Street, Brisbane (Capital Hotel site), assignment of the development agreement with the CR, debenture charges over Mainsel and two shareholder companies and joint and several guarantees of Herzog, Minuzzo, Nevins and Lasky;

(iv) conditions precedent included:
   - re-zoning of the Capital Hotel site before any drawdown for purposes other than the purchase of the hotel;
   - Tricontinental's solicitors to approve all necessary documentation, including the development agreement with CR;
   - valuation for mortgage purposes of the Capital Hotel site to be not less than $8.5m, and of the consolidated development site to be not less than $42m;

(v) Mainsel was to ensure the provision of a $5m performance bond to the CR to ensure construction of the railway facilities;

(vi) payments were to be made to the CR aggregating $10.06m, the last being payable "upon transfer of Strata Land which is subject to the issue of Certificate of Practical Completion of the Railway Facilities and the handing over of the Building Head Lease, unless the Commissioner exercises his discretion to waive these requirements";

(vii) the railway facilities were described; they included design and reconstruction of an overbridge and certain other demolition and construction work;

(viii) the building head lease was a lease to be granted to the CR, of 14,000 square metres of office space and other facilities, in the
project to be built on the site;

(ix) it was proposed to rezone the site to Special Uses to allow for the proposed development; and

(x) interest had been shown by a number of prospective tenants.

As Mainsel was a newly formed company, no financials were provided.

The facility was recommended by the credit committee on 22-24 April 1987. It was approved by Johns on 23 April, by Carr on 27 April and by Smith on 28 April. Ryan also approved the facility, but the approval date is not recorded. It is not clear that the facility was noted by the board at its meeting on 27 May, but it was recorded as the 22nd of the 30 largest group exposures as at 28 July 1987.

On 11 May 1987, Richard Ellis, valuers, provided Tricontinental with valuation, as at April 1987, of $45m for the consolidated site. The figure of $45m was predicated on the following assumptions:

(i) the site had been converted to full freehold title;

(ii) the site had full development and building approval and appropriate zoning to carry out the development of "a 104 storey building of outstanding design and technological advancement";

(iii) Queensland Railways was irrevocably committed to lease 16,591 square metres of office space at $245 per square metre per annum gross;

(iv) the State Government was irrevocably committed to lease 22,428 square metres of office for $200 per square metre per annum net;

(v) approximately 9,150 square metres of space were irrevocably committed to the private sector;

(vi) the Mariott International Hotel chain of five star status was irrevocably committed to a management/lease agreement on a long term basis;

(vii) the development would proceed to completion as proposed and
basically within the cost framework and feasibility as outlined by a Rider Hunt feasibility assessment of 16 April 1987;

(viii) Mainsel would remain the sole developer of the project or would retain at least 50% interest and become the project manager until completion; and

(ix) an interest rate of 12% had been included in the economic analysis of the project.

The value of the Capital Hotel site as an integral component of the total amalgamation was considered to be $11.9m.

After some discussions between the parties, a revised letter of offer was sent to Mainsel on 29 May 1987. It expressly provided that, after an initial drawdown of $8.52m (to purchase the Capital Hotel site) and a further amount of $0.6m for termination of certain hotel leases, no further drawdowns would be allowed until certain preconditions were met, including:

(i) Tricontinental was to receive copies of all formal and final council development approvals and permits in respect of the Special Uses re-zoning of the complete site;

(ii) Tricontinental's legal advisers were to sight and find acceptable all necessary documentation, including the development agreement between Mainsel and the CR that would allow the development to proceed; and

(iii) Tricontinental was to obtain, and find acceptable, valuations for mortgage purposes from a valuer of its own choice, as follows:

- of the Capital Hotel site - not less than $8.5m, and
- of the total consolidated development site - not less than $42m.

The first drawdown of $9.12m took place on 29 May 1987. The monies were applied for the limited purposes permitted until satisfaction of the conditions precedent.
On 30 July 1987, Lasky wrote to Mountford requesting Tricontinental’s consent to demolition works. Mountford replied on 31 July stating that, while Tricontinental would consider allowing partial demolition work to be undertaken at Mainsel’s expense, it was not prepared to permit further drawdowns until the development agreement had been executed and assigned to Tricontinental.

The development agreement was signed on 6 August 1987. In substance, the agreement contained provisions which reflected the summary of the principal terms of the draft agreement referred to in the credit submission of 16 April 1987. It is to be noted that, between the date of the agreement and the time when freehold title could be transferred to Mainsel (following completion of construction and the Commissioner taking possession of office space), Mainsel had and would have no proprietary interest in that part of the site owned by the CR. This situation affected Tricontinental’s security position most adversely, as its effective security was only over the Anne Street property. This property had been valued by Richard Ellis in April 1987 at $11.9m.

On 10 August 1987 Mainsel requested further drawdowns amounting to $3.4m. Tricontinental permitted the drawdown of that amount on 11 August 1987. On the same day Hunter had written to Mainsel noting that three preconditions had not been satisfied, namely, a copy of the demolition contract had not been received, nor the drawdown schedule, nor had Council development approvals and permits been received. Hunter said in the letter that no further drawdowns would be permitted until all preconditions had been met. Nevertheless, twelve drawdowns took place between that date and 29 April 1988, and two more drawdowns in June 1988 (after the facility had expired and been converted to a cash advance facility), despite the preconditions still having not been met.

In a Tricontinental file note dated 10 December 1987, and headed "Not for
Circulation", Mountford noted that:

(i) no joint venture or take-out arrangements were in place;
(ii) government approval for development had stalled and was unlikely to be given;
(iii) an extension of the facility would only be considered on the basis of an unconditional sale/project finance take-out;
(iv) Tricontinental understood that freeholding of the total site would only occur when development had commenced and the CR had taken up 10 floors of office space.

At the time Mainsel had drawn down approximately $17m under the facility (not including capitalised interest). Copies of that note were recorded as being given to Johns and Hunter.

(b) Increase to $42m and extension

On 25 May 1988, Mountford sent a memorandum to Alistair Clark (copied to Johns) asking Clark to prepare an urgent credit submission to increase the existing facility to $42m. The resultant credit submission dated 7 June 1988 recommended the increase and an extension of the facility to 31 December 1988. The increase in funds was to enable EDL to acquire a 50% shareholding in Mainsel by buying out the interests of Herzog, Lasky and Nevins, and to proceed with the remaining site preparation.

Repayment of the principal would be from the sale of the site and/or funding from a new equity partner and/or refinance. The credit submission noted:

(i) $28,798,310 had been drawn under the original facility;
(ii) Richard Ellis had valued the site at $45m subject to a number of critical assumptions, and the submission described the progress made in realising those assumptions; in particular it was noted that freehold title to the railway land would not be obtained until the CR took up occupation of office space and that re-zoning had not yet taken place, although it was anticipated by mid-July;
(iii) progress in obtaining a joint venture partner or effecting a sale had
been hampered by adverse publicity;

(iv) responsibility for relevant approvals had been given back to the Brisbane City Council by the Queensland Government following the change in State Premier;

(v) introduction of a new shareholder was essential and the Essington Group was willing to take this role;

(vi) of the additional funds, $3.282m would be for capitalised interest until the facility expired and $5m would be applied as a first payment in reducing the loan account of the vendor shareholders;

(vii) Minfam’s equity would be substantially reduced upon the introduction of a further equity partner, ie, in addition to EDL; although in the short term Minuzzo’s involvement was seen as essential;

(viii) several options were being considered for development of the site, including an 86 storey complex, 2 adjacent buildings or a 108 storey complex;

(ix) the precondition in the first letter of offer that all development approvals, permits and re-zoning be granted or have taken place had not been satisfied. (Nothing was said as to whether it should be fulfilled before further drawdowns would take place);

(x) the precondition of the existing facility that there be a valuation for the consolidated development site of not less than $42m. The April 1987 Richard Ellis valuation was noted, implying it satisfied the precondition. (Notwithstanding the disclosure in the credit submission of the assumptions on which the Richard Ellis valuation had been made, no recommendation was made that there should be no further drawdown until the assumptions had been satisfied); and

(xi) the proposal was recommended on the basis that the introduction of EDL would serve Tricontinental’s best interests and that the total transaction was highly profitable to Tricontinental.

The credit committee approved the submission between 6 and 8 June 1988.
Carr approved the submission on 8 June. Ryan initially declined to approve the submission because he would not approve a deal with Mr Minuzzo as a participant. On 8 June a memorandum was sent by Mountford to Ryan (copied to Johns) asking Ryan to reconsider his position. Ryan complied and gave his approval on 9 June. Moyle gave his approval subject to Tricontinental's solicitors being fully satisfied that s129 of the Code would not be breached, and subject to the proposed shareholding change being effected before settlement. (In short, s129 of the Code prohibits a company financing dealings in its own shares.) Moyle's requirement was made a precondition in the letter of offer dated 4 July. The facility, as extended and increased, was noted by the board on 22 June.

EDL informed Tricontinental on 20 July that it had been agreed that it would hold 60% of the equity in Mainsel, the remaining 40% to be held by Minfam. In fact, EDL acquired 50% of Mainsel with controlling voting rights and option to increase its shareholding to 60%.

On 2 August 1988 the railway land was rezoned under the category "Central Business".

(e) Further extension

A credit submission of 19 December 1988 sought a further extension of the facility to 31 March 1989. This was to enable EDL to arrange re-finance. The submission, prepared by Mountford and Guy Aird, stated that EDL was discussing with the Brisbane City Council a revised proposal for a 78 storey building and that EDL was confident that, through negotiations with the Council, the project would be, "...successfully advance[d]... to a stage where Council is supportive of the scheme within the next (3) months". It explained that, because of the changes in concept and other delays, EDL was not yet in a position to "...take an agreed project to the market in a form which would enable it to secure either development finance or the concrete interest of an end investor".
The Tricontinental file records do not include all the details relating to approval of this extension. It was certainly approved by Johns and Carr. On 22 December 1988, a letter was sent to Mainsel agreeing to extend the facility until 31 March 1989. The extension was noted at a board meeting on 25 January 1989.

In March 1989, Jones Lang Wootton provided Tricontinental with a valuation for the site as at that date, of $93m, assuming all development approvals were in place, and an "on completion appraisal" of the proposed development as at March 1994. The valuation made a number of assumptions, including one that the land owned by the CR would be transferred to Mainsel.

(d) Further increase to $59.915m

On 17 March 1989, Johns and Mountford sent an urgent credit submission, in memorandum form, to Smith, Ryan, Moyle, Morton and Carr. It showed that Mainsel was seeking an increase in the facility of $17.915m to $59.915m, to assist with further development, holding costs and full payout of former shareholders. $7.3m was required to pay out former shareholders and another $5.1m was for capitalised interest. The submission referred to improved relations between EDL and the Brisbane City Council, EDL actively seeking overseas equity participants, and confidence that development approvals would be given in August - September 1989. It was further recommended that a precondition to the increase and extension to 30 September 1989 would be an "as is" valuation of not less than $70m.

Directors were asked to assess the proposal "in conjunction with attached submission for Intellect Electronics Limited" ('Intellect Electronics'). The Intellect Electronics submission proposed granting a facility of $8.5m to EDL at the same time. This transaction has been examined separately by the Commission; see TR 5.
The submission was approved by Moyle, Ryan and Smith on 20 March 1989, by Morton (subject to the concurrence of other directors) on 21 March and Carr on 22 March.

Development approval was granted by the Brisbane City Council for a 78 storey building on 28 July 1989.

(e) Final increase to $65m and default

On 25 August 1989, SBV approved a proposal for cross-collateralisation of securities between this and other Essington facilities and an increase in the facility to $65m. The increase was principally to cover capitalisation of interest. The facility was further extended to 30 March 1990, however repayment was not made and the facility was placed in default on 31 March 1990.

The Capital Hotel site has been offered for sale, but not yet sold, and no funds have been realised from any other security. The anticipated loss is $61.7m.

D. Role of Mr Johns

Mr Johns had significant involvement in the transaction from the outset until merger with SBV in 1989:

(i) He personally dealt with the borrower in the lead up to the first credit submission in April 1987.

(ii) In a memorandum to Mountford of 7 May 1987, Johns referred to his recent travel with Mr Herzog during which Johns agreed not to request a mortgage debenture over LOF Investments and to consider a reduction in "exit fee".

(iii) When asked about whom he dealt with at Tricontinental, Malcolm Edwards said that discussions started with Johns and dealings were then handed over to Mountford or Hadley.

(iv) Mountford said that he was in charge of the facility on a day-to-day
basis, however he kept Johns fully informed.

(v) Johns was a co-author of the first credit submission of 16 April 1987 and approved the submission on 23 April 1987.

(vi) According to Ryan, Johns was aware of, and agreed with, his stipulation in April 1987 that Mr Minuzzo be removed from the Mainsel project. Soon after, Johns informed Ryan personally, and the board as a whole, that the other Mainsel shareholders had agreed to this removal. Mountford also said he thought Johns was looking to have Minuzzo removed as a shareholder.

(vii) According to Mountford, Johns authorised him to permit further drawdowns under the facility as first approved (in addition to the two authorised payments of $8.52m and $0.6m), thus waiving conditions precedent set by the board.

(viii) On 15 September 1987, Johns sent a memorandum to Mountford concerning a proposed re-arrangement of shareholders within Mainsel, and expressing his concern that the agreement did not allow for repayment of Tricontinental's facility "prior to taking out Herzog and Lasky". He asked Mountford to exercise tighter control in this and asked him to discuss the matter with him.

(ix) The file note of Mountford dated 10 December 1987, marked "not for circulation", was copied to Johns. This recited a number of concerns over delays and other matters and referred to the requirements for Tricontinental to obtain freehold title to the railway site. Mountford said this was marked "not for circulation" as, in the absence of such a direction, the note would have been circulated to Tricontinental's interstate offices (which were not concerned with Mainsel). In particular, he did not want this information going to the Brisbane office, given the property investment clientele it had at that time. Further file notes detailing progress on development approval and joint venture negotiations were made by Mountford and copied to Johns on 22 December 1987, 6 January 1987, 12 April 1988 and 25 May 1988.

(x) Mr Edwards said that the introduction of EDL to the project came
through Johns contacting him, saying that Essington was capable of
getting approvals and that it was an opportunity to become involved.
He described Johns as very much the chief executive of
Tricontinental and a very forceful character. Tricontinental was
looking to develop a banking relationship, which Essington was
most enthusiastic about encouraging.

(x) On 1 June 1988 Mountford wrote to Edwards, referring to recent
discussions, and confirming that Tricontinental was prepared to give
full consideration to the provision of a $42m facility to enable EDL
to acquire 100% of the shareholding in Mainsel and to meet other
expenditures as detailed in a finance proposal. This letter was
copied to Johns.

(xii) Edwards had earlier written to Herzog on 9 May 1988, confirming
EDL’s interest in acquiring, for $2, all of the issued capital of
Mainsel, other than the shares owned by Minuzzo, and indicating
that the proposal was subject to the approval of Tricontinental. In
the same letter he said that funding would be organised by
Tricontinental, and in evidence he said that he had taken it as a firm
assurance from Johns that EDL had Tricontinental’s backing.

(xiii) There is no notation on the Tricontinental file that Johns approved
the credit submission of 7 June 1988, but it is clear that he was
involved in the approval process:

- on 8 June 1988 a memorandum was sent to him by Clark
advising that Ryan had declined the submission because of
Minuzzo’s involvement. A more detailed memorandum,
dated 8 June 1988, from Mountford to Ryan on the same
issue was also copied to Johns;

- Mr Ryan gave evidence that he was angry at finding out that
Minuzzo was still part of the project. He could not recall
whether he spoke to Johns about it, but said that from then
on he quizzed Johns a lot more at board meetings;

- a memorandum from Clark to Mountford of 10 June 1988,
relating to queries by Moyle concerning s129 of the
Companies Code and other matters, was copied to Johns, as was a further memorandum on this matter from Mountford to Clark;

- Moyle said that he had discussions at this time with Johns and Mountford at a board meeting, when it was said that a catch-22 situation had developed in relation to the precondition concerning development approval; he also received information from Johns and Mountford on the subject of valuation.

(xiv) Edwards said that in one of the very early discussions he had with Johns it was indicated that Tricontinental would become involved in the syndication of the financing for the actual construction of the building, although the credit submissions of April 1987, June 1988 and December 1988 indicated that Tricontinental was requested only to fund the cost of site consolidation, not the project itself. The credit submission of March 1989 said Tricontinental had left Mainsel shareholders in no doubt that it gave no undertaking to participate in any syndicate for development finance.

(xv) In connection with the due date for repayment of the facility on 31 December 1988, Edwards said that EDL had undertakings from Johns for the rolling over and refinancing of this project as it went along, and agreed that it was just a matter of asking for a further extension and that it would be given. He said that he did not have written undertakings to this effect but this was the understanding when EDL got into the project.

(xvi) Johns approved the extension of the facility on 19 December 1988.

(xvii) He was joint author with Mountford of the urgent credit submission of 17 March 1989, recommending an increase to $59.915m and an extension to 30 September 1989, and he approved that facility.

E. Role of Other Managers

(a) Mr Mountford

31 Mr Mountford was also involved in a number of important aspects of the
facility. He gave evidence before the Commission that:

(i) He was aware before the first drawdown of the $31m facility (29 May 1987) that the development was on two sites, and that freehold title to the railway land would not pass to Mainsel until construction of the building had been largely completed and the CR had commenced his tenancy. He acknowledged the adverse effect of this situation on the security available to Tricontinental and agreed that it was a crucial point of which to inform the directors, but that this had not been done in the credit submission.

(ii) He agreed that full details concerning freehold title were not made known to the directors until the second credit submission in June 1988.

(iii) He did not agree that, in this case, board approval was required to change preconditions. He had agreed to permit drawdowns in excess of $8.5m after Johns told him that he had spoken to Lasky and Herzog. Mountford could recollect Johns' assurances that government approval would be forthcoming and that he could proceed with further drawdowns. He did not offer any explanation as to why there was no record of this authorisation on file, other than to say that he had been remiss. He said in hindsight it may have been better to inform the board of the further drawdowns.

(iv) He agreed it was dangerous to permit drawdowns beyond those initially approved by the board without development approval having been given.

(v) He was in charge of the Mainsel facility on a day to day basis and kept Johns fully informed of developments. He was given the authority to monitor the drawdowns and manage the facility. He knew that Ryan raised his concern over Minuzzo at the time of the first submission in April 1987, although he did not recall having discussions himself with Ryan. From discussions he had with Johns, he understood that Johns had taken this matter up with Herzog. Johns was furious with Mountford as Mountford had not told him of Ryan's perception that Minuzzo had a "colourful
background - as a result of his earlier dealings in Victoria (not concerning Tricontinental). Mountford thought Johns was aware of these matters.

(vi) When Ryan raised the Minuzzo issue again in June 1988, Mountford prepared a memorandum for Ryan in which he referred to matters set out in an EDL letter to him of 6 June 1988. The letter set out potential problems for the project if Minuzzo was excluded.

(vii) He agreed that the June 1988 credit submission was misleading when it referred to value of security held by Tricontinental as $45m. That valuation depended on future events. On the stipulation made by Mr Moyle, he had to get considerable legal advice on how to treat the $129 problems.

(viii) In December 1988, he supported the further extension because, despite being disappointed with the lack of progress, he thought it was better to take the government approval process to its conclusion. The basis for his optimism on the development approval process, and obtaining equity participants, came from discussions he had with Edwards and a meeting held with a financial group.

(ix) In March 1989, a "leverage situation" was applied in respect of Intellect Electronics. The proposal that EDL acquire the business of Intellect Electronics from Tricontinental as a quid pro quo for a $17.915m increase in the Mainsel facility, came from his initiative.

(b) Mr Hunter

Mr Hunter's evidence and involvement was as follows:

(i) As head of the securities division he was responsible for obtaining securities and satisfaction of preconditions; however he considered himself to be purely an administrator, not a policy maker.

(ii) While he wrote to Mainsel, on 11 August 1987, saying that an assignment of the development agreement was not required, he now assumes he did this on the express instructions of Mountford.

(iii) He was aware that, notwithstanding his statement in that letter to the
effect that no further drawdowns would be permitted until all preconditions had been met, further drawdowns did take place without satisfying these preconditions. He gave evidence that this was authorised by Mountford (as demonstrated by the documentation). However, he could not recall any discussions with Mountford about this matter.

(iv) With reference to Mountford’s instruction to him, in the memorandum of 7 September 1987, that no further drawdowns take place pending resolution of a number of matters, he agreed that further drawdowns did take place and explained this on the basis that Mountford had retracted that direction.

(v) If he did record that Mountford had approved a drawdown, the only place in which he would make a note would be on the application from the client for funds.

(vi) He could not recall whether he knew that Tricontinental did not have any security over the freehold of the railway land.

(vii) He had no specific recollection of the memorandum from Mountford to him and Johns of 10 December 1987, in which it was stated that total site freeholding would only occur when development commenced and CR had taken up 10 floors of the project.

F. Role of Directors

(a) Mr Ryan

Mr Ryan’s evidence of his involvement was to the following effect:

(i) He approved the first credit submission for $31m in April 1987 and recalled that he stipulated at the time that Mr Minuzzo be removed from Mainsel. He said Johns agreed with this and, soon after, assured him that Herzog and Lasky had agreed to take Minuzzo out. Johns then gave an assurance at the board meeting of May 1987 that Minuzzo had been or would be removed.

(ii) He discussed the initial proposal with Johns for some time, and didn’t think there would be much difficulty in finding a joint venture party to proceed with the development.
(iii) He had noted the preconditions which had to be complied with; had there been any doubt about meeting any one of them he would not have given his approval; preconditions were immutable and management had no discretion to waive them.

(iv) When he received the credit submission in June 1988, recommending an extension and increase to $42m, he was angry to find that Minuzzo was still a shareholder in Mainsel and he refused to approve the submission. He could not recall whether he spoke to Johns, but he had a long talk with Mountford after receiving a "pleading letter" from him to the effect that Mr Edwards had become the anchor man, and the project could not proceed without Minuzzo. He then approved the submission on 9 June 1988.

(v) He was unaware until giving evidence to the Royal Commission that freehold title to the railway land could not pass to Mainsel until construction of the building had been completed and the CR had taken up office space. Had he known that the effective security was only over the Anne Street property, worth $8.5m, he would not have agreed to the original facility. He acknowledged that rezoning and development approval were crucial conditions and was unaware that they had not been satisfied until he read the June 1988 credit submission. He was concerned that drawdowns in addition to the initial $8.52m and $0.6m had been authorised and had a long talk to Mountford about this. Mountford informed him that Tricontinental had relied on information from government ministers in Queensland, that Edwards had now become very involved and that the change in zoning was imminent.

(vi) He acknowledged that the June 1988 credit submission referred to the requirements for obtaining freehold title to the railway land and, although he read it then, he did not realise its significance.

(vii) He did not recall the December 1988 extension of the facility for a further three months, but said there was not much choice at the time other than to extend it.

(viii) In March 1989 he approved the further extension and increase of the
facility by $17.91m. Although the Intellect Electronics proposal was considered at the same time, he said that he didn't then make a connection between the two facilities.

(ix) Asked why he did not make any notation of conditions when giving approval to facilities, he said that he thought it was the result of a request (in 1986) from Johns, who said that such notations undermined his (new) authority, as managing director, with credit staff. Johns had asked that Ryan speak with him about such matters and Johns would see that they were dealt with.

(b) Mr Moyle

Mr Moyle's evidence and involvement was as follows:

(i) He met Mr Edwards in early 1988 at a social function, but had no discussion with him about Mainsel or other EDL facilities.

(ii) His approval of the June 1988 credit submission was made subject to Tricontinental being satisfied that there was no breach of s129 of the Companies Code, and that the change in shareholding would be effected on or before settlement. Although there is some correspondence in evidence about the s129 issue, it does not appear that Tricontinental ever received definitive legal advice that s129 was not breached. He was not comfortable with lending 93% on the property and said the maximum should be 85%. He agreed to accept the higher ratio as, following discussions with Mountford and possibly Johns (at board level), he thought it was clear that the property would be worth more than $45m and the actual ratio would be close to 85%. He accepted Mountford's argument that Tricontinental did not want to raise obstacles to Essington's entry into the Mainsel project by forcing EDL to bear the significant expense of obtaining a fresh valuation.

(iii) His belief, until the time of giving evidence to the Royal Commission, was that Tricontinental had mortgage security over the whole property and, had he known it was otherwise, he would not have approved the increase. Despite the information in the June
1988 credit submission about the requirements for obtaining freehold title to the railway land, he was under the impression that Tricontinental had a freehold mortgage over the whole site. Even though he had read the credit submission he "failed to understand the implications on that point", and, in particular, failed to understand that freehold title could not pass until the building was actually built.

(iv) In his opinion, further drawdowns beyond $8.52m and $0.6m under the original facility should not have taken place without a re-submission to the board. Preconditions stipulated by directors were "immutable", he said. He thought he had discussed the lack of development approval and re-zoning with Johns and Mountford at a board meeting, presumably in or around June 1988. As a result of these discussions, he understood that a "catch 22 situation had developed". This was because money had to be spent before development approval could be issued, yet moneys could not be disbursed until development approval had been given.

(v) He did not recall whether he approved the extension of the facility in December 1988.

(vi) When considering the further extension and increase approved in March 1989, he believed that Tricontinental was adequately secured, that the best prospects for repayment were to get a joint venture party involved, and the best prospects for that were to provide additional funds. He recalled the submission, and agreed that approval of the increase on the Mainsel facility was conditional on EDL borrowing $9m and spending $6m on acquiring the assets of Intellect Electronics.

(c) Mr Carr

Mr Carr’s evidence and involvement was to the following effect:

(i) he had no recollection of the facilities, although he did have a recollection of the project and of some publicity concerning it;

(ii) although he approved the grant of the facility in April 1987, he had
no recollection of it, nor did he, at the time, appreciate the role of Mr Minuzzo;

(iii) he agreed that when preconditions were set by the directors in the approval of a facility they were "immutable";

(iv) he had no recollection of the extension and increase of $11m in June 1988 (although his approval is recorded on the credit submission); and

(v) he approved the extension in December 1988, but did not give evidence about this.

(d) Mr Morton

Mr Morton's evidence and involvement was to the following effect:

(i) he recollected the Brisbane project, but not the name of Mainsel;

(ii) he had no recollection of whether he approved the three month extension in December 1988; but

(iii) he approved the increase and extension on 17 March 1989. He made his approval subject to the concurrence of other directors, because he wanted to discuss the proposal at the board meeting which was to take place on the following day, 22 March 1989. The reason for this was that he had, at the time, a general concern about facilities for major development projects. He does not recall whether in fact the matter was discussed at the board meeting. His practice was to discuss proposals with his fellow directors, rather than the lending officer.

(iv) He had no recollection of the Intellect Electronics submission, nor could he recall if he knew, in March 1989, whether the credit committee had approved the Mainsel increase and extension.

(v) He agreed that it was a choice of putting in another $17m or cutting the losses; he said it was a difficult time for decisions.

(e) Mr Smith

As to Mr Smith:

(i) he approved the initial credit submission of 16 April 1987; he is
recorded as having provided his consent to Mr Johns on 28 April 1987; and

(ii) he also approved the later submission of 17 March 1989 (extension to $59.91m);

Mr Smith was not questioned about this transaction as he was unavailable to give evidence.

G. Significant Issues Arising

The Commission's examination of this transaction has involved consideration of a number of significant matters. These include:

- the adequacy of the appraisal of the initial request for funding;
- permitting drawdowns when preconditions had not been met;
- the approval of increases in the facility while Tricontinental remained seriously under-secured, and when a substantial part of the additional funds was being applied to pay out shareholders; and
- the approval of an increase in the facility in March 1989, in part because it resolved Tricontinental's problem with Intellect Electronics.

(a) Adequacy of the appraisal of the initial request for finance

Counsel assisting submit that the credit submission of 16 April 1987 failed to analyse and describe important matters relating to the site. They argue the submission should have been more comprehensive, better researched and more analytical than it was and that, in places, it was demonstrably defective and ambiguous, if not positively misleading. It is submitted for example, that Mr Johns and Mr Mountford were either aware of, or had the means of ascertaining, the correct position in relation to the railway land. In particular, counsel submit, the submission should have -

- described the site with complete accuracy, so as to distinguish clearly between the smaller freehold element and the larger component which would continue to be owned for a substantial period by the CR;
highlighted the absence of security over the railway land until the project was largely complete and the CR occupied the building;

• analysed whether the developer could provide the necessary development costs from its own resources until the preconditions were met; and

• determined whether it was realistic to expect repayment of principal and capitalised interest when development approvals had still to be obtained and no firm arrangement was in place for construction finance, nor any firm commitment obtained from a joint venturer.

In the light of these deficiencies, counsel assisting submit that Johns and Mountford were negligent in the manner of their investigating and submitting the Mainsel proposal to directors.

Counsel assisting submit also that the credit submission was so significantly defective and, at the very least, in relation to the site and security, ambiguous, that a prudent director should not have been prepared to approve the facility on the basis of the information provided. It is further submitted that it should have been obvious to a director that very high risks were involved in providing finance for site purchase and development, in the absence of firm commitments for refinance and/or substantial financial resources available to the developer, whether on its own account or from a contracted joint venture arrangement. In such circumstances, a high degree of care and attention to the proposal and its risks was required. Thus it is argued that the approving directors were obliged to have sought further information and clarification. It is submitted that the failure of directors (Johns, Carr, Smith and Ryan) and Mr Mountford to assess credit risk adequately was a significant contributing cause to the loss suffered.

Counsel for the directors (other than Johns) and Tricontinental staff submit that all the matters which counsel assisting argue should have been included in the credit submission (some of which are referred to above) would have been satisfied had the preconditions stipulated by directors been adhered to
before the drawdown of the loan. Counsel for the directors submit that it cannot be said, merely because the credit submission does not contain each of the matters referred to by counsel assisting, that a director was negligent in approving the submission. For instance, one consideration might outweigh other considerations and provide a sufficient basis upon which it is appropriate to approve the loan.

As to Mr Mountford's role, his counsel argue that he should be looked at separately and independently from Johns, because Johns had established a close working relationship with the Essington group (particularly Mr Edwards) and Mountford was merely obeying Johns' directions in putting the proposal forward.

Counsel for the directors submit that, had the conditions precedent been satisfied before drawdown of the facility, then no loss would have resulted. They emphasise that it was Johns who instructed Mountford that the funds could be drawn even though the preconditions stipulated by directors had not been satisfied. Counsel submit that it was this failure to satisfy the preconditions which was the chief contributing cause of the loss suffered.

(b) Permitting drawdowns when preconditions had not been met

Three directors (Ryan, Moyle and Carr) gave evidence that preconditions were "immutable" and could not be departed from by management without board approval. Mountford did not agree that it was always necessary to go back to the board for approval of such changes, and particularly in this instance, where he authorised drawdowns only after discussions with Johns and having obtained assurances from him. Hunter took steps to advise Mainsel that no further drawdowns would be permitted, following the initial ones approved by the board in April 1987. He justified the later drawdowns on the basis that he received instructions from Mountford.

Counsel assisting submit that, although Mr Johns did not give evidence, the Commission is entitled to draw the conclusion that he shared the view of
Mr Mountford, namely, that whether changes to preconditions had to be resubmitted to the board depended on the potential impact of those changes and, to some extent, was left to the discretion of the managing director. This is confirmed by the evidence of Mr Moyle who, at around the time when the extension and increase to $42m was approved in June 1988, spoke to Johns and Mountford to find out the explanation for the additional drawdowns which had taken place. He was told that a "catch 22" situation had developed in relation to the development approval being required before further drawdowns could take place, yet moneys had to be spent, (which would have to come from the facility), to enable the development approval process to take place. It is not precisely clear to what payment he was referring, although it is correct that there were continuing obligations to make payments under the development agreement with the CR, provision for such payments having been made in the initial facility.

Counsel assisting submit that the board failed in its responsibilities in not establishing guidelines and policies which made it abundantly clear that preconditions set by the directors could not be waived except in a manner, or in circumstances, authorised by the board. Counsel submit it was the responsibility of the board not only to establish such guidelines (which would have conformed with the views expressed by the directors who gave evidence), but also to put in place adequate systems which would ensure that the management of Tricontinental would know what the guidelines were and would comply with them.

Nevertheless, counsel assisting submit, Mr Johns and Mr Mountford were negligent in permitting a waiver of preconditions set by directors without referring the matter back to them.

In response to these arguments, counsel for the directors submit that it is hard to imagine a more precise guideline and policy than stipulating a precondition to the drawdown of the loan. They submit that the guideline or policy suggested would do no more than state the obvious.
As to the submission that Mr Mountford was negligent in permitting the waiver of preconditions, his counsel submit that he could not be said to be negligent in circumstances where he acted in accordance with the directions of Mr Johns.

(c) **The approval of increases in the facility while Tricontinental remained seriously undersecured and when a substantial part of the additional funds was being applied to pay out shareholders**

When the facility was increased to $42m in June 1988, $5m of the increased figure was applied towards the buy-out of the interests of Herzog, Lasky and Nevins. EDL was obliged to make a further payment to those persons in 1989 and part of the increase approved by the board in March 1989 was to provide a further $7.3m for that purpose. In this context it is to be noted that, of the final exposure of approximately $65m (including capitalised interest) drawn down under the facility, $12.3m was never applied to the consolidation of the development site. Counsel assisting submit that Tricontinental not only took a substantial risk on the project in which it ultimately lost money, but at the same time ensured that the initiators of the project received a return of the funds they had invested. It is submitted that the directors failed to evaluate properly the additional exposure Tricontinental would have on funding EDL into the project, seemingly without any contribution on the part of EDL itself. This is particularly so as future funding for consolidation of the development site was expected to come almost exclusively from Tricontinental itself.

In June 1988, the approving directors (Carr, Ryan and Moyle) were told specifically that freehold title to the railway land would not be obtained until the project was almost complete and the CR took up occupancy of the developed office space. Counsel assisting submit directors failed to appreciate the significance of this information. In doing so, it is argued, they demonstrated a lack of commercial judgment in approving the facility in light of the seriously undersecured position which Tricontinental then faced.
Counsel for the directors submit that this argument ought to be rejected, on the basis that the approval of the facility could be justified in light of the preconditions laid down by directors.

As to the submission that approving directors demonstrated a lack of commercial judgment in approving the facility, in light of the seriously undersecured position which Tricontinental faced as at June 1988, counsel for the directors submit that it is important to recall that the evidence of the approving directors was that they were not informed that the freehold title to the railway land could not be obtained until the CR took up occupancy of the office space. However, it must be remembered that, in June 1988, the approving directors were informed of this situation, and still approved the increase in the facility to $42m.

(d) The approval of an increase in the facility in March 1989, in part because it resolved Tricontinental’s problem with Intellect Electronics

Counsel assisting submit the initiative for linking the Intellect Electronics submission with that for the extension and increase of the Mainsel facility in March 1989 came from Mr Mountford. They argue that the linking of the EDL facility for the purchase of the assets of Intellect Electronics with the Mainsel increase and extension distorted the submission process in relation to Mainsel. It is argued that, had Tricontinental not been so keen to resolve its problem with Intellect Electronics (the disposition of non-performing assets), it may have adopted a more hard-headed approach in March 1989 and put pressure on EDL to obtain from other sources all or some of the additional money required.

Counsel for the directors respond to this submission by repeating their submissions as outlined at paragraphs 43 and 44 above, that these later problems would not have arisen if preconditions had been enforced, and Johns was responsible for over-riding them.
H. Conclusions and Findings

This was a transaction which was always going to have difficulties. The borrower was faced with a project in which it had no equity, and it could not give any substantial security to a lender until the project was nearing completion.

When Tricontinental originally agreed to provide finance, it laid down a number of preconditions which would have protected its position had they been observed. It was the step by step departure from these preconditions which proved to be the chief cause of Tricontinental’s losses.

Having provided the funds for the purchase of the freehold part of the site, there was a certain logic about providing the funds to cover costs of demolition of the old building on that site; but the drawdowns did not stop there.

Directors had only given authority for drawdowns of less than $10m but, in fact, by June 1988, nearly $30m had been drawn down. It was in this month that directors were asked to increase the facility to $42m to enable Essington to take a controlling interest in the venture. The credit submission disclosed that $30m had been drawn down, but this did not produce any reaction from the directors. There was nothing in the credit submission to draw attention to the previous limit and it is quite possible that, with all the other credit submissions which had intervened, none of the directors noticed that their previous authorisation had been greatly exceeded.

In March 1989, there was another urgent credit submission seeking to increase the facility to $60m. The directors approved this also.

It could be argued that these later submissions were justified on the basis that Tricontinental was already deeply committed to the venture, and to
Essington's part in it, and could not turn back. However, this cannot excuse the insidious additions to loans which occurred in late 1987 and early 1988. Both Johns and Mountford were fully involved in these drawdowns, in spite of a clear recognition of the risks involved; see Mountford's note for file in para 16 above.

Although Johns was primarily responsible for this transaction, both because of his close association with Essington and because of his position as managing director, Mountford must also accept his share of responsibility. He saw clearly what was happening and yet made no attempt to dissuade Johns from the course which they were jointly taking, or to point out to him the desirability of consulting directors before becoming more deeply involved.

Although this ignoring of preconditions was, in the Commission's view, the most serious aspect of this transaction, there were other aspects of it which were also most unsatisfactory. In the first place, the original credit submission was seriously deficient. There was no attempt to distinguish between the 25% of the site over which freehold title could easily be obtained, and the 75% over which it could only be obtained after construction of the entire complex (which Tricontinental had no intention of funding) was almost complete. This, of course, had a very serious effect on the security offered, which was compounded by the fact that the valuation obtained was not carried out on a mortgage basis but on a ready-for-development basis, assuming freehold title to the railways land had passed and development approvals were in place. There was no analysis of the likely difficulties in obtaining development approvals, or procuring a joint venturer for the construction phase. In fact, of course, it took considerable time, a good deal of negotiation, and changes of plan, before development approvals were received. No joint venturer was ever attracted to the project.
It is true that Tricontinental's position was largely protected by the preconditions in spite of these deficiencies in the credit submission. This only serves to underline the seriousness of any major departure from those preconditions. The Commission is prepared to accept that minor departures, which did not go to the substance of any precondition, might properly have been accepted on the authority of the managing director. But in this case, the whole spirit of the preconditions was ignored. The argument put for Mr Mountford - that he was in a difficult position because he was not supposed to advance funds without development approvals being in place, but on the other hand, development approvals could not be obtained without the expenditure of additional funds, is not a sufficient excuse. This difficulty was entirely foreseeable at the time the transaction was entered into, and if it had not been fully appreciated, then the only proper course was to take the matter back to directors for their consideration.

Another criticism of the handling of this transaction that has to be made is that, as time passed, Tricontinental was seriously under-secured; but this did not stop Mountford and Johns proposing, and directors accepting, that most of the original partners in the scheme should be paid out in full, and Essington should be fully supported without having to make any equity contribution. The effect of this was that Tricontinental was bearing virtually the whole of the risk.

Finally, there was a serious error of judgment, in the opinion of the Commission, in introducing the Intellect Electronics transaction into Tricontinental's already complex dealings with Essington. The commitment to "exchange" non-performing loans with Rothwells should not have been entered into in the first place, contrary as it was to the known wishes of directors, and to saddle Essington with this additional burden, when it was struggling with all its existing transactions, was a very strange thing to do.
# TRANSACTION REPORT 5

**ESSINGTON DEVELOPMENTS LIMITED**

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A

Background and Summary

(a) The Essington group

1 An outline of the Essington group is provided at paragraphs 1 to 4 of the section on the Tibham transaction (TR3).

(b) EDL

2 Essington Developments Limited (‘EDL’) was a public company incorporated on 16 April 1984. It was jointly owned by Essington Limited (48.5%) Axis Ltd (48.5%) (a wholly-owned subsidiary of Japan-based EIE Australia Ltd), Mr Malcolm Edwards (1.5%) and Dr Robert Bungo Ishizaki (1.5%).

(c) Intellect facility

3 Intellect Electronics Limited (‘Intellect’) was a subsidiary of Western Australia’s Rothwells Limited (‘Rothwells’). Intellect was publicly listed, and engaged in the manufacture of video tapes and the development of projects in the field of electronic technology. Intellect traded under the name of AATEC.

4 In August 1988 Tricontinental approved the grant of a facility of $6m to Intellect for working capital purposes. At the same time, a facility of $4m for working capital was granted to Katanning Holdings (*Katanning*), another company associated with Rothwells. Both of these amounts were within Mr Johns’ discretion. The Intellect loan was recommended by 3 members of the credit committee and the Katanning loan by 2 members of the credit committee. These facilities were provided in an exchange between Rothwells and Tricontinental. Tricontinental lent $6m to Intellect and $4m to Katanning in return for Rothwells taking over two of Tricontinental’s non-performing loans, namely those to Mark Chew Holdings Pty Ltd (‘Chew’) and Lynette Robyn Holdings Pty Ltd (‘Lynette Robyn’), (both part of the Chew group of companies). In July 1988 Mr Ken Mountford estimated the ‘best case’ loss faced by Tricontinental on the Chew/Lynette Robyn facilities was $1.24m.
It was originally proposed by Rothwells that Tricontinental provide a $10m facility to Intellect in return for Rothwells' takeout of the Chew facilities. However, Mr Johns did not want the matter to go to the board as apparently there was an understanding amongst directors that Tricontinental would not deal with Rothwells. Tricontinental indicated to Rothwells its preference to restrict the exposure to Intellect to $6m (which was within Johns' discretion). The alternative eventually agreed on was for Tricontinental to provide a $6m facility to Intellect and a $4m facility to Katanning so that these facilities could be approved by Mr Johns under his discretion. Mountford and Johns concealed any direct reference to Rothwells in documentation which might be sighted by directors. For instance, the Intellect ($6m) credit submission of 3 August 1988 contained no reference to a confirmed guarantee from Rothwells, whereas the letter of offer dated 19 August 1988 stipulated that part of the security comprised that guarantee.

Rothwells went into receivership in November 1988. Tricontinental appointed a partner of Arthur Andersen & Co as receiver to Intellect in the same month. Mr Johns then, for the first time (but in an incomplete way), informed the board of the Rothwells connection, indicating however that no loss was envisaged on the Intellect/Katanning facilities.

(d) EDL as a potential purchaser of Intellect

The first suggestion that the Essington group may have been a potential purchaser of the assets of Intellect arose in October 1988. At this time Mountford told Johns he didn’t favour Essington as a purchaser as he was hopeful that Tricontinental could trade out of its difficulties with Intellect. However, by 22 February 1989, Mountford was vigorously negotiating with Edwards, offering Intellect's assets for $6.5m, and indicating that Tricontinental would consider providing the bulk of the finance. At this time, Tricontinental had been informed by Intellect's manager that the value of realisable assets was $2.32m. Thus Tricontinental faced a loss of $4.03m.
In a memorandum to Johns, dated 3 March 1989, Mountford noted Tricontinental’s potential loss on Intellect of $4.03m (and its worsening position). He said one possible opportunity for Tricontinental, to avoid taking a significant loss, included a “trade off” on the Mainsel facility of $40m (actually $42m) due for repayment on 31 March 1989. Mountford referred to the fact that Edwards was wanting to increase the Mainsel facility by $16.5m, and that Tricontinental was "very reliant on Edwards" for the sale of Intellect. Mountford made it clear that the Intellect sale and the Mainsel extension were linked when, on 17 May 1989, he informed Johns of the problems and cost to Tricontinental resulting from delays in consummating the Intellect deal. He said "I intend to inform Edwards today that agreement to acquire Intellect assets was based on provision of increased facility to Mainsel".

On 4 March 1989, Arthur Andersen & Co informed Tricontinental that, due to Intellect’s rapidly deteriorating position and following limited interest in its purchase, the net amount which would be realised on the sale of Intellect assets had dropped further to $1.88m. The board were told of this in the credit submission of 17 March 1989.

(e) Summary

In July and August 1988 Tricontinental and Rothwells agreed to exchange certain non-performing loans. Tricontinental provided a $6m loan facility to Intellect for working capital. Rothwells went into liquidation in November 1988 and, as a consequence, Intellect was placed into receivership in the same month. By March 1989 Tricontinental’s potential loss on Intellect was $4.03m and the position was worsening. At this time Tricontinental was experiencing its own serious liquidity problems. The Essington group was looking for an extension and increase on the Mainsel facility from $42m to $57.9m. Tricontinental made the Mainsel extension and increase conditional on EDL borrowing $8.5m (later $9.5m - $6.5m to purchase the assets of Intellect and $3m for working capital). This deal was somewhat reluctantly agreed to by
the Essington group, which was anxious to maintain Tricontinental’s support. By May 1990 EDL had failed to repay the loan, which was then placed in default. EDL failed to respond to notices to pay, served in October 1990. Security proved wholly valueless, and the anticipated loss is $9.35m.

B. **Chronology**

1988

30 August Tricontinental lent $6m to Intellect as part of an arrangement with Rothwells to avoid a potential $1.24m loss on two Tricontinental non-performing loans (Chew/Lynette Robyn).

3 November Rothwells placed in liquidation.

30 November Intellect placed in receivership.

1989

17 March Johns and Mountford sent an urgent credit memorandum for an $8.5m facility to EDL to Smith, Ryan, Moyle, Morton and Carr to be considered in conjunction with a memorandum for an increase in and extension of the Mainsel facility.

20 March Ryan, Smith and Carr approved the submission.

21 March Morton indicated he would approve the facility if the other directors did so, but he preferred to discuss it at the next board meeting.

22 March Moyle approved the facility. Tricontinental board meeting. No evidence in the minutes or agenda papers that the facility for $8.5m was discussed or ratified.

3 April Letter of offer for $8.5m sent.

11 April Mountford asked Maddison to prepare a credit submission for an increased facility of $9.5m (an additional $1m for working capital).

13 April Credit submission prepared for increase to $9.5m.

19-21 April Credit submission for $9.5m recommended by credit
20 April Letter of offer for $8.5m accepted
24 April Johns recommended credit submission for $9.5m.
27 April Carr and Smith approved credit submission for $9.5m.
            Ryan also approved (date unknown).
28 April Letter of offer for $9.5m sent. (No evidence of when it was accepted).
24 May Tricontinental board meeting scheduled. Credit submission for $9.5m included in board papers, but the meeting was not held. The minutes of two board meetings held around this time (22 May and 26 May) do not indicate that credit submissions were ratified.
1 June Essington requested waiver of the charge over assets situated in New South Wales (to reduce loan security duty), and deletion of the requirement in the letter of offer of a guarantee by Tibham. A facsimile to Mr Hunter dated 29 June indicates Tricontinental agreed to both of these requests.
3 July EDL drew down $7.865m on the facility to effect purchase of Intellect’s assets.
5 July EDL drew down balance of funds held on deposit.
1990
10 May EDL failed to meet discount fee and facility placed in default.
18 October Notice to pay served on EDL.

C. Narrative

On 17 March 1989 a credit submission in the form of an urgent memorandum was presented by Johns and Mountford to Smith, Ryan, Moyle, Morton and Carr. The purpose of the facility was not mentioned, but it obviously involved Tricontinental financing the sale of the assets of Intellect (in
receivership) to Essington. On the same day the directors received a similarly urgent credit memorandum from Johns and Mountford recommending an increase in the Mainsel facility from $42m to $57.9m. The Mainsel submission asked directors to assess that proposal "... in conjunction with attached submission for Intellect Electronics Limited."

The memorandum informed directors, among other things, that Intellect’s receiver had advised that the estimated close-down value for assets (net realisation) was $1.88m (as at 4 March 1989). It was indicated that, of all possible purchasers, the Essington group had expressed the strongest interest and had undertaken its own valuation. The submission continued:

"The proposed acquisition of Intellect forms part of Malcolm Edwards’ plans for an entertainment division. Crawford Productions which is wholly owned by Ariadne, is at an advance[d] stage of negotiations with UK interests (Lord Lew Grade) to acquire rights to Crawfords’ film library and vice versa.

For the present and pending consummation of a controlling shareholding in Ariadne, the business is to be purchased by Essington and ultimate intention is to on-sell to Ariadne.

Whilst current and proposed exposure to Essington Group (excluding this proposal) is $124.9m, both facilities are of a short term/bridging nature. As previously indicated, in the event Intellect is wound up, Tricontinental faces a principal loss of $4(m) plus.

The proposal is Recommended on basis submitted".

Security for the facility was to be a first registered fixed and floating charge over the borrower. The charge was to cover the Intellect assets to be purchased. These assets were valued at $3.03m with a net realisation value (ie after costs), of $1.88m. The credit submission showed a value for security purposes of $2m. Other security was to be an unlimited guarantee from EDL (which had shareholders’ funds of $34.2m), but this was later changed to a guarantee from Tibham, and later still removed altogether by SBV/Tricontinental management. Thus, at best, security for the $8.5m amounted to $2m. A ‘precondition’ was that EDL undertake to repay the first
$4m of any profits generated from the on-sale of either the Mainsel or Tibham projects. It is to be noted that, at this time, Tibham had failed to repay the $20m Ariadne facility, no development approvals had been granted for either the Tibham or Mainsel projects and the borrowers were having no success in finding joint venture parties to complete the projects. The directors were informed that current and proposed exposure to the Essington group (excluding this EDL facility) was $124.9m (in fact the figure should have been $134.9m as the Magic Millions facility was not mentioned).

On 20 March 1989, Mountford wrote to the directors informing them that the amount and nature of the facility had been omitted from the earlier memorandum. He expressed regret for this ‘major oversight’ and said that $6.5m was for acquisition costs and $2m for working capital.

The submission was approved by Ryan and Smith on 20 March and by Moyle on 22 March 1989, in addition to being approved by Johns. It is not clear whether Morton or Carr approved the facility. A memorandum from Maddison to Johns of 21 March 1989 indicated that Morton had considered the two proposals, and was willing to approve the submissions if other directors did so, but would prefer to discuss them at the board meeting on 22 March 1989. This memorandum also said Carr had approved. There is no record in the minutes that this facility was discussed or noted at the board meeting held on 22 March.

A letter of offer for $8.5m was sent on 3 April and accepted on 20 April. Despite this, Mountford and Edwards continued to negotiate as to the terms of the offer. Tricontinental agreed to accept a guarantee from Tibham rather than one from EDL. As noted, this security was later dispensed with altogether. The alteration in security arrangements was not referred to the board. It was arranged by Mountford who also dispensed with certain reporting requirements specified in the submission.
On 11 April 1989, Mountford asked Maddison to prepare a further submission to increase the facility to $9.5m. He proposed that the $4m to be paid to Tricontinental from the sale of the Tibham or Mainsel projects be increased to $5m and that "an irrevocable undertaking" be obtained for this purpose. The additional $1m was for working capital.

A further submission for $9.5m was dated 13 April 1989. It was approved by Johns, Ryan, Smith and Carr between 24 and 27 April 1989.

On 28 April 1989, Ms P Lee from the securities department noted that, in preparing the second letter of offer (for the additional $1m), Mountford had been queried about the difference between the covenants in the earlier letter of offer and those in the later credit submission. She was told by Mountford that the covenants were to remain as per the first letter of offer. The revised letter of offer for $9.5m, signed by Mountford and Lee, was sent on 28 April 1989.

The assets of Intellect were acquired by EDL for $6.5m on 5 July 1989 (all staff having been dismissed by the receiver on 3 July). After the deduction of receiver's costs, Tricontinental received $4.5m to apply against the debt of Intellect.

Interest was paid by EDL until 10 May 1990, when the facility went into default. Tricontinental did not itself enforce its security over the Intellect assets. They were sold by EDL in October 1990 for US$500,000, of which Tricontinental received A$286,114.05. Tricontinental's recovery from the sale of security was applied against notional unpaid interest and the anticipated loss on the EDL facility is $9.35m.
D. Role of Mr Johns

23 The arrangement with Rothwells was approved by Johns under his discretion and on terms agreed to by him. With Mountford, he prepared the initial credit memorandum of 17 March 1989 for the $8.5m facility to EDL. Edwards said that Johns had put pressure on Essington to do the deal in a way that was best for Tricontinental. According to Mountford, however, Johns had only a minor role supporting Mountford's negotiations for the sale of Intellect's business to EDL.

E. Role of Other Managers

(a) Mr Mountford

24 Mr Mountford played a significant role in this transaction:

(i) He initiated the proposal to have Essington purchase the Intellect assets. He said Essington became the only entity likely to save Tricontinental from a loss on Intellect. He put this potential loss as high as $7.8m - $8m. He jointly prepared the initial credit memorandum of 17 March 1989 and was very closely involved with the Mainsel transaction.

(ii) Mr Mountford said that the purchase of Intellect by EDL was a "leverage" or an "opportunity-driven" situation. He said "... I did see this as an opportunity, as some sort of a squaring of the books". He agreed that in fixing the price of $6.5m for Intellect's assets he was "clearly out for the big dollar". He also said it was clearly acknowledged by all parties at the time that the value of the assets was not $6m. At the time Tricontinental was getting into its own more general problems. He said it was strongly implied by Tricontinental that the increase to Mainsel was conditional on EDL making the purchase, and in fact EDL was asked to make the purchase.

(iii) As a result of discussions in the early stages with Edwards, Mountford said he believed that Essington intended to enter the entertainment
industry. This is why he referred to this aspect in the submission.

(iv) Mountford agreed that taking security of $2m for a facility of $8.5m contravened all guidelines. However, he said that, as it was a "workout proposal", it was completely ungoverned by any guidelines, as he considered guidelines to be inappropriate for a workout of this nature. He agreed that, at the time, there was no guarantee of any profits from the Tibham or Mainsel projects.

(v) Mountford said he would have spoken to Ryan and Smith as he had noted their approval on the submission, but he cannot recall anything specific about these conversations.

(vi) He removed some standard reporting conditions in the letter of offer, at the request of EDL, as by that stage Intellect was failing and he thought EDL would close the business up (thus the conditions would be redundant).

(vii) Mountford said the substitution of the Tibham guarantee had been a compromise, again at the request of EDL, but he decided he would take what he could get as he wanted the transaction to proceed "come hell or high water".

(viii) Mountford said he didn't consider it necessary to go back to the board for approval of the change of guarantee, given the overall nature of the transaction. He believed he had power to waive or vary "minor matters".

(ix) He was aware that, at the time, Tricontinental were not doing any money market transactions with Rothwells, so he assumed the secrecy over Rothwells' involvement was because Johns had somehow told the board that Tricontinental did not deal with Rothwells. Mountford himself had given no undertakings about doing anything with Rothwells. He said Johns didn't want to go to the board (for the $10m approval to Intellect), which explained why he split it into two facilities of $6m (Intellect) and $4m (Katanning). Mountford believed the board would have approved a $10m facility to Intellect anyway.

(x) Mountford said that, at one stage, Edwards told him that he considered
the Intellect deal merely an extension, or establishment fee for the Mainsel approval.

(x) At the time of preparing the credit memorandum, Mountford said he was working extremely long hours and Tricontinental was under extreme pressure due to liquidity problems.

(b) Mr Hunter

EDL had already given charges over its assets in favour of BNZ. Corrs, Tricontinental’s solicitors, had informed Mr Hunter of this fact and of their concern as to:
- the question of ownership of any new stock manufactured or new plant acquired; and
- future problems if moneys were to flow from Intellect to EDL.

Hunter asked Mountford’s advice about another Essington subsidiary purchasing the assets, so as to resolve any uncertainties over security which this problem might cause. Apparently Mountford failed to respond to Hunter.

F. Role of Directors

(a) Mr Ryan

Mr Ryan said in evidence that he was not sure he understood the connection between the EDL and Mainsel submissions at the time but, having read the documentation relating to EDL that was before the Commission, it became very clear that a chain of events had taken place. He agreed that the documentation suggested that Rothwells and Tricontinental had swapped bad debts, and that the Intellect business was to be purchased by EDL as a condition of approval on the Mainsel extension and increase.

(b) Mr Morton

Mr Morton had no recollection of the EDL submission which was considered in conjunction with the Mainsel submission. At the time he was concerned about Tricontinental’s general liquidity problems, and thought it best that major proposals (such as Mainsel) should be discussed at the board.
(c) Mr Moyle

Mr Moyle recalled that there was a benefit to Tricontinental in the proposal as it removed the problems with Intellect Electronics. He believed that the directors were being asked to assess the EDL proposal with the Mainsel submission, on the basis that approval for Mainsel's increase and extension was conditional upon Essington borrowing $9m and spending $6m on Intellect.

G. Essington's Attitude

Mr Edwards explained his attitude to the facility. He said the Essington group was facing roll-over fees on their outstanding facilities for some considerable time to come. As to the EDL facility he said:

"... we were uncomfortable with the proposition, but pragmatically and commercially, I suspect that in taking the decision to proceed with it, we knew that in real terms, we would be no more or less out of pocket. There were disadvantages in doing it in that form, but I suspect that my respect for Ian Johns as chief executive, looking after his own company, heightened, given the pressure that he put on us to do it in a way that was best for his company, and I had to make a decision if it was satisfactory to mine".

Importantly, Edwards said his group had never been in the business of video tape production and had no interest in this area. This contradicted the statement in the credit memorandum as to EDL's alleged future plans in the entertainment industry (see para 13 above). As noted, EDL sold the assets as soon as they could. Edwards said he paid the $6m for the Intellect assets because at the time his group believed Tricontinental would continue to trade and fully support the Essington group in its ongoing projects. In light of Tricontinental's demise it was, he agreed, the "... most expensive extension fee" he had ever had to pay.
H. **Significant Issues Arising**

The Commission’s examination of this transaction has involved consideration of a number of significant issues. These include:

- the procedures for approval of the facility;
- the adequacy of the information provided to directors;
- the adequacy of security;
- the quality of the decision made by directors; and
- the conduct of management following approval.

Counsel for the directors (other than Johns) and Tricontinental staff submit generally that Mr Johns’ involvement in negotiations and in the introduction of EDL as a purchaser of Intellect was more significant than the limited role which counsel assisting suggest he played. They contend that approval of the facility to EDL was not governed by the usual guidelines applicable to a loan approval (because it was a workout situation) and that the facility was unique in many respects.

(a) **Procedures for approval of the facility**

Mr Mountford conceded that the EDL proposal was completely ungoverned by any guidelines. This was undoubtedly true as it was not presented to directors as an ordinary credit proposal. Counsel assisting submit that Tricontinental saw an opportunity to off-load its bad debt in Intellect by making its purchase a condition of approval for the Mainsel increase and extension. It is argued by counsel assisting that there were no pre-existing policies and guidelines which would have provided a proper framework within which directors could make a decision on a submission such as this.

Counsel assisting note further that the usual procedures for obtaining credit approval were not followed. The original credit submission for $8.5m was not in the usual form or recommended by the credit committee.
Counsel for the directors submit that counsel assisting’s submission misunderstands the circumstances surrounding this transaction. They argue that the approval of the facility to EDL should be viewed in the context of a workout situation. Tricontinental was facing a potential bad debt with Intellect, and EDL found itself in a vulnerable position in March 1989. Tricontinental had an opportunity to get rid of its potential bad debt. In these circumstances, counsel for the directors argue it is hardly surprising there was an absence of guidelines. Such an unusual submission required directors to look at all the material available to them at the time, and to consider the merits of approving or rejecting the facility as a special case.

(b) Adequacy of information provided to directors

Counsel assisting submit that the memorandum of 17 March 1989 failed to provide adequate information in that:

(i) it failed to disclose a lending/security ratio, which would have highlighted the extreme variance between the value of the assets being sold and the sum being paid for them (even using the accountants’ valuation of $3.03m at 4 March 1989, the lending/security ratio was 215% on $8.5m and 313% on $9.5m);

(ii) it failed to disclose the facility extended to Magic Millions as a related exposure; and

(iii) servicing and repayment capacity of the borrower was not adequately covered, nor was there any analysis of the borrower’s credit history.

In reply, counsel for the directors submit that the information contained in the credit memorandum of 17 March 1989 may have been supplemented by information provided by Johns (who was, in effect, the account manager) or Mountford.

(c) Adequacy of security

Counsel assisting submit the security taken was wholly inadequate. The primary security was the charge over the assets to be acquired. EDL had
already given charges over its assets in favour of BNZ. This fact had been notified to Tricontinental (Hunter) by Corrs on 26 April 1989 and Mr Mountford had been informed without apparent response. Counsel note the business of Intellect had been deteriorating markedly, to the certain knowledge of Tricontinental, and that this was the very motive in selling to EDL. The assets were valued at $2m in a bad market and it was highly likely things would only get worse. They did, and the assets were ultimately realised for only $US500,000 in October 1990.

Counsel assisting note further that the guarantee from EDL was not valued for security purposes, and it was only as strong as the Essington group itself. At the time Tibham had failed to repay the $20m facility for the Ariadne shares. Both the Tibham and Mainsel projects were in great trouble, neither having secured development approvals or joint venture parties and/or take-out finance. Counsel submit directors should have been aware of all these factors. The later substitution of the Tibham guarantee was done without directors' knowledge or approval. In this context it should be noted that Tibham was a single purpose entity of little financial worth. In any event, Tricontinental later agreed to EDL's request that the requirement that Tibham provide a guarantee be removed.

Counsel assisting also submit that the suggestion that $4m (later $5m) could be obtained as "profits generated from on-sale" of the Tibham/Mainsel projects was quite unrealistic in all the circumstances then faced by the Essington group and Tricontinental. Counsel contend this prospect could provide no real comfort to directors. At best, Tricontinental had $2m to secure its facility of $8.5m (later $9.5m) at a time when the Essington group was facing a bleak outlook.

(d) Quality of the decision made by directors

Directors considered this proposal along with that for Mainsel. Accordingly, counsel assisting submit that their decision-making process must be seen in
that context. With security in real assets valued at $2m, to secure an $8.5m facility, reliance for repayment was effectively placed on sources external to the business being purchased. Tricontinental was exposed to the Essington group for more than $134m (assuming the Mainsel increase was granted). It is submitted that, in these circumstances, extending further funds to EDL did nothing more than expose Tricontinental to a greater loss. Counsel assisting submit it was imprudent, a breach of duty and a failure of commercial judgment for directors to have approved the facility. They further submit that the decision of directors to approve the facility was a significant cause of the loss suffered.

Counsel assisting sum up the situation by recalling that in June 1988 Tricontinental faced the prospect of a $1.24m loss on the Chew/Lynette Robyn facilities (after realisation of security). By taking the ultimate course which it did - providing facilities totalling $10m to Intellect and Katanning and providing EDL with $9.5m, $6.5m of which was to purchase the assets of Intellect - Tricontinental face a loss of approximately $15m. The loss comprises approximately $2m on the Intellect facility, $3.5m on the Katanning facility and $9.5m on the EDL facility.

Counsel for the directors submit that counsel assisting’s arguments are based substantially on hindsight and not upon information which was known at the time. They also submit that the rationale behind EDL paying a premium for Intellect (at a price considerably in excess of market value) was because Intellect formed part of EDL’s plans for an entertainment division. In other words, the purchase of Intellect by EDL was part of an overall market strategy of EDL which would, ultimately, result in the sale of Intellect to Ariadne at a substantial profit to EDL. In addition, counsel argue, it was perceived at the time that the merger of the two entities would add value to the Essington group. Counsel impliedly contend directors would have been motivated by these considerations. However, EDL were only purchasing the assets of Intellect not Intellect itself. It should be noted, further, that Mr Edwards did
not confirm the suggestion contained in the credit memorandum that Essington was purchasing the business of Intellect as part of a plan to establish an entertainment division. He said that his motive in agreeing to the deal was to ensure Tricontinental's continuing support of the Essington group's projects (see paragraph 30 above).

Counsel for the directors further submit that, in contending that directors have breached any duty owed to the company by making a "failure of commercial judgment", counsel assisting appear to equate lack of prudence with negligence. Counsel for the directors argue that the standard of reasonable care and diligence is not a standard of perfection and that an error of judgment or a wrong decision is not necessarily negligent.

In response to the submission of counsel assisting that Tricontinental lost approximately $15m (see para 42 above), counsel for the directors and managers submit that there is no evidence as to the loss sustained, if any, by Tricontinental. In any event, counsel submit, if there was a loss, there was no sufficient evidence to enable this to be attributed to the decision of directors to advance the facility to EDL.

(e) Conduct of management following approval

Mr Mountford took it upon himself to remove covenants relating to reporting conditions. His reason for doing so was that, by that stage, he believed EDL would close the business down. Counsel assisting concede there was a basis for this belief and that, given the continuing losses under the receivership, it was difficult to see how EDL could turn the business around.

At the borrower's request, Mr Mountford also agreed to accept a guarantee from Tibhamb rather than EDL without further reference to the board. Counsel assisting note that, in theory, this provided Tricontinental with less security, but it had little practical effect. Nevertheless, counsel assisting submit that Mountford had no authority to make such changes and should not have done
so without approval from the board. This was said to be another example of a lack of a clear board guidelines to govern the exercise of managerial ‘discretion’.

I. **Conclusions and Findings**

It seems that Tricontinental may have lost some $15m over this series of transactions. The first point to be noted is that Johns went to some pains to conceal from his fellow directors the fact that he was entering into an arrangement with Rothwells to exchange some potential bad debts. In an attempt to avoid a probable loss of $1.24m, Tricontinental lent a total of $10m to two Rothwells subsidiaries.

In the process of trying to rid itself of this liability, Tricontinental lent to EDL $9.5m. It did so in the last few weeks of its existence, at a time when managers, and particularly Johns and Mountford, were working under great pressure. The result was that the credit memorandum, put forward by Johns and Mountford, was more than usually deficient in information. It even omitted to mention the amount and nature of the facility proposed.

The idea that Essington was an appropriate purchaser of a non-performing loan which Tricontinental wished to remove from its books, was extremely doubtful. Essington was in serious difficulties with other projects to which Tricontinental was very heavily exposed, and its willingness to take on this liability, in return for an urgently needed increase in one of its existing facilities, was a measure of its desperation.

The security for the facility was minimal and it is very hard to understand, looking back on the matter, why directors were prepared to approve the arrangement. The best that can be said for them is that they continued to trust, and be persuaded by, their senior managers.
The Commission accepts that Mr Mountford believed that what he was doing was in Tricontinental’s best interests, although it is difficult to see how this could be so. It cannot be sure of Mr Johns’ motives, particularly in the absence of any evidence from him, but it seems reasonable to assume that he was always reluctant to accept a bad debt on Tricontinental’s books, and invariably preferred to try to negotiate some deal which at least delayed the day of reckoning and might, if all went well, avoid it altogether.
TRANSACTION REPORT 6

DIRECT ACCEPTANCE CORPORATION LIMITED
AND RELATED COMPANIES

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A. Background and Summary

1 Direct Acceptance Corporation Limited (‘DAC’) was a publicly listed finance company which was incorporated in 1926. Mr Raymond Lord and some associates of his gained control of DAC in mid-1985.

2 The transactions examined by the Commission involved four separate groups of companies. The common characteristic of each group was its shareholding in DAC. The groups were:

- the Smith and Lane group, including Smith and Lane Holdings Limited (‘SLHL’), a company associated with Lord which, between October 1985 and May 1989, held between 32 and 85% of DAC’s issued capital;

- the Rocado group, principally Rocado Investment & Finance Limited (‘RIFL’), but including six other companies: Churchill Leisure Industries Ltd (‘CLIL’), Amaldela Pty Ltd (‘Amaldela’), Rocado Holdings Pty Ltd (‘Rocado Holdings’), Lidala Pty Ltd (‘Lidala’), Bosane Pty Ltd (‘Bosane’) and Boley Holdings Ltd (‘Boley’); and

- the Duke group of companies. The Duke group’s association with Tricontinental developed in early 1988 through a proposed merger with DAC and a series of transactions which were designed by Mr Johns to resolve Tricontinental’s problem loans to SLHL, Rocado Holdings, Amaldela and CLIL.

3 Tricontinental advanced over $104m to DAC and these various related companies between late 1985 and mid 1989. These advances resulted in losses of approximately $77m as follows:
Tricontinental's loans were granted for the purpose of financing the acquisition of shares in DAC, and other related investments including interests in overseas casinos. The DAC group's major assets and source of cash flow were from its related investments, finance business, shareholdings and casino interests in Turkey, U.S.A. and the Caribbean.

Security for the loans granted by Tricontinental generally consisted of:
(a) first registered mortgages over DAC shares; or
(b) registered charges and mortgages over casino interests.

The value of DAC shares declined in 1986 and early 1987, and declined further as a result of the stock market crash in Australia in October 1987. The fall in share value resulted in breaches of security covenants on the various facilities to the DAC group. Interest payments due on the facilities were frequently in arrears.

Mr Johns was the account manager and the facilities were margin lending transactions.

In 1988 Tricontinental attempted to reduce its exposure to the DAC group by selling to the Duke group the DAC shares held as security, at a price of 70c per share. The sale was funded by Tricontinental itself providing facilities to the Duke group. At this time the market value of DAC shares had fallen to 22-25c. Full disposal of the shares was frustrated because of
the inability of the Duke group to purchase further DAC shares without making a formal takeover offer, and the later liquidation of the Duke group. Tricontinental provided two facilities totalling $21.55m to the Duke group in 1988 and 1989, both related to the proposed merger. Tricontinental has not recovered any part of this amount.

As a result of defaults on Tricontinental facilities to these companies, Tricontinental now effectively controls 79% of DAC's share capital. The total losses recognised from all these related facilities amount to $56m.

B. Chronology

The chronology of relevant events is as follows:

July 1985    SLHL gained control of DAC from TAL Holdings Ltd (Ipec Group)
October 1985 Tricontinental approved a $20.8m facility to Rocado Holdings to assist in purchase of Enacon Ltd shares, and a $20m facility to SLHL for the same purpose
March 1986   Tricontinental approved facilities to RIFL of $1.25m and $4m to assist with the acquisition of DAC shares
April 1986   Tricontinental approved a $16m letter of credit/guarantee to RIFL to fund a preference share issue
May 1986     Tricontinental approved a $2m facility to RIFL to purchase additional DAC shares
July 1986    Tricontinental approved a $4.3m facility to Amaldela to assist in acquisition of an interest in a Caribbean casino development
August 1986  Tricontinental approved a US$4.5m facility to SLHL to refinance the acquisition of an interest in a US casino site
October 1986  Tricontinental approved a $20m facility to DAC to assist in the Enacon Ltd takeover bid ($7m utilised)
November 1986  Johns requested Clark to prepare a report on DAC's 1986 Annual Report
December 1986  Tricontinental approved a US$3.3m facility to CLIL to fit out the Caribbean casino
June 1987  Amaldela facility went into default
June 1987  CLIL facility went into default
June 1987  RIFL facility in default due to non-payment of interest
February 1988  Tricontinental board approved the sale of RIFL security to Duke Securities and Tricontinental Australia Limited ("TAL")
April 1988  Tricontinental entered into a 'workout' arrangement with RIFL. Duke obtained $11.55m facility from Tricontinental to purchase 16,500,000 DAC shares; TAL purchased the remaining 9,300,000 DAC shares for $6.55m
June 1988  TAL recorded a $2.5m provision for diminution in value of DAC shares. Tricontinental provided $1.5m for RIFL write-off
January 1989  SLHL's $20m facility in default
April 1989  DAC announced the proposed Duke-DAC merger, with Tricontinental to underwrite a debenture issue; Tricontinental provided Duke with $10m facility
May 1989  Tricontinental provided DAC with $3m facility to meet cash flow problems
Provisional liquidator appointed to Duke Securities
C. Narrative - Initial Facilities for Enacon Bid

In late September 1985, Mr Peter Hunt and Mr Stephen Matthews, directors of Rocado Holdings, met Mr Johns in Melbourne for the purpose of discussing a proposed facility to enable Rocado Holdings to acquire a strategic interest in Enacon Limited (‘Enacon’). After a meeting lasting over two hours, Mr Johns tentatively approved a $20.8m facility to support the acquisition of an initial 20% stake, and sufficient funding to allow for a takeover offer for Enacon.

$11.4m was drawn down by Rocado Holdings to fund the acquisition of 19% of Enacon. The relevant credit submission, if it exists, has not been located by the Commission’s investigators. Mr Ryan had no specific recollection of Johns ever consulting him about the facility, although he did say that it would be extraordinary for Johns to have given verbal approval in the manner described by Hunt.

Following the approval of the initial facility to Rocado Holdings, Hunt approached Mr Raymond Lord to inform him of the opportunity that existed in relation to Enacon, and introduced Lord to Johns. Lord later sought, on behalf of SLHL, a $20m facility from Tricontinental to finance the acquisition of a 19% strategic stake in Enacon. This facility was approved in October 1985, although the SLHL-owned shares were acquired at a higher average price than the Rocado-owned shares. The relevant credit submission relating to the facility granted to SLHL, if it exists, has not been located by the Commission's investigators.

Mr Ryan had a limited recollection of these facilities, other than recalling the names of the borrowers. He had no specific recollection that Tricontinental was taking, as security for the two advances, up to 40% of the issued capital of a company. He was uncertain as to whether he was
aware of the problems associated with Tricontinental taking security over more than 20% of the issued capital of a company, and expressed some surprise that it was apparently not until 1988 that any legal adviser to Tricontinental raised the legal significance of such security.

Mr Moyle, when questioned about these facilities, said that he was aware as early as late 1985, or early 1986, that Tricontinental was financing strategic holdings of shares, particularly where the shares were already the subject of a takeover bid.

Mr Moyle said that he was not aware of the approval of the facility to Rocado Holdings in October 1985 to purchase a strategic interest in Enacon, and agreed that short cuts must have been taken by Johns for the facility to have been approved in the time frame described by Mr Matthews.

Mr Matthews was questioned at some length as to whether there was any common purpose or understanding between himself and Lord in relation to their respective acquisitions of strategic stakes in Enacon.

Although the evidence arouses suspicion, there is not sufficient evidence to find that there was a common purpose or understanding between Rocado Holdings and SLHL in acquiring their respective interests in Enacon, giving rise to an "association" within the meaning of s7 of the Companies (Acquisition of Shares) Code and s136 of the Companies Code.

Ultimately the strategy of Hunt and Matthews failed, because Mr Lee Ming Tee, who had a controlling interest in Enacon, made a placement of 10% of the issued capital to friendly parties and ceased all dividend payments.
When Mr Tee later made a bid for Enacon, Matthews was unable to accept the bid on behalf of Rocado Holdings because Tricontinental was holding the scrip, and Johns refused to agree to a sale because of the negative impact a sale would have had on SLHL's holding, which had cost well above the 90c that was being offered by Mr Tee. Mr Matthews estimated the average cost per share for SLHL's acquisition in Enacon at approximately $1.30-$1.40.

Later it was decided that DAC would bid for Enacon. Tricontinental approved a $20m facility for this purpose in October 1986. This credit submission was approved by Johns, Moyle and Rawlins. The takeover bid was not successful.

Mr Moyle acknowledged in his evidence that the credit submission for this facility contained very serious omissions, in that it did not refer to Tricontinental's exposure to DAC through the SLHL and Rocado Holdings facilities, which were secured by shares in DAC. He further said that it may have influenced his decision when approving the facility had he known more about DAC, particularly the allegation that 40% of DAC's total assets comprised loans to director-controlled companies.

In November 1986, Johns requested Clark, a credit analyst, to prepare a report on DAC's 1986 annual report. The report notes a number of serious misgivings held by Clark about the financial position of DAC. In particular, at page 2 of the report he observed:

"Secured corporate loans of $24.8m as at 30 June 1985 comprised $24m to Elsea Holdings Limited (the old Ipec), whereas the amount of $27.9m as at 30 June 1986 comprised $19.8m to director controlled companies. The worrying aspect about this, apart from credit quality/conflict of interest, is the reduced income generated from these loans in 1985/86 ($3.2m) compared with 1984/85 ($8.4m). Part of the explanation for this could be that there was a timing delay between
Clark also observed in his report that the profit from the Turkish casino operations controlled by DAC had declined.

Mr Ryan in evidence agreed that the internal review was never brought to the attention of the board. He said that he would have expected the information contained in the report to be included in any later credit submission relating to DAC. Further, Mr Ryan said that he would have expected that a report of this type would have been brought to the attention of the board by Johns in any event.

Mr Moyle said in evidence that he had no recollection of the report prepared by Clark being brought to the attention of the board. He said that he would have expected Johns to inform the board of any deterioration in the position and financial condition of DAC which was revealed by the report prepared by Clark. Mr Moyle further said that the credit submission dated 4 February 1987, submitted to directors seeking approval for an amendment to the existing facility, should have included the concerns expressed by Clark in the internal review.

D. Narrative - Facilities to Rocado Investment & Finance Limited

Tricontinental Securities Limited ('TSL') was retained by RIFL to advise and to underwrite its restructure, which was anticipated to be completed by June 1986.

Mr Hunt had previously known Johns from his (Hunt's) role as general manager, corporate services at Tricontinental's Sydney office from 1982 to 1984.
Mr Johns was appointed group managing director of Tricontinental on 1 January 1986, one week after accepting an appointment to the board of RIFL. Mr Matthews viewed the appointment of Johns to the RIFL board as a statement of partnership between Rocado and Tricontinental. Mr Hunt said they invited Johns to join the board as it was seen as advantageous to RIFL to have him familiar with its objectives and strategies. Mr Matthews also said that, while Johns sat on the board of RIFL, he effectively left the critical decisions about asset purchases to be made by Matthews and Hunt. All decisions, however, were taken to Johns for his ratification.

Tricontinental provided four facilities to RIFL in 1986. The first was a $1.25m facility, approved in March 1986, to assist RIFL in the purchase of 5,000,000 rights in DAC. Security for the facility was to be the lodgement of these rights, together with signed blank transfers, and the lodgement of 4.87m fully paid ordinary shares in Westcoast Holdings Ltd with signed blank transfers. The value of these securities, as recorded on the credit submission, was $2.711m.

Mr Johns approved this facility under his discretion as managing director. He was at this time a director of RIFL and declared that interest in the credit submission.

Mr Ryan said that he could not recall being aware of Johns using his discretion to approve loans to a company of which he (Johns) was a director, and that he would not have done so if he had been in Johns' position, even if his interest was declared in the credit submission. In effect, all Johns was doing was declaring the interest which he had in RIFL to himself. Mr Ryan said that, in his view, it was not appropriate for Johns, being a director of RIFL, to approve the facility without it also having been approved by another director of Tricontinental.
Mr Moyle said that, in his view, it was inappropriate for Johns to approve a loan under his discretion as managing director to a company of which he was a director.

The letter of offer to RIFL for the $1.25m facility was dated, and accepted by RIFL, on 7 March 1986. A credit submission was later prepared and circulated to the credit committee on 12 and 13 March.

The second 1986 facility to RIFL was a $4m facility, also approved in March, to assist in the conversion of 8,000,000 rights in DAC to fully paid shares. This facility was approved by Johns, Ryan and Moyle and noted by the board in April 1986.

Mr Ryan agreed that this credit submission was inadequate as it contained no financial information concerning RIFL. He said that he was sure he would have discussed the matter with Johns before approving the credit submission, although he could not specifically recall such a discussion. He further said that he must have been satisfied by Johns' explanation as to why the loan facility should be approved.

Mr Ryan also said that he was not aware, at the time of approving the credit submission, that Tricontinental had also provided a facility to SLHL to acquire shares in Emacon, which had a major shareholding in DAC. He said that this was the sort of information which he would have expected to be incorporated in the credit submission. He said that related exposures included not only moneys lent to related borrowers, but also moneys lent to a borrower who offered as security equity in a company to which Tricontinental already had an exposure.

Mr Moyle agreed that the credit submission was very thin in the area of financial information about the borrower. He also said that he had accepted the statement contained in the submission that the source of
repayment for the facility was to be a $5.2m advance from the Commonwealth Trading Bank, to be made available by 31 March.

The third facility to RIFL was a $16m letter of credit/guarantee facility, approved in April 1986, to facilitate a preference share issue. Proceeds of the issue were to be used to reduce the existing debt ($11.41m) of RIFL's subsidiary, Rocado Holdings, as well as to reduce RIFL's debt by $4.45m. The facility was approved by Johns, Ryan, Carr and Moyle and noted by the board in May 1986. Johns declared his interest as a director of RIFL.

Mr Ryan said he remembered discussing this credit submission with Johns. He added that, although there were no details of DAC's financial position or capacity to maintain dividends (upon which the facility was to be serviced), he believed there was only a marginal increase in exposure overall, and a change from actual exposure (to Rocado Holdings) to a contingent one. He recalled that Johns was confident about the proposal. He particularly remembered discussing this facility with Johns as the facility was different, in that it provided a letter of credit against dividend flows on preference shares.

The final RIFL facility in 1986 was a $2m bridging facility, approved in May, to fund the purchase of additional DAC shares. By this time, RIFL had acquired 22 million DAC shares, which Tricontinental had accepted as security for the four facilities. Mr Ryan appeared to be the only director who approved this facility.

This facility was to be a bridging facility for 47 days, and repayment was to come from the proceeds of a one-for-five rights issue, which would raise $1.6m and would be underwritten by Kimberley Securities Limited.

In June 1987, RIFL defaulted on Tricontinental loan facilities totalling $19.7m. In February 1988, the board approved a 'workout' arrangement
proposed by Johns, with Tricontinental taking possession as mortgagee of 26,000,000 DAC shares held as security. Tricontinental then funded the sale of the DAC shares to Duke and TAL (at an over-valued 70c per share) so as to "recover" $18.1m of the facility and reduce the RIFL write-off to just $1.5m.

E. **Issues Arising from Tricontinental’s Assessment of Credit Risk - RIFL**

By early 1986, the strategy of Hunt and Matthews had moved towards obtaining a major shareholding in DAC. No credit analysis of DAC, or of the wisdom behind RIFL’s acquisition of a strategic shareholding in DAC, was undertaken by Tricontinental.

Security cover afforded by DAC shares was calculated incorrectly on later credit submissions to extend the facility, when sale rather than buy prices were used. The credit submissions also failed to draw attention to the declining value of DAC shares and the infrequency with which they were traded. Mr Moyle conceded that the primary emphasis in making an assessment of margin lending facilities was upon the security, ie the shares themselves, rather than the capacity of the borrower to meet the commitments.

RIFL’s intention to service its own preference share dividends with dividends from DAC was noted in the credit submissions, and compounded Tricontinental’s exposure to the performance of DAC. Such dividends were not received from DAC, due to its poor financial performance.

Mr Matthews agreed that the failure of Enacon and DAC to declare and pay dividends to Rocado Holdings and RIFL led to the inability of those companies to pay interest on Tricontinental borrowings, and to their subsequent defaults.
RIFL was unable to meet demands for additional security as the margin shortfall increased to $8m by February 1987. Johns was aware, by May 1987, that RIFL did not have sufficient funds to pay dividends on its preference shares. This prompted his first request, expressed as urgent, for full details of RIFL's assets and liabilities. Financials had not been considered important in earlier credit analysis.

Mr Moyle agreed, in his general evidence, that credit evaluation of the borrower, in addition to looking at cash flow, should also extend to an understanding of its balance sheet and the capacity of the borrower to realise substantial sums at short notice. However he added that, in the case of listed shares, the market value would normally reflect the underlying value of the shares.

Loans advanced to fund DAC share purchases relied upon a continuing strong market. The DAC share price was steadily in decline before the October 1987 stock market crash. RIFL's 30% holding in DAC was a minority stake and could not be traded on the open market at full value. These factors were not examined in any credit analysis. There similarly was no recognition in Tricontinental board papers of the adverse effect of the stock market crash on the value of the security. Board reports from October 1987 onwards referred to a possible bid for the DAC shares at 70c per share.

Tricontinental's attempt to enforce the RIFL security by sale of DAC shares to Duke Securities was funded by a low interest loan of $11.5m. This workout scheme was approved by the directors in February 1988, on the basis of a short report tabled at a board meeting, without sighting any supporting documentation or analysis.
52 Mr Ryan said he was surprised that Duke Securities would want to pay 70¢ for DAC shares, but he recalled that Johns told the board that the back door listing of Duke Finance was an added attraction to the proposition.

53 Mr Moyle requested Johns to get legal advice on the transaction to make sure it did not contravene the Takeovers Code.

54 Mr Ryan said the board gave 'in principle' approval to go ahead with the $11.5m facility for Duke Securities as there did not appear to be any problems with it, and Tricontinental would be getting something out of nothing. (See Section T below - The Duke Group Workout Arrangements.)

F. Issues arising from Monitoring of RIFL Facilities

55 Loans advanced to RIFL and its related companies during this period totalled over $30m. Johns acted as the account manager and supervised the loans almost exclusively.

56 Despite consistent security shortfalls from mid-1986, margin calls were not made until November 1986, when Johns announced his resignation from the board of RIFL. Mr Matthews said that Johns had been invited to join the RIFL board as it was seen as an advantage to have the continuing banker to the group on the board. Mr Ryan said Johns had no authority or discretion to decide not to make a margin call when there was a security shortfall.

57 Payment of RIFL interest, due for the period May/June 1986, was deferred by Johns until July 1986.

58 The security for RIFL's facilities included shares representing about 30% of DAC's issued capital. Together with SLHL's DAC security, Tricontinental held over 60% of DAC's issued capital as security for its
Tricontinental held over 60% of DAC's issued capital as security for its loans. If the additional 14.9 million DAC shares held by Tricontinental as security for SLHL's facility from mid-1987, but never mortgaged to Tricontinental, are also taken into account, Tricontinental held 82% of DAC's issued capital.

Mr Moyle said he was not aware at the time that Tricontinental was holding over 50% of DAC's issued capital, and only became aware of it in the course of the Royal Commission's proceedings.

However the margin lending reports, which went to the board quarterly, had been requested by Moyle. They consistently noted that Tricontinental held over 60% of DAC's issued capital from March 1987 to August 1988. This is particularly significant in the light of the fact that, in March 1987, the board decided that the maximum security exposure to any one company was not to exceed 5% of that company's issued capital.

Tricontinental's board papers continued to assert that no loss was expected, due to the proposed sale to Duke of DAC shares held as security. Johns assured the board, from August 1987 onwards, that a sale of the security had been negotiated and that no loss was anticipated.

Mr Moyle agreed, in relation to the RIFL workout, that there was no financial information to assist the board in making a decision as to whether Duke Securities was financially viable and able to undertake such a borrowing. Mr Moyle believed the board took comfort from the fact that it was a short term facility for 6 months, and the board paper stated there was $40m available within DAC to ensure the repayment.

However, Mr Moyle conceded that there was nothing to prevent DAC from using the $40m in some other way, which would effectively defeat Tricontinental, as there was no charge over the money. The statement that
DAC controlled $40m in cash was not challenged by anyone, but it contradicted available accounts which showed cash deposits of $2.9m.

The sale of the remaining 9,300,000 DAC shares to TAL for $6.55m was not critically examined by the board. Just three weeks after this transaction was completed, a provision of $2.5m was raised in TAL's books, as the DAC shares were purchased at above market level.

G. Significant Issues Concerning RIFL

Counsel assisting submit that the board failed to exercise the degree of care and diligence required by s229(2) of the Companies Code in failing to ensure that appropriate policies and guidelines were formulated and implemented in relation to margin lending and lending against shares as security. They further submit that, in the absence of appropriate policies and guidelines, the approving directors ought to have obtained independent verification that the proposed security was adequate. They argue that the approving directors not only failed to obtain any independent verification of the security, but approved the facilities in the absence of sufficient financial information relating to RIFL - in particular its ability to service the loans and ultimately to repay them. They also submit that the directors failed to take account of the declining value of the security, and the difficulties Tricontinental would inevitably encounter in realising such a large parcel of shares, if that became necessary.

Counsel assisting also contend that Johns displayed a serious lack of judgment in accepting appointment as a director of RIFL and continuing to approve loans to RIFL within his own discretion. Other members of the board were also in error when they condoned his serving on the board of a major borrower.
Counsel for the directors, on the other hand, submit that Johns, having accepted an appointment as director of RIFL, had access to all relevant information about RIFL, and would have been fully acquainted with its operations and financial position. They submit that Johns, as account manager for the RIFL facilities and a director of RIFL, was in a unique position to inform the board of Tricontinental about such matters. They further submit that any omissions or errors contained in the credit submissions for the RIFL facilities must ultimately be the responsibility of Johns.

Counsel for the directors also contend that the problem loans reports and summary of non-accrual loans, submitted to the board, told the board that management was closely monitoring RIFL's position and that no loss was anticipated on the facilities. They submit that the directors were not required to go behind those reports when there was nothing to suggest that management was in any way failing to inform the board fully, or was misleading the board, as to the true position of the RIFL facilities.

Counsel for the directors submit further that Johns ought to have reported to the board the difficulties confronting RIFL in servicing its debts to Tricontinental. They submit that, in failing to report these difficulties to the board, Johns failed adequately to perform his roles as account manager of the RIFL account and managing director of Tricontinental.

**H. Conclusions and Findings Concerning RIFL**

In the view of the Commission, it was probably inappropriate for Mr Johns to serve as director of a major borrower, and it was quite wrong for him, while exercising his delegated power to approve a loan, to do so for a company of which he was a director. The fact that he declared his interest is not to the point, because that would not come to the notice of any of his fellow directors. He should have passed the responsibility for approving
the loan to another director or, at least, involved a second director along with himself. Mr Johns was also at fault in failing to make a margin call, and in deferring an interest payment, while in this conflict of interest situation.

There is clear evidence in these RIFL transactions that credit submissions were inadequate; see paras 36, 38, 40, 45, 48 and 50 above. Mr Johns' knowledge of RIFL and its affairs, gained as one of its directors, was not reflected in the credit submissions. He must accept primary responsibility for these inadequacies. Directors should also have required correction of the obvious defects.

In fact, almost total reliance was placed upon the security of shares - in this case DAC shares. Undoubtedly the worst aspect of credit risk management in relation to these RIFL transactions was the very large number of DAC shares accepted as security. These totalled 25.8 million, or 30% of DAC's issued capital. When added to SLHL's DAC share security, Tricontinental held over 60% of that issued capital as security for its loans. This made it quite impossible for Tricontinental to realise anything like the market price of the shares, which was itself depressed. Yet none of the credit submissions attempted to analyse the risks involved in taking additional shares as those figures were built up.

Finally, the so-called workout scheme was completely artificial, calling as it did for the Duke group to pay a greatly inflated price for the DAC shares. This is dealt with at the end of the present transaction report.

I. Narrative - Facility to Smith and Lane Holdings Limited

As previously noted, Tricontinental provided a $20m facility to SLHL in October 1985 to assist in the purchase of up to 19.9% of Enacon. This facility was later amended and extended in 1986, 1987 and 1988. The
$20m facility was drawn down to $15m, which was used to purchase 12.1m shares, as well as some 5.5 options and notes in Enacon.

In July 1986, SLHL accepted a share swap offer by which it received one DAC share for one Enacon share. It is not clear how many shares were swapped, because Tricontinental retained 12m Enacon shares as security.

In August 1986, Ryan and Moyle approved a submission which provided for:
(i) A one year extension of the $20m facility;
(ii) A change in purpose for the $5m undrawn portion of the $20m facility, which was to be used to refinance a $5m facility provided by CIBC;
(iii) A new facility to guarantee a US$4.5m ($A7.7m) loan provided by CIBC to assist with the purchase of a US casino, secured by a charge over the casino; and
(iv) A change in security from ordinary shares, options and convertible notes in Enacon to a first registered mortgage over 12 million ordinary Enacon shares and 16 million ordinary DAC shares.

No analysis of the effect of the stock market crash on the value of DAC shares was undertaken at this time.

In late October 1987, Johns, Ryan, Rawlins and Smith approved a credit submission which indicated that the maximum exposure was to be reduced to $20m and proposed a six month extension. The facility was in fact reduced to $20m by 2 November 1987. The usage of the original $20m facility had been reduced to $17m during October 1987, the payment under the guarantee had been $A5.015m - not the full amount of $7.7m, and $2.015m which had been held on deposit had been applied to reduce the facility. No analysis of the effect of the stock market crash on the value of DAC shares was undertaken at this time.
In April 1988, it was proposed that the facility be extended for one month, to enable the workout arrangement involving the sale of DAC shares to Duke Securities to be effected. Johns, Ryan, Moyle and Smith approved the extension in early May 1988. A further one month extension was approved by Johns, Ryan and Carr in early June 1988. In July 1988 the facility was further extended to September 1988, awaiting completion of the proposed DAC-Duke merger. Johns, Ryan and Carr approved this extension. The Tricontinental board noted all extensions.

J. **Issues Arising from Tricontinental’s Assessment of Credit Risk - SLHL**

At the time of the approval of the initial $20m facility in October 1985, SLHL was already diversifying its activities. For the year ended 30 June 1985 its net profit was $30,000. The financial statements for the year ended 30 June 1987, which were referred to in all credit submissions to extend the facility in 1987 and 1988, revealed net tangible assets of $5.42m. However, the net tangible asset position had clearly declined following the October 1987 stock market crash and, by 30 June 1988, was in fact showing a deficit of over $9m.

Mr Matthews said in evidence that Johns had been aware that the directors of SLHL had borrowed significant amounts from DAC. Mr Clark had pointed this matter out to Johns in a report he prepared on DAC in November 1986.

By late 1986 and early 1987, Tricontinental management was aware that its facility to SLHL was inadequately secured. In December 1986 Johns wrote to Lord seeking additional security to correct a security shortfall of $5.4m. Additional security was not provided. In February 1987 Johns again wrote to Lord about a $5.6m security shortfall. More DAC shares were offered by Torrna Trade Nederland B V ('Torma') as additional security. This resulted in Tricontinental holding over 80% of DAC's
issued capital as security for SLHL and RIFL facilities, although the shares from Torma were merely deposited with Tricontinental. No signed transfers or mortgage documents were obtained.

By October 1987, Tricontinental was holding about 43,000,000 DAC shares as security for the SLHL facility. Later credit analysis failed to examine adequately DAC’s performance. Mr Ryan said that an internal report on DAC, provided to Johns in November 1986, was never brought to the attention of the directors. He said that, if it had been, no further lending to DAC would have occurred without a thorough investigation. The report raised real doubts regarding the value of DAC’s investment in casino operations. Mr Ryan said these were matters which should have been included in any credit submission relating to DAC.

Following the share market crash in October 1987, repayment of the facility by sale of DAC shares was unlikely, as the shares went untraded on most days. No sensitivity analysis of the DAC share price or net asset backing for the shares was undertaken. The share price continued to fall throughout the term of the facility.

Mr Moyle agreed that the report on DAC prepared by Clark in November 1986 indicated that the information provided to directors, in credit submissions and in board papers, was misleading.

K. Issues Arising from Monitoring of SLHL Facility

Tricontinental held about 43,000,000 DAC shares as security for this facility. This represented about 50% of DAC’s capital. Although such a holding was contrary to Tricontinental’s guideline limiting security exposure to 5% of a company’s issued capital, and this exposure was contained in margin lending reports to the board, the issue does not appear to have been considered by either management or the board.
Mr Ryan, in evidence, agreed that it was not prudent for Tricontinental to hold 65% of DAC's issued capital in respect of advances to SLHL and RIFL (leaving aside the shares from Torna), but said that it was never a preconceived plan to finish up with this level of holding.

Mr Moyle, upon being shown the margin lending report for December 1987, did not recall having any conscious understanding of the level of shareholding held in DAC, which was shown as being 64.69% (and should have been shown as 82%).

In 1988 Johns attempted to reduce Tricontinental's exposure to SLHL by the sale of DAC shares to the Duke group. The board was kept informed of these workout arrangements. (See Section T - The Duke Group Workout Arrangements).

L. Issues Arising from the Monitoring of SLHL's Compliance with Security Covenants

In October 1987, Johns wrote to Lord seeking an executed mortgage over the DAC shares provided to Tricontinental by Torna by way of additional security. Although this executed mortgage was requested on several occasions it was never received.

A credit submission was prepared, in October 1987, to extend the facility for a term of 6 months. The credit submission referred to the DAC shares provided by Torna as part of the security, and was approved by Johns, Ryan, Rawlins and Smith.

Mr Ryan said in evidence that he had assumed, when giving his approval to the extension, that there was a mortgage over the additional 14,900,000 shares in DAC provided by Torna. He said that he was not aware that Tricontinental merely had possession of the share scrip and had no
mortgage. The credit submission simply referred to Torma as the 'registered holder'.

Mr Hunter said that he did not believe that the directors had been misled by the reference in the credit submission to the additional shares from Torma. He did agree, however, that it would have been misleading if the legal position had been that there was no power of sale over those shares.

There were continued security shortfalls in the SLHL facility. The share crash in October 1987 caused Johns to write to Lord seeking immediate payment of a security shortfall of $6.2m. In February 1988 Johns again wrote to Lord requesting a 'top-up' security of $2m.

No attempts were made after February 1988 to obtain further top-up security.

Although servicing of the SLHL facility ceased in July 1988, it was not included in Tricontinental's list of problem loans reported to the board until June 1989. At least $2.7m of interest income was incorrectly accrued, and non-accrual loans understated by $20m in Tricontinental records, from August 1988 until June 1989.

Mr Hunter said that, when the facility went into default in July 1988, Johns had instructed him to exclude it from the summary of non-accrual loans and the arrears reports to the board.

No provision for the SLHL facility was raised as at 30 June 1988 - on the basis that the loan was still performing at that stage.
M. **Significant Issues Concerning SLHL**

Counsel assisting submit that the board failed to exercise the degree of care and diligence required by s229(2) of the Companies Code in failing to ensure that appropriate policies and guidelines were formulated and implemented in relation to margin lending and lending against shares for security. They further submit that, in the absence of appropriate policies and guidelines, the approving directors ought to have sought independent verification that the proposed security was adequate. They contend that from July 1986, when DAC shares became security for the SLHL facility, directors in approving increases to and extensions of the facility, acted in the absence of sufficient financial information relating to SLHL and, in particular, its ability to service the loans and ultimately repay them. They further submit that the approving directors failed to take account of the declining value of the security and the ability of Tricontinental to realise such a large parcel of DAC shares if it became necessary to do so.

Counsel for the directors submit that the facilities provided by Tricontinental to SLHL were appropriate commercial transactions, that Mr Johns had failed to inform the board fully of SLHL’s default, and that this was a major factor contributing to the loss suffered by Tricontinental in respect of the SLHL facilities.

N. **Conclusions and Findings Concerning SLHL**

This transaction illustrates again the way in which decisions were made by directors on inadequate information, some important matters having been withheld from the board by Ian Johns. It also illustrates how directors failed to make inquiries, or raise concerns, about potentially worrying matters which were placed before them.
The first point to be noted is that there were serious security shortfalls throughout the life of this transaction. Security shortfalls occurred from December 1986 onwards, often amounting to more than $5m. Johns demanded top-up security on a number of occasions and also requested SLHL to reduce the usage of its facility. The credit submissions never showed a shortfall of security. The submission prepared in October 1987 included as security the parcel of DAC shares registered in the name of Torna, over which mortgages were sought by Tricontinental but never provided. The evidence suggests that their inclusion as security may have been understood to signify that Tricontinental had a mortgage over them or at least the power to sell them. When credit submissions were prepared in April, May and July 1988, the price of the DAC shares had fallen. The charge over the casino in Nevada (not included in the calculations of security value in the October 1987 submission) was treated in the 1988 credit submissions as security worth US$49.5m. The charge may in fact be limited so that it constitutes security only for the guarantee facility of US$4.5m - not the whole of the facility. The position is further complicated by the fact that a party in the United States has claimed an interest in the casino which would prevent Tricontinental recovering the proceeds of its sale. The question of the scope of the charge and the claim by the other party are the subject of litigation in the United States. At first glance, it appears that the charge should not have been attributed a value for security purposes equal to the full value of the casino (and therefore that the credit submissions should have disclosed a security shortfall). But there is no evidence to suggest that Tricontinental knew, at the relevant times, that the charge might be of limited security value (which has not in fact been decided by the courts) or that it could be misleading to rely on the contracted sale price for the casino in calculating Tricontinental’s security cover.

No security shortfalls were brought to the notice of directors, a circumstance for which Mr Johns must take responsibility.
Mr Clark had made a useful report about DAC in November 1986, which drew attention to a number of the potential problems the company faced. None of this material was ever included in credit submissions or otherwise brought to the notice of directors. Finally, the share prices quoted for DAC in credit submissions were consistently the 'sell' price. There was, in fact, very little trading of the shares during the period, and the sell figure was obviously unreliable - particularly in view of the fact that the great majority of DAC shares were controlled by Tricontinental.

This was a circumstance which was known to the board, because of the periodical margin lending reports which were presented, at Mr Moyle's request, after the stock market crash.

In spite of this there is no evidence that the board ever discussed the fact that it was holding 65% of the shares in DAC and, if the Torna shares were added, 82%.

In view of the total exposures of Tricontinental to DAC-related companies, it seems quite extraordinary that there was never any call by directors for better financial information or analysis.

**Narrative - Facility to Amaldela Pty Ltd**

In July 1986, Johns and Ryan approved a $4.3m facility to Amaldela to assist it to acquire a 13.33% interest in Dutch Hotel & Casino Development Corp N V ("Dutch Co").

Dutch Co was proposing to undertake the redevelopment and refurbishment of a casino on the island of Aruba in the Netherlands Antilles.

The facility was to be for a term of 6 months and secured by:

(a) a registered charge over the shares in Dutch Co; and
(b) an assignment over funds to be raised by the flotation of CLIL, which was expected to raise $6m by mid October 1986.

The credit submission that was prepared was subject to a precondition to drawdown that Tricontinental was to receive confirmation of a firm underwriting agreement for the public flotation of CLIL, such underwriting agreement to be acceptable to Tricontinental. The precondition was omitted from the letter of offer which Johns signed. The credit submission also referred to a report of the project prepared by Howarth & Howarth (UK) which placed a minimum value of $10m on the shares in Dutch Co and the rights to the operating licence.

Amaldela had no independent capacity to service the facility. Mr Matthews said in evidence that the cash flow to satisfy interest payments was to come from the sale of Amaldela to a suitable listed structure and a later share issue.

Drawdown of the facility for the full amount occurred on 24 July 1986. The supposed precondition to drawdown was not dealt with until October 1986, and even then depended on Tricontinental receiving firm commitments for the majority of the underwriting exposure.

Mr Ryan gave evidence that, although he had some concerns about the facility and, in particular, as to whether Tricontinental ought to be funding off-shore casinos, he recalled that Johns had told him that the take-out was assured. Mr Ryan also placed reliance on the precondition to drawdown that there be a firm underwriting agreement in place for the CLIL float.

The Amaldela facility was approved shortly after the board introduced a new guideline requiring euro-currency borrowers to have a minimum net worth of $10m. Amaldela, being a $5 company, did not comply with this guideline.
Following several extensions of this facility in early 1987, it went into default in June 1987. Tricontinental delayed recognising a loss on the facility in its non-accrual loans reports. In June, July and August 1987, directors were told that directors of the company were actively pursuing refinance of the facility and no loss was expected. In September, October and November, they were told that the company was wholly owned by CLIL which was "subject to a takeover bid" and no loss was expected. The bid was never made.

Tricontinental has not recovered any part of this facility.

P. Significant Issues Concerning Amaldelia

Counsel assisting submit that the loss in relation to this facility occurred as a result of the failure of Mr Hunter to monitor the precondition to drawdown of the facility. A firm underwriting agreement for the public flotation of CLIL was not in place until October 1986 and, even then, was dependent upon Tricontinental receiving firm commitments for the majority of the underwriting exposure. They submit that, as Mr Hunter was responsible for the management of the securities division, which was an important aspect of Tricontinental's business, he was responsible for ensuring that no drawdown occurred until such time as the precondition had been fully satisfied. For these reasons they submit that Mr Hunter, as an executive officer of Tricontinental, failed to exercise the degree of care and diligence required by s229(2) of the Companies Code.

Counsel for the directors and Mr Hunter submit that the July 1986 credit submission, as presented to directors for their approval, was a commercial transaction. They submit that preconditions imposed by the board could not be waived by Tricontinental's management and, if the situation was that the precondition could not be met, then the facility should have been referred back to the board for further consideration. They contend that had
this procedure been followed, the Amaldela facility would not have been drawn down and no loss would have been sustained. They submit it was the responsibility of Mr Johns as the account manager for the Amaldela facility to ensure that the precondition was satisfied. They also argue that Mr Hunter was not an executive officer within the meaning of the Code.

119 Mr Hunter said that the precondition was not carried forward into the letter of offer, which was the document he referred to in monitoring compliance. This must have been due either to an instruction from Johns or a genuine mistake by an officer of his department. Such a mistake was unlikely, since it would have been checked by himself and Mr Stott. On the other hand, he did not know of any instruction from Johns.

Q. Narrative - Facility to Churchill Leisure Industries Ltd

120 CLIL, previously known as Pegmin Limited, was a publicly listed mining company. In late 1986, RIFL gained effective control of Pegmin and changed its name to CLIL. In October 1986, CLIL acquired from RIFL its casino and hotel interests for $2.5m. Hunt and Matthews were directors of CLIL, RIFL and Amaldela.

121 Mr Matthews gave evidence that he had a plan that involved incorporating the casino interests of DAC into CLIL and floating the company on a foreign exchange. He said further that Mr Johns had been involved in discussions relating to the plan for the casino interests.

122 In October 1986, Tricontinental agreed to underwrite the flotation of CLIL, the proceeds of which were identified as the source of repayment for the Amaldela facility approved in July 1986.
In November 1986, Ryan and Johns approved a facility for $5,084,570 to CLIL to provide bridging finance for several months, until the receipt of the proceeds of a rights issue to raise $5.4m, which was being underwritten by Tricontinental.

As a consequence of the approval of this facility, Tricontinental's exposure to Amaldela and CLIL was approximately $9m. The source of repayment for both facilities was the proceeds of the rights issue, which was to raise $5.4m. The credit submission contained a general condition that CLIL, in its capacity as holder of 100% of the issued shares of Amaldela, was to confirm that the existing $4.3m facility was to be refinanced by 31 January 1987 (expiry date). This was not included in the letter of offer. The credit submission referred to the related exposure of $20m to RIFL, $4.3m to Amaldela and $1.2m to Boley, making a total of $25.5m exposure to the Rocado group. Mr Johns did not declare his interest as a director of RIFL, but two days after approving the credit submission on 19 November, sent a memorandum to Mr Ziebell, recording his resignation as a director of RIFL on 18 November 1986.

The facility was extended in April 1987 for one month and was in default of interest payments by June 1987. Attempts to sell or restructure the debt were reported in board papers from July 1987 to June 1989.

R. Significant Issues Concerning CLIL

Counsel assisting submit that no prudent director of a merchant bank would have approved the CLIL facility and that Johns and Ryan failed to exercise the degree of care and diligence required by s229(2) of the Companies Code in approving the facility, in circumstances where CLIL had no capacity to repay the facility other than out of the proceeds of the proposed rights issue, which was also to be the source of repayment for the $4.4m Amaldela facility previously approved by them. They further submit that
the investments by CLIL in casino operations were speculative by nature, which required the approving directors to examine critically all aspects of the proposed facility and, in particular, the security and capacity of the borrowing entity to repay.

127 Counsel for the directors submit that the Amaldela and CLIL credit submissions are clear evidence of credit submissions which have been submitted to the board which are misleading and inaccurate in material ways. In particular, they did not disclose that the rights issue, shown as the source of repayment, was already committed to repay the Amaldela facility. They submit that Mr Johns as account manager is responsible for the board having been misled and provided with inaccurate information.

S. Conclusions and Findings Concerning Amaldela and CLIL

128 The main point to be made about the Amaldela facility is that there was a serious failure to enforce a precondition upon which the directors' approval had been based. This condition was that a firm underwriting agreement was to be in place before drawdown. In fact, drawdown occurred towards the end of July 1986, and the precondition had still not been met in October 1986. In that month steps were taken towards establishing an underwriting agreement, but it seems that Tricontinental never succeeded in obtaining the sub-underwriters that it was looking for.

129 The complete disregard of the precondition must be seen against a background in which a eurocurrency loan was being made to a $5 company, totally disregarding a recently introduced guideline; the money was being borrowed for purposes of renovating a casino, in a remote part of the world of which Tricontinental could have no knowledge; and the only security apart from a charge over the proposed share issue, was in the form of a charge over shares in a Dutch company, which owned the casino and in which Amaldela was seeking to take a minority interest. It is to be
noted that, when the facility went into default, there was never any suggestion that the security over the Dutch company's shares could be realised. All this meant that the underwriting agreement was crucial to the security of the facility.

130 Mr Ryan was persuaded by Mr Johns to give his approval to the facility, and there is no doubt that Mr Johns, as account manager, must accept primary responsibility for the granting of this loan, with all its attendant defects.

131 The Commission is not satisfied that Mr Hunter should be held even partly responsible for allowing drawdown to occur without the underwriting agreement being in place. In the light of Mr Johns' total control of this matter, and the fact that there is no suggestion in the material that he disapproved of the drawdown taking place when it did, the Commission believes it is probable that he either directed or, at least, approved the drawdown at a time when he knew that the precondition was not in place.

132 In any event, so far as Mr Hunter's possible liability under the Companies Code is concerned, the Commission very much doubts whether he was an executive officer within the meaning of the Code. This matter is dealt with in chapter 14.

133 The loan to CLIL was intended to provide bridging finance until the proceeds of the rights issue were received. The bridging finance was to be repaid by the funds secured from the issue.

134 The defect in this plan, which was not brought to the notice of directors, was that the expected $5.4m from the float was already committed to the Amaldela facility, and could not be stretched to cover the $9m required for both that and the new CLIL facility. It is true that the credit submission provided that the Amaldela facility was to be refinanced by CLIL before it
was due to be repaid at the end of January 1987. However the submission did not indicate how this was to be achieved, and the requirement was not included in the letter of offer. For all this, Mr Johns must be held responsible.

T. Narrative - The Duke Group Workout Arrangements

The Duke group of companies was formed in 1988. Duke Securities Limited ('DSL') obtained two facilities from Tricontinental totalling $21.55m in 1988 and 1989. The first facility was a loan of $11.55m at a concessional interest rate, to enable DSL to purchase a 19% interest in DAC before the acquisition of a majority interest in DAC from SLHL. A second facility of $10m was provided by Tricontinental to DSL in April 1989; it was used to refinance an inter-company loan.

The proposed restructure of the Duke group, involving members of the DAC group, collapsed in May 1989 when the Duke group went into liquidation.

The $11.55m facility to DSL was approved by Tricontinental directors without any credit submission having been prepared, and relying upon a presentation by Mr Johns at the February 1988 board meeting. The loan formed part of the workout arrangement negotiated by Johns. The arrangement proposed by Johns was that Tricontinental would sell 16.5m DAC shares to DSL at a price of 70c per share to realise $11.55m, and that Tricontinental would advance $11.55m to DSL, for a "maximum six months", to fund the acquisition by DSL of the DAC shares at a concessional rate of interest of 8% per annum payable on maturity. The facility was to be secured by a first registered mortgage over the 16.5m DAC shares.

In a memorandum dated 8 March 1988, Johns informed the directors that
DSL wished to vary the workout arrangement which had been approved in principle at the February board meeting, and asked the directors to approve the variation (that DSL be required to repay only $4m of the $11.55m advanced within six months, and be allowed to retain the balance of the facility for up to 18 months at commercial interest rates rather than the concessional rate of 8% per annum). There is no record of the directors' approving this variation, but on 11 March Johns wrote to DSL confirming it.

Mr Moyle said in evidence that he did not receive this memorandum or approve the variation. He further said that the amendment to the term by which the funds would be repaid was such that it required a fresh application, and the appropriate analysis to be done with respect to the borrower's financial position.

A further facility of $20m was approved by Johns, Ryan and Carr in August 1988, to facilitate the purchase by DSL of SLHL's DAC shares. This facility, although accepted, was never drawn down.

The Commission's investigators found no financial information relating to DSL on Tricontinental's files, and the information relating to the parent company, Duke Holdings, comprised preliminary draft unaudited figures for June 1988. The gearing of all Duke group companies was high.

Interest for the $11.55m facility was payable quarterly in arrears, with the first payment due on 31 July 1988. This payment was made late. A memorandum from Mr Robert Kenshole to Mr Johns dated 15 February 1989 stated that, as at that date, DSL had not paid quarterly interest on the advance since 31 July 1988 "despite constant follow-up". Payment of interest for the period to 31 January 1989 was not received until the middle of March 1989.
Despite these problems with the first facility, in April 1989 a further $10m was advanced to DSL for a term of five months. This facility was approved by Johns and Carr and noted by the board of Tricontinental. The facility was associated with Tricontinental’s restructuring proposal for the Hartogen group. A review prepared by Mr Douglas of the corporate services division said of the proposed restructuring that:

"It is clearly apparent that the proposed restructuring is extremely complex and convoluted. Accordingly, there is considerable opportunity for the restructuring not to proceed according to plan. Details may be critical and may result in the whole restructuring 'falling over'".

Mr Ryan gave evidence that he did not recall seeing this report and did not believe that any other directors were aware of these views expressed by Mr Douglas.

Mr Johns had provided an outline of the proposed restructure in a memorandum to directors dated 31 March 1989. The memorandum described the transactions associated with the restructuring, and noted that the first step in separating the financing business from the minerals and resources business of the Genoa/Hartogen/Duke groups involved the severing of a financial link between the two businesses. The financial link was in the form of a loan to DSL from Genoa Resources and Investment. This was to be purchased from Genoa by Tricontinental for its face value of $10m. Johns’ memorandum stated that, "The loan will be unsecured but with recourse back to Genoa".

Security for the facility was to include an irrevocable letter of undertaking from North Flinders Mines, a member of the Hartogen Genoa group of companies, to lodge $25m cash on deposit with Tricontinental’s money market division on or before 31 May 1989, and to execute a deed of set-off in favour of Tricontinental. This $25m deposit was also to provide
security for two other loans by Tricontinental to Genoa Resources Limited totalling $35.3m.

147 On 6 April 1989 Mr Burke, a director of Genoa Resources, wrote to Johns informing him that, although the letter of offer had been accepted, it was not intended that the $25m would be deposited as security for the loans to DSL, as distinct from Genoa. Johns responded by a letter dated 11 April 1989, pointing out that the requirement for a $25m deposit was a precondition of approval of the facilities by the board of Tricontinental and must be complied with.

148 Mr Ryan gave evidence that he could not recall approving this facility and had no recollection other than of some discussion about a deposit from North Flinders Mines. He had no recollection of any further discussion as to whether or not the $25m was ever deposited by North Flinders Mines. He stated, however, that he believed it was a condition precedent to drawdown that North Flinders Mines lodge the $25m cash on deposit. He conceded that the drawdown could occur before the moneys were placed on deposit, provided the letter of undertaking was in place.

149 On 17 April 1989 Mr Reid, chairman of DSL, advised Mr Johns that the Duke group had non-income-producing assets of $57m.

150 On 27 April 1989 a subsidiary of North Flinders Mines deposited $100 with Tricontinental. No further funds were received.

151 On 1 May 1989 a $3m facility to DAC was approved. DAC had sought urgent funding to enable it to meet redemption and interest payments in respect of its outstanding debentures. A memorandum from Johns, dated 1 May 1989, stated that the cash flow problem at DAC had arisen due to the inability of Duke group to repay a $6m loan. Mountford obtained verbal approval for the $3m loan from Smith, Morton and Carr on 1 May 1989.
The letter of offer to DAC was forwarded the same day and the facility drawn down on 2 May 1989.

On 4 May 1989 Mr Lord of DAC told Mr Johns that, "Given recent events regarding Duke", DAC should reconsider whether or not to proceed with the takeover of Duke. Johns then told Mr Douglas Green, general manager of Tricontinental's corporate services division, "It would appear we may have a problem".

Mr Ryan gave evidence that he did not recall the board ever being made aware by Johns or any other person of developing difficulties in the Duke/Hartogen/Genoa group.

Mr Carr gave evidence that he generally recalled the workout arrangements involving DAC and the Duke group, but said he was not aware of the detail. He did not recall discussing approval of the $3m facility to DAC with anyone.

At the time this facility was approved, no financial information of any kind about DAC was provided to directors. A formal credit submission was not prepared until 14 June 1989, 6 weeks after the loan was advanced and 3 weeks after integration of Tricontinental with SBV.

In May 1989, the Duke group collapsed and a provisional liquidator was appointed who, in late May 1989, reported that the Duke group had external liabilities of approximately $150m and assets of $60m. The provisional liquidator's review stated that the worst company in the Duke group appeared to be DSL, where 27¢ in the dollar was available to creditors.
U. **Significant Issues Concerning the Workout Arrangements**

157 Counsel assisting submit that each of the facilities approved by directors to facilitate the Duke group workout arrangement involved the exercise of commercial judgment by the directors in circumstances where a substantial loss would have been incurred had the existing security then been enforced. They submit that, in the absence of evidence of Mr Johns as to the nature of the information provided by him to directors in order to persuade them to approve the facilities, it is not open on the evidence presently available to make any findings adverse to the directors. Counsel assisting submit that, at the time of approving these facilities, Tricontinental was already exposed to substantial losses if it sought to enforce its security. The workout arrangement may have provided a means by which the losses could have been reduced.

158 Counsel for the directors submit that the board in considering the workout proposal put forward by Johns was making a commercial judgment based on the information which had been provided to it by the managing director of Tricontinental, who was also the account manager.

V. **Conclusions and Findings Concerning the Workout Arrangements**

159 The Commission accepts that the workout involving the Duke group occurred under considerable pressure to try to recover the other DAC-related loans. It may well have seemed, to those concerned, to be a reasonable solution to a fairly desperate situation. For this reason, the Commission is not concerned to criticise particular persons involved with these facilities. However it notes the following circumstances which provide further evidence of the way in which Tricontinental did business:

(i) The Duke group was being called upon to pay 70c for shares which were worth, at most, about half that amount. This immediately introduced an artificial element into the arrangement.
(ii) Once again there was no proper credit submission prepared; the matter was put to directors by Johns at a board meeting, based upon a short statement in the managing director’s report.

(iii) Shortly afterwards, the approved loan was varied on the basis of a short memorandum from Johns to his fellow directors. There appears to be no formal record of their approvals.

(iv) At the time this arrangement was being entered into, and varied, Tricontinental had no financial information concerning the borrower, DSL.

(v) The $10m facility was provided in April 1989 even though:
(a) Tricontinental did not then have any current information about the borrower or the Duke group;
(b) DSL’s interest payments for its existing facility had been very late; and
(c) A review concluded that the proposed restructure was quite likely to fail.

(vi) The $10m facility provides yet another example of the way in which Tricontinental failed to obtain important items of security.

(vii) Johns arranged for a facility to be provided to DAC after he became aware that it had a cash flow problem because of the Duke group’s inability to repay a $6m loan.

(viii) When the directors approved the DAC facility, they received no financial information about the borrower, no formal credit submission and, according to Mr Ryan, no indication of problems faced by the Duke group.
TRANSACTION REPORT 7
QINTEX LIMITED

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A. Background and Summary

QL (Qintex Limited) was incorporated in Tasmania on 23 November 1920 as P O Fysh & Co. Ltd. Its name changed to QL in June 1975 when interests associated with Mr Christopher Skase gained control (52%). QL was listed on Australian Stock Exchange (Brisbane) Limited (ASX). Its activities were recorded by ASX as "Investment and operations of [businesses] in media and entertainment and resorts and leisure, provision of management advice and to act as management and holding company".

Tricontinental was one of a number of financial institutions which provided financial accommodation to the Skase group, including QL. Tricontinental first provided funds to QL in 1979.

The Commission examined a $75m facility provided by Tricontinental to QL in November 1985 for the purpose of financing the acquisition of 19.9% of Amalgamated Wireless (Australasia) Limited (AWA).

The directors who approved this facility believed that Tricontinental's exposure was to be limited to a participation of $25m in a proposed $75m syndicate. The approvals were also given on the condition that Tricontinental's exposure to the Skase group should not exceed $75m. It then stood at $67m, according to the credit submission.

The letter of offer for this facility, sent to QL on 26 November 1985, was signed by Johns and Hunter and was inconsistent with the approved credit submission in that it offered to QL a $75m facility, and merely referred to Tricontinental having the right to syndicate the facility.

Before acceptance of the letter of offer, the terms of the facility were again amended by Mr Johns, causing it to depart further from the approved credit submission; in particular, the term was extended from two to three years.
In February 1986 a further credit submission was approved by Johns, Moyle and Ryan which formally extended the term of the facility from two to three years.

By July 1986 the facility was drawn down to $71m, resulting in a very clear breach of the condition imposed by directors that Tricontinental's exposure to the Skase group should not exceed $75m. The proposed syndicate was never formed.

In March 1988, Mr Moyle expressed concern at the overall Tricontinental/SBV exposure to the Skase group and requested that an internal review be prepared. This review was prepared and circulated to all directors and considered by the board in June 1988. The review disclosed that the facility limit was $75m and that the usage was $69.5m.

In November 1988, Mr Skase requested a six-year extension of the facility. A credit submission for the six-year extension was prepared, but was not accepted by directors. The facility was extended for three years to December 1991.

In April 1989, QL's subsidiary Qintex Australia Ltd ('QAL') announced a proposed acquisition of MGM/United Artists for US$1b. The acquisition did not proceed. This caused a loss of confidence in the group and a decline in the market price of QL and QAL shares on the ASX.

QL's and QAL's shares were suspended by the ASX in October 1989, following the failure of the directors to reply to queries from the ASX. A liquidator was appointed to QL in November 1990. The Victorian Government has assumed from Tricontinental a debt of $69m.
13 **Chronology**

The chronology of relevant events is as follows:

1985

22 October  Letter sent to Johns by Skase and Capps requesting a facility from Tricontinental.

22-26 November  Ryan, Moyle, Rawlins and Hancock approved credit submission dated 14 November 1985. The submission indicated that Tricontinental was arranging a $75m syndicated facility of which it proposed to contribute $25m.

26 November  Letter of offer, signed by Johns and Hunter, sent to QL offering $75m facility which Tricontinental had the right to syndicate.

29 November  Board noted facility at board meeting (facility limit recorded in board minutes as $50m).

9 December  Letter of offer accepted.

11 December  State Bank of New South Wales resolved to refuse to participate in the syndicate.

17 December  First drawdown of the facility ($20m).

1986

16 January  QL requested drawdown of $2.75m for purposes other than the approved purpose of the facility (purchase of AWA shares).

24 February  Credit submission dated 11 February 1986 for 12 month extension of facility approved by Moyle and Ryan. (Note: As a result of discussions between Johns and Skase, this extension was already a term of the letter of offer accepted on 9 December 1985).

26 March  Extension noted at board meeting (existing facility recorded in board minutes as $25m).
1987

24 February
Tricontinental released $4m worth of shares in AWA held as security.

July
Acquisition of AWA abandoned.

27 November
Tricontinental released its charge over QAL shares held as security (approved by Johns on 25 November).

18 December
Tricontinental released 13m QAL shares held as security (approved by Stott on 15 December).

1988

1 March
Internal review of QL cancelled.

22 March
Johns, prompted by request from Moyle, asked Stott to undertake full review of Qintex group exposure for report to the board.

June
Internal review considered by board.

8 September
Letter sent to Johns by Skase requesting an extension of the facility to November 1991.

November
QL in breach of share cover covenant (never rectified).

3 November
Letter sent to Johns by Skase requesting an extension of the facility to 31 December 1994.

24 November
Ryan approved the extension only to December 1991 - not to December 1994 as proposed in a credit submission of 11 November.

30 November
Credit submission, amended to seek extension to 31 December 1991, approved by directors.

21 December
Board noted the extension (existing facility recorded in board minutes as $75m).

1989

8 March
Johns sent memo to the directors stating that Skase had said he would repay facilities so as to reduce Tricontinental's exposure to $155m.
C. Narrative

(a) Quality of Credit Submission - November 1985

Adequacy of financial information

The credit submission dated 14 November 1985, for a $75m syndicated facility was urgently prepared in response to a request by Mr Johns. It indicated that Tricontinental was to be the lead manager of the syndicated facility, but was only to share in the facility to the extent of one-third. The funds were to be on-lent by QL to Industrial & Pastoral Holdings Limited (‘IPH’) (which in 1987 became QAL), or a subsidiary of IPH to enable IPH to acquire up to 19.9% of AWA (described in the credit submission as ‘Marconi’).

The credit submission proposed that the syndicate members were to be the State Bank of Victoria, the State Bank of New South Wales and Tricontinental - each to contribute $25m.

The submission did not contain up-to-date financial information concerning QL. The most recent information was extracted from the "Financials as at 31 July 1984 (Audited)".
Mr Moyle and Mr Ryan both gave evidence that, when approving the credit submission, they placed reliance on the security that was offered, namely a mortgage over "share scrip in public listed companies acceptable to TCL to provide a security cover of 1.25 times", and the fact that $9.4m of the facility, and some of the proceeds of a rights issue, were earmarked to be used to service the facility.

Inconsistency on face of credit submission

The credit submission face sheet proposed a $50m facility and noted that Tricontinental was "endeavouring to syndicate $25m of this exposure". It indicated that the proposed facility was to form part of a $75m syndicated facility to be lead managed by Tricontinental. Elsewhere in the credit submission the proposed facility was stated to be $50m. However, the recommendation section of the submission recommended "the proposed facility of $25m ...".

It was therefore quite unclear whether the approving directors were being asked to approve a $50m or $25m facility. Moyle and Ryan said in evidence that they believed they were approving a $25m facility and not a $50m or $75m facility. They also said they expected that the proposed syndicate would be put in place before any drawdown.

The original credit submission approved by the directors has not been located by the Commission's investigators. A draft copy of the credit submission records on its face sheet that the proposed amount for the facility was $25m and not $50m. Just when the draft was altered, and for what reason, must remain something of a mystery. A figure of $25m or $75m would have been understandable; $50m cannot be readily explained.

Inaccurate information

The credit submission tendered in evidence stated that Tricontinental was endeavouring to syndicate $25m of the proposed $50m exposure and was
presently negotiating with SBV and State Bank of New South Wales to participate with $25m each. Before the directors approved the facility in late November 1985, Moyle knew, and the other approving directors probably knew, that SBV had declined to participate in the proposed syndicate. Mr Moyle gave evidence that he recalled informing Ryan of SBV's decision and thought that he also informed the other approving directors, Hancock and Rawlins.

Mr Ryan said that he did not recall being informed of SBV's decision before he approved the facility, but conceded that he would almost certainly have discussed with Moyle whether SBV was going to participate in the proposed syndicate.

Mr Moyle said that SBV declined to participate because SBV's and Tricontinental's exposure to the Skase group was already too high in relation to SBV's capital base.

(L. Departure from terms of credit submission - November 1985
Amount of facility

Mr Moyle and Mr Ryan gave evidence that, in approving the facility, they believed they were approving a syndicated facility of $75m in which Tricontinental's participation was limited to $25m and subject to a Skase group maximum exposure of $75m.

The letter of offer, dated 26 November 1985, was signed by Johns and Hunter and offered a $75m facility to QL. It referred to Tricontinental having the right to syndicate the facility, rather than stating that the provision of funds was conditional upon syndication.

Syndication

No syndicate was formed as contemplated by the credit submission. Despite this, the facility was drawn down by more than $25m by January
1986. The condition imposed by the approving directors that a $75m maximum group exposure not be exceeded was breached by the first drawdown of $20m on 17 December 1985.

Ryan and Moyle gave evidence that they expected that no funds would be drawn down until a syndicate had been formed. A later credit submission, dated 11 February 1986 (for an extension of the facility), indicated that the existing facility was $25m which "will form part of a syndicated facility of $75m ... which [Tricontinental] is currently in the process of forming". However, it then showed current usage as $52m. Moyle and Ryan gave evidence that, despite these matters, they were both under the impression that the syndicate had been formed and did not appreciate that Tricontinental had an exposure of $75m under this facility.

Mr Stott gave evidence that the credit submission dated 11 February 1986 probably should have included information on the status of the proposed syndication and that he was probably aware at the time that a letter of offer for a $75m facility had been sent to QL.

Term of the facility

As approved by Ryan, Moyle, Rawlins and Hancock, the term of the facility was two years. The term was then changed to three years, apparently as a result of discussions between Skase and Johns. The original letter of offer sent to QL was amended by hand to reflect this change, and initialled by Skase and Johns (Mr. Hunter gave evidence that the initials opposite the amendments were Johns'). This and other amendments were made without the prior approval of the directors. They were not referred back to the board until a credit submission dated 11 February 1986 was prepared and later approved by directors. This submission did not indicate that the extension of one year had already been approved in the amended letter of offer.
Purpose for which facility was used

The purpose of the facility as stated in the submissions was to enable one of the Qintex companies to acquire up to 19.9% of AWA. A drawdown of $2.75m for other purposes was made in January 1986 and not reported to the board. The proposed acquisition of AWA was abandoned by QL in July 1987. The board was not informed of this until a credit submission for a three year extension was prepared in November 1988. Ryan and Moyle gave evidence that it was the obligation of Mr Johns, as the account manager, to ensure that funds were only drawn down for the approved purpose and that drawdowns for other purposes were the subject of a submission to the board or at least reported to it.

Security

The security for the proposed syndicated facility ultimately consisted of QAL shares.

Ryan and Moyle gave evidence that, when they approved the facility, they did not anticipate that the security would consist solely of QAL shares, but rather that it would consist of shares in AWA with a top up of QAL shares. They had, however, approved a credit submission which, in effect, gave Johns the right to accept as security any "scrip in publicly listed companies".

AWA shares were initially held as security, but were released and replaced by QAL shares. The board was not notified of the change in security when it occurred. Nor was it told that the facility was drawn down to $69.5m. In a credit submission dated 11 November 1988, it was revealed to the board that the security then held consisted solely of QAL shares, representing 25.2% of the issued ordinary capital in QAL. The guidelines provided that Tricontinental would normally take no more than 5% of the issued capital in a company as security.
Release of shares

On 18 December 1987, Mr Stott released 13m partly paid QAL shares held as security so that they could be used as security for borrowings by the Qintex group from other banks. He gave evidence that he considered himself as having authority to approve the release of shares in the absence of Johns and Mountford, provided adequate security cover was maintained. He believed that Tricontinental could not insist on holding security in excess of the security cover requirements.

Mr Hunter gave evidence that he agreed with Stott’s view that it was correct to release shares held by Tricontinental in excess of security cover requirements. He said that he regarded it as being up to the account manager to look into the question of whether Tricontinental should allow shares to be released so as to enable the borrower to use them as security for other lending.

(c) Extension of facility for 3 years

Adequacy of information

On 30 November 1988 Johns, Ryan, Moyle and Carr approved the credit submission dated 11 November 1988 which granted a three year extension of the facility to 31 December 1991. Ryan had earlier declined to approve the six-year extension proposed by Johns.

The submission showed that the existing facility was $75m with a current usage of $69.5m, and made no mention of any "syndication". It referred to the unsuccessful attempt to acquire AWA, and showed that, since that time, the facility had "been used to provide funds for the development of the Qintex group in the last two financial years 1987 and 1988".

According to Mr Ryan, when the submission was noted by the board on 21 December 1988, the directors did not discuss why the change of purpose had not been reported to them earlier. It appears from their evidence that
neither he nor Mr Moyle recalled at the time that the facility had originally had a different purpose and a syndication had been proposed.

Mr Mountford gave evidence that he considered the submission as a member of the credit committee, but without recourse to the earlier submissions or the history of the facility.

Directors' knowledge of the financial position of the borrower

Mr Carr gave evidence that, from January 1988 onwards, the board was aware of, and concerned about, the size of Tricontinental's exposure to the Qintex group and its under-secured position. The review of the Skase group prepared by Stott and Maddison forecast a cash flow deficit to July 1989 of $49.2m, and provided directors with other information relating to the Skase group. Johns’ accompanying memorandum was couched in optimistic terms.

Carr also gave evidence that, when considering the extension, his view was that the prospects for the borrower were positive except for a short term cash flow shortage and an inability to provide adequate security. However, he considered that projected profitability over a three year period would overcome the group’s cash flow shortage, and decided that the best course of action was to support the group.

Mr Ryan gave evidence that there was no option for Tricontinental - it had to approve the extensions. He said that QL could not obtain refinance to repay the loan because the security had deteriorated in value.

Mr Moyle gave evidence that Johns informed the directors that seeking repayment of the facilities might disturb the whole Skase group and that no additional security was available.
For these reasons the approving directors resolved to extend the Skase group facilities, including the QL facility, for three years.

D. **Role of Mr Johns**

(a) **As account manager**

Mr Johns was account manager for the QL "syndicated" facility. The facility was a margin lending transaction. Johns had a special relationship with Mr Skase who was the executive chairman of the Skase group.

(b) **The $75m "syndicated" facility**

As account manager Mr Johns had extensive involvement in the facility. In particular:

(i) he received the request from the borrower for the facility and its later extension;

(ii) he initially recommended the facility as a member of the credit committee;

(iii) he signed the letter of offer, together with Hunter, which offered QL a facility of $75m;

(iv) he amended the letter of offer in significant ways without first seeking the approval of the board; in particular, he extended the facility for one year;

(v) two or three months later, as managing director, he approved a credit submission to extend the facility for one year;

(vi) he permitted the facility to be drawn down by QL despite the failure to form a syndicate;

(vii) he authorised the release of QAL shares held as security;

(viii) as managing director, he approved a credit submission dated 11 November 1988 to extend the facility for three years; he had previously recommended a six-year extension.
E. **Role of Directors**

The directors who approved the three credit submissions relating to the syndicated facility were:

(a) 14 November 1985 - Ryan as managing director and Moyle, Rawlins and Hancock. Noted by board in November 1985;

(b) 11 February 1986 (extension) - Johns, Ryan, Moyle. Noted by board in March 1986;

(c) 11 November 1988 (extension) - Johns, Ryan, Moyle, Carr. Noted by board in December 1988.

According to Mr Carr, from early 1988, the board discussed Tricontinental’s exposure to the Skase group and noted its "under-secured" position; see also TR8, Qintex Australia Ltd, paras 50-53.

In March 1988 Mr Moyle, being concerned at the level of SBV/Tricontinental exposure to the Skase group, requested a review of Tricontinental's exposure.

The review was prepared by Stott and Maddison and considered by the board in June and September 1988.

The board received a schedule of listed equities for margin lending as at 31 January 1989, showing that from 16 October 1987 until 31 January 1989 the value of QAL shares had fallen by 74.92%, and that the percentage held to issued capital was 15.42%. The board took no action.

F. **Role of Management**

(a) Mr Stott

Mr Stott was involved in a number of important aspects of the "syndicated" facility. In particular:
(i) he probably authorised the drawdown of $2.75m, which was for purposes other than the purpose specified in the credit submission and letter of offer; if he did, then it may well have been after having had discussions with Mr Johns, whom he regarded as having authority to permit drawdowns for purposes other than those approved by the directors;

(ii) he was involved in attempting to arrange syndication of the facility and discussed progress of the syndication with Johns;

(iii) he was responsible for monitoring the facility. Johns appears to have delegated at least some responsibility for monitoring Skase group facilities to Stott. Counsel for Stott submit that Johns was account manager and, although he may have delegated specific tasks to Stott from time to time, he remained in control of overall monitoring;

(iv) he was responsible for the release of 13m partly-paid QAL shares held as security so that they could be used as security for borrowings from other banks;

(v) together with Maddison, he prepared the review of Tricontinental’s exposure to the Skase group. This review was relied upon by the directors when considering an application by Mr Skase for a six-year (and then a three-year) extension in November 1988.

(b) Mr Hunter

53 Mr Hunter was responsible for the preparation of the letter of offer dated 26 November 1985 and signed it with Mr Johns. The letter offered to QL a $75m facility which was not conditional upon syndication. Hunter gave evidence that the letter of offer was prepared under instructions from Johns, although he could not recall an instruction from Johns to change the amount of the facility to $75m.
Hunter said further that he knew nothing about the circumstances in which the letter of offer was amended, but identified the initials opposite the amendment as being Johns'.

G. ** Significant Issues Arising **

(a) **Quality of credit submission - November 1985**

**Adequacy of financial information**

As to the adequacy of the financial information contained in the credit submission dated 14 November 1985, counsel assisting submit that no reasonable director of a merchant bank would have approved the credit submission as it did not provide sufficient financial information concerning the borrower to enable the approving directors to assess the creditworthiness and ability of the borrower to repay the facility. In this respect they submit that Ryan and Moyle, the approving directors who gave evidence, failed to exercise the degree of care and diligence required by s229(2).

Counsel assisting submit further that the staff, managing director and board of Tricontinental did not demand or expect full financial details of borrowers when assessing the credit risk in margin lending transactions, because all concerned expected the facilities to be repaid by resale of the securities in the foreseeable future.

Counsel for the directors and senior management reject the submissions of counsel assisting which, they contend, ignore evidence of the considerations taken into account by the directors in approving the credit submission. They further submit that the approach adopted by counsel assisting displays a simplicity which is not appropriate where there are often complex commercial judgments to be made at a relevant time. In this case, they submit that there was sufficient information available to the approving directors to justify their decision to approve the credit submission.
Inconsistency on face of credit submission

As to whether the directors were being asked to approve a $50m or $25m facility, counsel for the directors submit that a possible explanation for the inconsistency in the credit submission, referred to in paragraph 14(ii) above, is that the credit submission was altered after approval had been obtained from directors. They submit that it is likely that the original credit submission, which was not tendered in evidence to the Commission, was altered on its face so that the approved facility for $25m was replaced by the $50m facility which appears on the face sheet. This is supported to some extent by the existence of a draft copy of a credit submission showing the proposed facility as $25m, not $50m.

Counsel assisting concede that the possibility exists that the original credit submission may have been altered in the manner suggested by counsel for the directors, and submit that, on the evidence, it is not possible to make any positive finding on this point.

Inaccurate information

As to whether the approving directors knew, at the time of approving the credit submission, that SBV had declined to participate in the proposed syndicate, counsel assisting submit that it is open to the Commission to find that Mr Moyle did know, and that the other approving directors probably knew. They further submit that the refusal of SBV to participate in the syndicate was a significant event, and that the approving directors, in these circumstances, failed to exercise the degree of care and diligence required by s229(2) in approving the credit submission rather than seeking further information on the progress of the formation of a syndicate.

(b) Departure from terms of credit submission - November 1985

Amount of facility

Counsel assisting submit that it is open to the Commission to find that Mr Johns and Mr Hunter were directly responsible for offering QL a facility of
$75m, contrary to the terms of the approved credit submission and, in particular, to the condition relating to "group maximum exposure of $75m". They further submit that it is probable that Johns instructed Hunter to prepare and send the letter of offer in the terms in which it was sent, and that Johns made the various handwritten amendments to the letter of offer. In this respect they submit that Mr Johns failed to exercise a reasonable degree of care and diligence within the meaning of s229(2) in preparing and authorising the letter of offer for a $75m facility to QL.

Counsel for Mr Hunter submit that, as he was instructed by Johns to send the letter of offer in the terms in which it was sent, responsibility must lie with Johns and not Hunter. They submit that Hunter had a clear responsibility to act in accordance with directions given by Johns and had no responsibility to report to the board other than through Johns.

Syndication

As to the drawdown of the facility despite the failure to form a syndicate, counsel assisting submit that it is open to the Commission to find that Ryan and Moyle, in considering the credit submission dated 11 February 1986, failed to exercise the degree of care and diligence required by s229(2) in failing to note that a syndicate had not been formed and that the facility had been drawn down to the extent of $52m contrary to the credit submission dated 14 November 1985 and the condition imposed relating to group maximum exposure of $75m.

Counsel for Ryan and Moyle submit that they could not have been expected to pick up (without express reference to it) the exposure of $75m, or the fact that the summary statement "Forms part of a $75m syndicated facility which TCL is forming", showed that no syndicate then existed. However, this seems to ignore the fact that, although the credit submission face sheet showed a "maximum exposure" of $25m, it also showed that Tricontinental had a "current commitment" of $75m. Counsel for the directors rely
further on the summary of exposures, provided to the board in March 1986, which showed that Tricontinental’s exposure to QL was $25m. They also submit that the summary provided to the board was misleading and that on the evidence it is probable that the board was told that the exposure was only $25m.

**Term of the facility**

Counsel assisting submit that it is open to the Commission to find that Mr Johns failed to exercise the degree of care and diligence required by s229(2) in agreeing to an extension of the facility for a period of one year without the prior approval of the directors.

**Purpose for which facility was used**

Counsel assisting submit that it is open to the Commission to find on the evidence that Mr Stott authorised a drawdown of $2.75m for purposes other than the purpose specified in the credit submission dated 14 November 1985 and the letter of offer. They further submit that the absence of adequate monitoring procedures at Tricontinental enabled this to occur and that the directors failed to exercise a reasonable degree of care and diligence in failing to ensure that such procedures were in place and strictly adhered to, so as to prevent drawdowns for any purpose other than the approved purpose.

Counsel for the directors and Mr Stott reject these submissions. They submit that, having regard to the fact that Mr Johns was the account manager, it was highly unlikely that Stott authorised a drawdown of $2.75m for purposes not within the purpose specified in the credit submission, unless on instructions from Johns. They further submit that the only way to prevent such an occurrence is to rely upon management, primarily in this case, Mr Johns, who took an extraordinary role in relation to many accounts. They submit that the board must rely upon the honesty and diligence of management in such matters and were entitled to do so.
Security

Counsel assisting submit that it is open to the Commission to find that Mr Johns failed to exercise the degree of care and diligence required by s229(2) in failing to inform the board that the AWA shares held as security were released and replaced by QAL shares as the sole effective security for the facility.

Release of shares

Counsel assisting submit that it is open to the Commission to find that Mr Stott was responsible for the release of 13m QAL shares held as security and that the absence of any guidelines relating to the release of security enabled this to occur. In this respect they submit that the directors failed to exercise the degree of care and diligence required by s229(2) in failing to ensure that such guidelines were in place and strictly adhered to.

Counsel for the directors submit that there were guidelines in place which provided that security was not to be released where there was not a certain times cover adhered to, and that in any event, one relies upon the management of the company not to release security in inappropriate circumstances and this is a matter of judgment in individual cases unrelated to board policy.

(c) Extension of facility for three years

Adequacy of information

Counsel assisting submit that it is open to the Commission to find that the directors who approved the credit submission dated 11 November 1988 failed to exercise the degree of care and diligence required by s229(2). They say this because the directors approved the extension of the facility for three years in circumstances where it was apparent, on the face of the credit submission, that no syndicate had in fact been formed (as was originally contemplated when approval was given to the November 1985 credit submission), and because the original purpose for the granting of the
facility had lapsed and the funds had been used for other purposes. They further submit that it is open to the Commission to find that Mr Johns failed to exercise the degree of care and diligence required by s229(2) in not informing the board before November 1988 that the original purpose for the making of the advance had lapsed and that the funds were being used for different purposes.

Counsel for the directors submit that, if the transaction was an appropriate one to enter into originally, it is irrelevant whether, at that particular time, the directors were aware, or it became apparent to them on the face of the credit submission, that no syndicate had in fact been formed. They further submit that it was an appropriate transaction to enter into for sound commercial reasons.

**Directors' knowledge of the financial position of the borrower**

Counsel assisting submit that no reasonable director of a merchant bank would have approved a three year extension of a facility that was already substantially in default of share cover (shortfall of $11.360m), particularly where the original purpose for the loan had lapsed and the funds had since been applied for purposes not approved by the board.

Counsel for the directors submit that it was reasonable for the directors to approve the three year extension for a number of commercial reasons including that, as at November 1988, the circumstances surrounding the facility were such that the board of directors had no alternative but to extend the facility for a term of three years.

**Conclusions and Findings**

There is an element of confusion in the original granting of this very large facility. It is clear that, at the time it was entered into, the management and directors of Tricontinental expected that the company's exposure would only be $25m in a total syndicated facility of $75m. This was the way the
credit submission was originally drafted and it was the way the directors understood it - a maximum exposure of $25m. However it seems that Mr Johns always saw it as a $75m facility which he was confident could be syndicated.

From that time onwards, the facility was variously referred to in board papers as being for $50m, $25m and $75m.

What is clear is that Mr Johns, as managing director and account manager, treated the facility as being for $75m, but subject to expected syndication. The Commission accepts the evidence of the directors that they all believed they were approving a facility of $25m only. This is entirely consistent with the condition they attached to their approval that Tricontinental’s exposure to the Skase group should not exceed $75m in total. It already stood at $67m, but it was expected that some smaller loans would soon be repaid. This would have left scope for a new facility of $25m but not for $75m.

One puzzling feature about the directors’ approvals is that, at the time they were given, Mr Moyle knew that SBV would not be participating and he would almost certainly have passed this information on to his fellow directors. Yet the credit submission still showed SBV as a proposed participant. The Bank of New South Wales declined the proposal some two weeks after the facility had been approved.

In the absence of evidence from Mr Johns, the Commission cannot know what was in his mind when, the following February, he referred in a fresh credit submission to the "syndicated facility which [Tricontinental] is currently in the process of forming". If he had no other participants clearly in prospect, the statement was very misleading.
Another puzzling feature of this transaction is the fact that, after the board became concerned about the size of its exposure to the Skase group, and an internal review was studied in June 1988, there seem to have been no questions asked as to how Tricontinental had become committed to the full extent of $75m. As indicated in para 38, it seems that neither Mr Moyle nor Mr Ryan recalled the circumstances of their original approval.

Apart from the question of syndication, there was a clear breach of the condition that the total exposure to the Skase group should not exceed $75m. This can only have resulted from a deliberate decision by Mr Johns to ignore the precondition and not to refer the matter back to directors for further consideration. Directors, and particularly Mr Moyle, who imposed the condition, and was concerned about SBV’s exposure to Qintex, might have been expected to pick this up when an extension of 12 months was sought from them in February 1986 - notwithstanding the fact that such an extension had been granted by Mr Johns to the client two or three months earlier. However, in this submission, Mr Moyle and Mr Ryan received confusing messages. The existing facility was shown as having a “maximum exposure” of $25m - “part of a $75m syndicated facility which [Tricontinental] is forming”. But current commitment was shown as $75m and current usage as $52m. Assuming that they absorbed each of these pieces of information, as they should have, and probably did, the most likely explanation is that the two directors believed that Tricontinental’s obligation was in fact limited to $25m, and that whenever $75m was mentioned, the reference was to the syndicated facility. Similarly, the reference to a drawdown of $52m may have suggested to them that the difference represented the contribution, to that point, by another member or members of the syndicate. This is the best explanation the directors can give of their thought processes at the time, and the Commission is inclined to accept it.
The granting of the three-year extension appears, at first sight, to have been generous. However, the Commission is inclined to accept the submission of their counsel that the directors had little choice. There was no money available to Tricontinental from any source other than the realisation of security. Had Tricontinental sought to sell its 25% holding of the operating company, there would have been an immediate impact both on the price of the shares and the viability of the group. As it was, there appeared to be at least a chance that the group could trade out of its current difficulties over a period of several years. The directors were clearly right in limiting the extension to three years, rather than the six years which Skase had sought and which Johns had immediately recommended. This, at least, gave the directors an opportunity to review the situation within the foreseeable future. The directors were faced with a very difficult commercial decision, and the Commission is unable to find that the course they took was negligent. In the event, of course, all was lost.

This covers the basic history of the transaction, but there are several other aspects of it which require attention. In the first place, it was argued by counsel assisting that the original submission had no current financial information concerning the cashflow or the underlying strength of the Qintex group. The directors, by their own account, relied significantly upon the 1.25 times share cover which was promised by way of security (see para 17). This fact tends to underline the rather casual approach of Tricontinental to loans that were secured by shares. There was a tendency not to trouble to look behind the security. However, in this case, the shares involved at the time the facility was approved were to be, substantially, AWA shares. Bearing in mind the intention of syndication, it is not possible now to say that the decision to grant a facility for $25m was in itself a bad commercial decision. However, syndication should have been made a precondition of drawdown. The case also provides another example of Tricontinental’s slipshod analysis of major loan applications - provided by management and accepted by directors.
The next point to be noticed relates to the purpose of the loan. The sole purpose of the original loan was to enable a takeover bid for AWA to be made. All the AWA shares held as security by Tricontinental were released in February 1987. When the attempted takeover was abandoned by QL in July 1987, it sold all its AWA shares. However, no attempt was made at this point to review the facility, and neither the change of purpose nor the release of AWA shares was reported to the board. This again illustrates the fact, brought out in other transactions, that once a facility had been granted, Johns regarded it as being entirely within his prerogative to approve changes in the purpose of the facility and in the nature of the security held. By the time these changes were reported to the board in an extension submission of November 1988, directors had apparently forgotten the original terms of the facility.

On the subject of security, there is again, in this case, an example of a very large parcel of shares (25%) in the operating company of the group being treated as if they were a sound form of security should the group be unable to service or repay the loan. What it meant, in effect, was that Tricontinental was a substantial minority shareholder in the operating company and, if it failed, then Tricontinental's claims would be deferred, falling behind all those holding a better type of security, such as a charge over the income-earning assets of the company.

Still on the question of security, Mr Stott's approval of a release of shares at a time when the security held exceeded 1.25 times the loan, has been criticised by counsel assisting. In the view of the Commission, he cannot be blamed for carrying out what he understood to be company policy. It was, in fact, the normal practice of Tricontinental to return shares, on request, when the number held as security temporarily exceeded the 'times cover' set out in the letter of offer. This was a question of policy which might well have been considered by the board at some time, but it does not seem to have been brought to the attention of directors.
Further, there is the question of Mr Stott’s allowing the drawdown of $2.75m for purposes which were quite unrelated to the expressed purpose of the facility. The Commission accepts the submission of counsel for Mr Stott that this would almost certainly have been done with the approval of Mr Johns as account manager. Not having heard his account of the matter, the Commission does not feel that it can usefully comment further on the propriety of the decision. In an organisation where a proper flow of information passed between the chief executive officer and the board, it would be expected that such a decision would have been, at least, reported to the board and explained. There is no reason to think that might have happened in the present case.

Finally, this transaction provides clear evidence of Mr Johns’ willingness to ignore a vital precondition of drawdown (para 81), extend the facility (para 81), and approve a change of purpose and of security (para 84), all without reference to the board. It is clear that he exceeded his authority in the first two cases, and the third instance demonstrates at least a lack of candour with his fellow directors.
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A. **Background and Summary**

1 Qintex Australia Limited (‘QAL’) was incorporated in Victoria in June 1949 as Industrial Pastoral Holdings Limited. Its name changed to QAL in October 1987. QAL was listed on the Australian Stock Exchange. Qintex Limited ("QL") gained control of QAL in 1981. QL had come under the control of interests associated with Mr Christopher Skase in 1975. QAL became the holding company of the Skase group’s operational activities, which included investment in and management of, media, entertainment, resorts and leisure businesses. These businesses were located principally in Australia and the United States.

2 The Commission examined two facilities which Tricontinental provided to QAL:
   - Facility 1 - a $27m facility provided in August 1988;
   - Facility 2 - a $25m facility provided in January 1989.

3 Facility 1 was provided by Tricontinental for the purpose of assisting QAL to make an early discounted repayment of its debt to John Fairfax Ltd (‘Fairfax’). Its term was to expire on 31 October 1988. The security was to consist of a guarantee from QL and an assignment over all of the proceeds of a call on partly-paid QAL shares, together with letters of acknowledgment from three major shareholders that they would pay the call when made. The call was delayed and the term of the facility was extended by one month to 30 November 1988.

4 In November 1988, Mr Skase requested a six-year extension of all Skase group facilities, including QAL’s facility 1. Directors approved a three-year extension of all Skase group facilities. The security for the extended facility 1 was reduced to a guarantee from QL. The assignment over the call proceeds was not included as part of the security for the extended facility.
Facility 1 went into default when fees due in November 1989 were not paid. The facility represents a total loss to Tricontinental as no part of the sum advanced has been repaid or is likely to be repaid.

Facility 2, which was to provide funds to QAL to be on-lent to a US subsidiary of QAL to fund the development of an Hawaiian resort, was initially to be for a three month term. The security was a guarantee from a US company and a charge over units in a limited partnership which owned the resort.

On 3 April 1989, three days after the term of the facility expired, it was extended to 17 April 1989.

The facility was not repaid at the expiration of its extended term and interest was not paid after that date. The assets of the limited partnership had been provided as security for other loans from other lenders and were fully encumbered. Tricontinental received $1.5m for the release of its charge over the units in the limited partnership; but it has not received, and is not expected to receive, any further repayment of the sum advanced.

B. Chronology

The chronology of relevant events is as follows:

1988

25 July Letter sent to Johns by Skase confirming requirements for facility 1
25 July Directors approved facility 1 before credit submission prepared
10 August Credit submission for facility 1 prepared
11 August $27m drawdown of facility 1
16 August Credit committee approved facility 1
24 August Facility 1 noted by board
28 September Johns advised directors at board meeting on status of Qintex, that the proposal for additional
funds would be declined but that existing loans would be extended

3 November  Directors approved extension of facility 1 for one month

7 November  Johns asked Stott to prepare credit submission for extension of all Skase group facilities to December 1994

24 November  Ryan approved the extension of Skase group facilities to December 1991

30 November  Directors approved three-year extension of facility 1

13 and 14 December  Directors approved facility 2 on basis of information provided by Stott, before credit submission prepared

14 December  Letter of offer, signed by Stott on behalf of Johns and by Dyring, for facility 2 sent to QAL

21 December  Board approved three year extension of facility 1

26 December  Credit submission for facility 2 prepared

1989

5 January  $25m drawdown of facility 2

10 January  Credit committee approved facility 2

25 January  Board noted facility 2

3 April  Extension of facility 2 approved by directors without credit submission

14 November  Notices of demand served on QAL

17 November  Bankers’ meeting held and attended by Skase

24 November  Receivers and managers appointed to QAL

C: Narrative

(a) Facility 1

Oral approval

A credit submission dated 10 August 1988 was prepared in response to
a request by Mr Johns to record a commercial bill facility of $27m provided to QAL. QAL had negotiated an early discounted payout of the $285m debt which it incurred when it purchased Fairfax's television and media interests in Sydney, Melbourne and Brisbane in 1987. The $27m facility was required to be used as bridging finance.

At a meeting on 25 July 1988, before the credit submission was prepared, Johns sought and obtained the approval of Smith, Moyle and Ryan to the grant of facility 1.

**Assignment over call proceeds**

The security for facility 1 was to consist of:

- a guarantee by QL;
- an assignment over all call proceeds from partly paid shares in QAL upon successful takeover of Qintex America Limited by QAL, being approximately $27m; and
- letters of acknowledgment from three institutions confirming that they would meet calls on their partly paid shares in QAL which would produce proceeds of $16.71m.

The submission stated that repayment was to be from cash flow provided by a call on partly paid shares in QAL after successful completion of the QAL takeover of Qintex America Limited. The credit submission noted that:

"The call proceeds which will amount to $27,310,819 will be directed to pay off TCL's bridging facility. As the holding of Qintex America partly paid shares is almost totally institutional and as three institutions with the largest holdings have all confirmed payment of the call it is expected that there should be no complications with the collection of call moneys due".

The approving directors each gave evidence that they could not specifically recall what information was provided to them by Johns when they were asked to give their approval to facility 1 at the meeting on 25 July 1988.

The approving directors said they placed particular reliance upon the letters
of acknowledgement and the fact that Tricontinental was to obtain an assignment over the call proceeds. They said that the assignment over the call proceeds provided an "assured takeout" and source of repayment. Mr Ryan said that he could recall being provided with the letters of acknowledgment from three major holders of unpaid shares indicating that they would take up their part of a call on the shares. He said that the facility involved minimal risk because QAL would receive the call proceeds and an assignment over the call proceeds had been provided. He did not feel it was necessary to satisfy himself as to the borrower's servicing capacity because the facility was only going to run for ten weeks. He said further that Johns would have explained that an urgent response to the proposal for the facility was needed, given the exceptional circumstances in which the facility was being considered. He could not recall the reason for the urgency.

Mr Moyle said that he could not recall any documents being provided when the facility was being considered, but was able to recall that he had been aware that there was pressure to consider the facility quickly. He said that he relied on the fact that the loan was for a short term and would be repaid from call proceeds assigned to Tricontinental. He took the view that the facility would actually improve Tricontinental's position, because capital would be raised through the call on partly paid shares, and an issue of unsecured notes would mean that the holders of the notes would rank behind Tricontinental in priority. He said he believed this justified approving the facility despite the fact that the internal review prepared by Stott and Maddison, considered by the board in June 1988, had indicated that the profitability of the group had not been sufficient to meet its obligations over the last fifteen months. He also said that when considering the facility he regarded the $1m establishment fee, and the fact that the Skase group debt was being reduced by an early repayment, as positive factors.

Mr Smith relied on the same matters in deciding to approve facility 1 and said further that he thought the facility on its face was an attractive investment for Tricontinental.
The board noted facility 1 at its meeting on 24 August 1988.

Extension of facility 1 for one month

Facility 1 was extended for one month to 30 November 1988. The credit submission for the extension, dated 26 October 1988, was prepared at the request of Clark and was approved by Smith, Carr and Ryan on 3 November 1988. It stated that the existing arrangements for repayment were to continue to apply during the period of the extension. The letter of acknowledgement was said to have been obtained.

The face sheet of the submission stated that the security was to include an "assignment over all call monies from partly paid shares in Qintex Australia Ltd upon successful takeover of Qintex America by Qintex Australia Ltd".

Mr Ryan said that when considering the extension he would have been concerned about the delay in receipt of call proceeds, but would have thought that the facility was adequately secured and therefore would not have been particularly interested in obtaining further financial information about the borrower.

The board of Tricontinental noted the extension of facility 1 at its meeting on 17 November 1988.

Extension of facility 1 for three years

A credit submission dated 14 November 1988 was prepared in response to a request by Johns, seeking an extension of all Skase group facilities (including facility 1) to 31 December 1994. An extension of the facility to 31 December 1991 only was approved by Ryan, Moyle and Carr. The approving directors had previously been provided with the internal review of the group prepared by Stott and Maddison.

The credit submission prepared for the extension stated that the security was to consist of a guarantee from QL. No other security was specified. The
assignment over call proceeds was not included as security in the credit submission. It was noted that Tricontinental held a first registered debenture mortgage over QL and all wholly owned subsidiaries of QL. Repayment was stated to be from cash flow and/or refinance.

The approving directors in their evidence accepted that they had received little information about security and repayment when approving the extension of facility 1 in November 1988. They each agreed that, because the only security was a guarantee from QL which had been attributed nil value for security purposes, the facility for its extended term was effectively unsecured. Carr and Ryan could not recall any discussion as to whether the assignment over the call proceeds was available as security. Mr Moyle said that he did not believe it was possible to improve Tricontinental’s security position in November 1988.

The internal review prepared by Stott and Maddison showed that the projected profitability for the group was strong, with the projected net after-tax profit for 1988 and 1989 being $28m and $45m respectively. Mr Ryan said that this supported a repayment capacity from cash flow. He also relied upon certain Potter Partners’ projections to 1991 in satisfying himself that the facility could be serviced.

Ryan and Moyle said that, at the time they gave consideration to the extension, they believed that QAL was in fact unable to repay facility 1. As a consequence, they said that Tricontinental had two options: either call up the loan and risk bringing about the collapse of the whole Qintex/Skase group or extend the facility for a further three years (not six as had been sought by Skase). Mr Ryan said that the board was aware of Tricontinental’s undersecured position, but had made the decision to "go through with the company for the next three years as the best way of recovery".

The credit submission did not provide details of the borrower’s cash flow, which had been in deficit for over a year. Mr Stott acknowledged that the
submission should have provided this information, given that servicing was to be from cash flow.

The call proceeds were later received by QAL after Tricontinental had agreed to extend facility 1 to 31 December 1991. No part of the call proceeds was paid to Tricontinental pursuant to an assignment or otherwise.

The Commission was unable to locate the assignment of the call proceeds or confirm that it existed. Mr Hunter said that he had no reason to doubt that the assignment over the call proceeds was taken by Tricontinental. He said that if it was not taken the only reason would have been that Johns, as account manager, gave instructions not to take the security. Mr Hunter could not recall any such instruction from Johns.

The board of Tricontinental noted the three-year extension of facility 1 at its meeting on 21 December 1988.

(b) Facility 2

Oral approval

A credit submission, dated 26 December 1988, recorded a $25m facility provided to QAL for a period of three months. It was to be repaid "from refinance", which was to be arranged in early February 1989.

Stott obtained the approval of Smith, Ryan and Carr to the granting of facility 2 on 13 and 14 December 1988, before the credit submission was prepared. Stott signed both the letter of offer dated 14 December 1988, and a later letter of offer dated 4 January 1989, on behalf of Johns. Mr Stott said that Johns would have approached him about the proposed facility and asked him to seek the directors' approval of it.

The approving directors, Smith, Ryan and Carr, gave evidence that they could not recall approving this facility at all.
Neither Mr Smith nor Mr Carr could recall ever being asked by Stott to approve any new facility without seeing documentation; and Mr Ryan and Mr Carr found it difficult to understand how enough information could have been given, without documentation, for approval to be given to this facility.

Mr Carr said that he thought he first became aware that Tricontinental had advanced $25m to QAL at the January 1989 board meeting.

Mr Stott said that he estimated that he would have obtained approvals from directors, on the basis of oral information about new facilities, about 8-10 times a year, and that he recalled discussing facility 2 with the directors. He said further that whenever he recorded on a credit submission that a director had said "yes" to him, he had personally spoken to the director and obtained his approval. He was unable to give evidence of the actual information provided to the directors, but said that he discussed the deal and explained "the ownership and structure of the exercise".

Mr Mountford said that he could not recall that the directors had approved the facility before the credit committee had considered it.

Adequacy of security
The credit submission stated that the security for facility 2 was to be a guarantee from Mirage Hotels USA Inc supported by a charge over partnership units representing 57.6% ownership of the Mirage Princeville Hotel. There was no information on the financial position of the guarantor. Nor was there any suggestion that the partnership assets could not be encumbered in favour of other lenders - which in fact happened. Repayment was stated to be from refinancing of principal, which was to be arranged in early February 1989.

Mr Moyle said that management had been asked by the board to investigate the possibility of obtaining additional security. The board was told, in November 1988, that no additional security was available.
The board of Tricontinental noted facility 2 at its meeting on 25 January 1989.

Extension of facility 2

An extension of facility 2 was approved by Smith, Morton and Carr, on 3 April 1989, for a period of 17 days from 31 March. No credit submission was prepared for this extension. It was recorded by Mountford on a memorandum addressed to Maddison dated 3 April 1989.

Smith, Morton and Carr said that they had no recollection of approving the extension. The directors had probably been informed that an extension was needed for 17 days to enable settlement of the sale of the Mirage Resorts to Mitsui to be completed and that the facility would be repaid out of the proceeds of that sale. This was the situation set out in Mountford's memorandum.

Mr Maddison said that the reason a credit submission was not prepared was probably because the extension was for a short term and the directors had already approved it.

D. Role of Mr Johns

(a) As account manager

Mr Johns was the account manager for the facilities provided to QAL. Mr Pratt, the assistant treasurer of the Skase group, said that Johns and Mr Skase developed a special business relationship over a period of 7 or 8 years and that Skase conducted delicate negotiations directly with Johns.

(b) Facility 1

As account manager, Johns had extensive involvement in this facility. In particular:

(i) he discussed QAL's requirement of facility 1 with Skase and received a written request for the facility;

(ii) he recommended facility 1 to Smith, Moyle and Ryan for approval on 25 July 1988, before the preparation of a credit submission;
(iii) he was involved in the preparation of the credit submission for facility 1, dated 10 August 1988;

(iv) he advised on the current status of Qintex at the board meeting held on 28 September 1988, and informed the board that the proposal for additional funds would be declined, but that existing lines would be extended;

(v) he approved a one month extension of facility 1, together with Carr, Smith and Ryan;

(vi) he received a request from Skase for a six-year extension of all the Skase group facilities and asked Clark to prepare credit submissions for the extensions;

(vii) he approved a six-year extension of facility 1 on 23 November 1988;

(viii) he was informed by Clark on 24 November 1988 that Mr Ryan would only approve a three-year extension of the Skase group facilities;

(ix) he signed a letter of offer dated 30 November 1988 for a three-year extension of facility 1.

(c) Facility 2

As account manager, Johns was also involved in this facility. In particular:

(i) he provided Stott with information about the facility and instructed Stott to obtain the directors' approval of it;

(ii) he recorded his approval of the facility on the credit submission on 10 January 1989;

(iii) he advised the directors, by a memorandum dated 8 March 1989, that facility 2 would be repaid on 21 March 1989 and that Tricontinental's exposure would be reduced to $155m; and

(iv) he wrote letters to Mr Capps of QAL concerning repayment of facility 2;

(d) General

Johns was also involved in other matters which affected the Skase group. In particular:
(i) he advised Skase of investment opportunities, including MGM Studio Facilities;
(ii) he held a discussion with Skase on 7 March 1989 about the restructuring of the Qintex group and reduction of its total debt;
(iii) he investigated, with the State Bank of Victoria, the possibility of Tricontinental providing a $114m facility to the Skase group in March 1989.

E. Role of Directors

49 The directors who approved the facilities provided to QAL and extensions of them were:

Facility 1 -

(i) Original approval - Johns, Smith, Moyle and Ryan: oral approval given 25 July 1988;
(ii) Extension for one month - Johns, Carr, Smith and Ryan: approved credit submission dated 26 October 1988;
(iii) Extension for three years - Johns, Ryan, Moyle and Carr: approved credit submission dated 14 November 1988.

Facility 2 -

(i) Original approved - Johns, Smith, Ryan and Carr: oral approval given 13 and 14 December 1988;

50 At its January 1988 meeting, the board discussed Tricontinental’s exposure to the Skase group and noted its "under-secured" position. Mr Ryan said that the board was informed by Johns that, because of the share crash, the market value of the shares had fallen and that Tricontinental was under-secured "across the group".

51 In March 1988 Moyle, being concerned at the level of Tricontinental’s exposure to the Skase group, requested a review of the exposure. The review was prepared by Stott and Maddison and considered by the board in June and
September 1988. The review disclosed a liquidity problem in the Skase group but concluded that it was operating profitably and was expected to improve in profitability.

On 28 September 1988 the board was advised by Johns on "the current status of Qintex and that a proposal for additional funds would be declined but that existing lines would be extended". Mr Moyle said that Johns spoke about the continuing liquidity problems of the Skase group at that board meeting. None of the other directors who were asked about it could recall any discussion on the current status of Qintex.

At the October 1988 board meeting, the board considered the report on the status of group facilities of $35m and over at 30 September 1988. The report revealed that the usage of Skase group facilities totalled $223.56m.

F. Role of Management

(a) Mr Stott

N. Stott was involved in facilities 1 and 2. As a member of the credit committee he recommended facility 1, the 3 year extension of that facility and facility 2. In addition:

(i) he was asked by Johns on 29 July 1988 to prepare a credit submission for facility 1, which had already been approved by the directors;

(ii) he recorded on the credit submission for facility 1 the approval given by the directors to Johns on 25 July 1988;

(iii) he prepared a memorandum to Clark stating that the call on QAL shares from which facility 1 was to be repaid was delayed and that the facility would, as a result, have to be extended by 1 month;

(iv) he signed the letter of offer dated 14 December 1988 for facility 2 on behalf of Johns;

(v) he signed the credit submission for facility 2, which was prepared after he had obtained the directors’ approval to the facility and signed the letter of offer;
(vi) he recorded the approval given by the directors to him on 13 and 14 December 1988 on the credit submission for facility 2;

(vii) he signed, on behalf of Johns, the letter of offer for facility 2 which superseded the letter dated 14 December 1988;

(viii) he signed a memorandum relating to the drawdown of facility 2;

(ix) he discussed the status of facility 2 with Mr Capps of QAL in March 1989.

(b) Mr Mountford

As a member of the credit committee Mr Mountford recommended the one month and the three-year extensions of facility 1 and recommended facility 2. He was also involved in facility 2 and the monitoring of the facilities as follows:

(i) he recorded the approval given on 3 April 1989 by the directors to the extension of facility 2, which had expired on 31 March 1989;

(ii) he signed the letter of offer for the extension of facility 2;

(iii) he discussed on 26 May 1989 repayment of facility 2 with Mr Capps of QAL and asked Maddison to prepare a credit submission for a further extension of the facility to 30 June 1989;

(iv) he signed the credit submission for the extension of facility 2 to 30 June 1989;

(v) he reported to Mr Leonard of SBV on 8 September 1989 on attempts made to contact Skase after the deterioration of share prices and to obtain further financial information.

G. Significant Issues Arising

(a) Facility 1

Oral approval

As to the giving of oral approval to facility 1 at the meeting on 25 July 1988, counsel assisting submit that no reasonable director of a merchant bank could have instituted or tolerated a system of granting oral approval for lending funds in excess of $6m in the absence of documentation - except in circumstances of extreme urgency. They submit further that the approving
directors failed to exercise the degree of care and diligence required by s229(2) of the Code, in giving their approval to facility 1 before the preparation of a credit submission and in circumstances where there was no extreme urgency. Although under "pressure to consider this facility quickly", this did not justify the giving of oral approval to a facility for $27m without proper credit evaluation.

Counsel for the directors submit that it is not established on the evidence that there was a complete absence of documentation, because the approving directors gave evidence that they could not specifically recall what information was provided to them by Johns when they were asked to give their approval at the meeting on 25 July 1988. They further submit that, even accepting that there was no documentation, it cannot be said that in appropriate circumstances, putting aside extreme urgency, a director was not able to rely upon officers and staff to provide information. They submit the question is whether or not the directors took reasonable care in the circumstances, one of the circumstances being that oral approval was obtained. They submit that it is improbable in the extreme that staff would approach a director without some information at hand.

Assignment over call proceeds

As to whether the assignment over the call proceeds was taken as security by Tricontinental, counsel assisting submit that on the evidence it is probable that it was never taken as security. They submit further that Mr Hunter, as group manager securities division, was responsible for any failure to obtain the designated security and that Mr Johns, as the account manager, was responsible for permitting drawdown to occur before the designated security was obtained. On this basis they submit that both Mr Johns and Mr Hunter failed to exercise the degree of care and diligence required by s229(2).

Counsel for the directors and Mr Hunter submit that it is not open to the Commission to conclude that the assignment over the call proceeds was never taken as security by Tricontinental, because no evidence was given by the
solicitors who in the normal course of events would have been responsible for preparing the documentation. They further submit that it is not possible to find that Mr Hunter breached s229(2) in the absence of evidence from Mr Johns as to whether he gave Mr Hunter instructions not to take the designated security. Mr Hunter’s evidence was that he had no recollection of Mr Johns giving such an instruction, but he had no reason to doubt that an assignment was obtained.

Extension of facility 1 for one month

As to whether the directors who approved the extension of facility 1 ought to have been aware that the assignment over the call proceeds was not taken by Tricontinental, counsel assisting submit that the wording of the credit submission for the extension should have alerted them to the fact that the assignment over the call proceeds had not been provided, although the drawdown had already occurred. They rely on the face sheet of the credit submission, where it states “assignment over all call moneys from partly paid shares in QL upon successful takeover of Qintex America by QAL”.

Counsel for the directors submit that it is unreal in the extreme to expect directors confronted with this documentation to pick up the nuance of the word “upon” as indicating the assignment had not already occurred. They further submit that, if the assignment had not occurred, it was up to management to bring this specifically to the attention of the directors. It is convenient to say immediately that the Commission accepts the gist of both these submissions.

Extension of facility 1 for three years

Counsel assisting submit that the approving directors failed to exercise the degree of care and diligence required by s229(2), by approving the extension of facility 1 without obtaining sufficient information about the borrower’s cash flow to enable them to be satisfied that the facility could be serviced and without requiring proper and adequate security. They further submit that Mr Johns failed to exercise the degree of care and diligence required by s229(2) by failing, as the account manager, to inform the approving directors that the
security for the extended facility did not include any assignment over the call proceeds which had been part of the original security for the facility. By November 1988, the directors were aware of the cash flow deficit identified in the internal review prepared by Stott and Maddison and held a concern about the level of Tricontinental's exposure to the Skase group.

Counsel for the directors submit that the credit analysis in the submission for the extension of facility 1 was proper, and also that the submission made the directors aware of the cash flow deficit. They further submit that the internal review prepared by Stott and Maddison identified Tricontinental's concern about its exposure to the Skase group, and that the directors did not need to insist upon obtaining any further information, having regard to their background knowledge and also information provided by Johns. In this connexion they submit it cannot be concluded that the directors approved the extension without obtaining sufficient information on cash flow to enable them to be satisfied that the facility could be serviced and without requiring proper and adequate security. They submit it is clear that there was sufficient information available to the approving directors.

(b) Facility 2

Oral approval

As to the giving of oral approval to this facility, counsel assisting submit that the conflict of evidence between Stott on the one hand and Smith, Ryan and Carr on the other should be resolved in Stott's favour. They further submit that, if it is found that Smith, Ryan and Carr gave approval as noted by Stott, it is highly improbable that Stott gave the directors enough information to justify the approval of the facility, particularly having regard to the information contained in the credit submission which was later prepared. At this time the directors were aware that the Skase group was unable to repay its facilities and was in substantial breach of security covenants. Facility 1 was extended because there was "no option". They submit that Smith, Carr and Ryan, in approving the facility without information as to the adequacy of the security or how the facility was to be repaid, failed to exercise the degree
of care and diligence required by s229(2) of the Code. They further submit that Mr Johns failed to exercise the degree of care and diligence required by s229(2) in proposing the facility in circumstances where the security was inadequate and repayment depended upon the uncertain event of refinance.

Counsel for the directors submit that it is not open to the Commission to find beyond reasonable doubt what events took place and that, on the evidence, it should not conclude that facility 2 was approved by the directors. They further submit that, if the Commission finds that Carr, Ryan and Smith did approve facility 2, the Commission cannot find that they were not given sufficient oral information to place them in a position to approve the facility. In this respect it is submitted they cannot be said to have been negligent.

Adequacy of security

As to the adequacy of the security, counsel for the directors submit that there is no evidence to suggest that any other security was available and that the evidence establishes that Mr Johns' advice was that Tricontinental was unable to obtain any better security than that obtained.

Counsel assisting submit that the approving directors failed to exercise the degree of care and diligence required by s229(2) in approving this facility in circumstances where there was insufficient information on the adequacy of the security to be provided. They submit that the approving directors should have rejected the credit application when told that no better security was available to Tricontinental.

Extension of facility 2

Counsel assisting submit that the approving directors failed to exercise the degree of care and diligence required by s229(2) in approving the extension of facility 2, knowing that the borrower had failed to adhere to previous arrangements for repayment of the facility and that there was concern about Tricontinental's exposure to the Skase group and under-secured position on its facilities.
Counsel for the directors submit that the extension was a proper transaction and that it should be recalled that the directors had found themselves in a "work-out arrangement" due to the failure of Mr Johns to ensure the security of the initial facility was in order.

**Delays in enforcement action**

Counsel assisting submit that, as the only enforcement action taken before the service of demands in November 1989 was attempts by Mountford and Wigginton in September and October 1989 to obtain financial information from the Skase group and arrange a meeting with Skase, it is open to find that the enforcement action taken was unacceptably slow. They further submit that the absence of adequate enforcement procedures at Tricontinental allowed this to occur, and that the directors failed to exercise the degree of care and diligence required by s229(2) in failing to ensure that such procedures were in place and strictly adhered to, to ensure that enforcement action was considered as soon as a facility expired without repayment.

Counsel for the directors submit that there is no evidence to suggest in the circumstances of this case that the enforcement action was too slow. They submit it is a matter of looking at such action on a case-by-case basis and making a judgment at the time. They further submit that there was no real examination by the Commission of events after May 1989 and that, in the circumstances, it is not open to the Commission to make any finding as to the adequacy of enforcement action taken by Tricontinental.

**H. Conclusions and Findings**

These two transactions provide examples of the fact that major loans were often approved by Tricontinental directors without any documentation being provided. The directors gave evidence that this was a rare occurrence, and they were obviously surprised by the number of cases which were put to them in evidence. However it was Mr Stott who handled the credit submissions, in the sense that his department was responsible for their preparation and processing, and his evidence was that there were several new transactions each
month dealt with in this way. In a number of cases which the Commission has examined, including these two, there was an expression of urgency, but little or no evidence to support it.

In this case, the Commission is satisfied, on the balance of probabilities, that directors did give their approval to two transactions on the basis of what they were told in conversations. In the first case there was a meeting, and Mr Johns was the informant; in the second case, Mr Stott contacted the directors by telephone.

This was obviously an undesirable practice, to be adopted only in cases of genuine emergency. The directors themselves do not suggest otherwise. Because they have little recollection of the occasions, they can only say that they must have been satisfied at the time that the matters were appropriate to be dealt with in this way. The Commission can find nothing to support that view.

The directors were persuaded to approve the first facility because it was for such a short term and there appeared to be an assured takeout through an assignment of the call proceeds. In fact, it seems probable that no such assignment was ever obtained. It is puzzling that, when it became apparent that there was in fact no assured takeout at all, and the facility had to be extended for a period of years, the directors do not seem to have asked any questions about how this situation arose. It must be assumed that, when the three-year extension was considered, the directors did not recall and were not reminded that there had been an assured takeout. The extension was considered at the same time and apparently on the basis of the same background information as other extensions of Skase group facilities. There may well have been no additional security available by November 1988. Yet, the security which QAL had already agreed to provide would have been adequate as the security for the extended term. The evidence suggests that Skase only asked for an extension of the facility - not for Tricontinental to give up its primary security and source of repayment.
The real problem with the extension stemmed from the fact that the directors did not recall what the agreed security had previously been. They may not have questioned the security because they had already been told and accepted that the security position could not be improved. If they had queried the security (which they could have been expected to do, given that they all regarded the extended facility as effectively unsecured), the assignment may have been obtained and the facility may have been repaid. There is no evidence to suggest that at some point before the extension was approved it became impossible for Tricontinental to obtain the assignment.

The Commission accepts the submissions of counsel for Mr Hunter that there is not sufficient evidence to show that he was in breach of his duty in failing to obtain the necessary assignment. It may be that he was acting on Johns' instructions or, less likely, the fault may have lain with Tricontinental's solicitors.

So far as the three-year extension of the first facility is concerned, the Commission cannot say that this was, in itself, a bad commercial decision. Although the credit submission was clearly deficient, both on the subject of cash flow and in failing to refer to the former security which was no longer offered, the directors had by now received an internal review of the Qintex group and were aware of its difficulties. Without knowing exactly what they were told by Mr Johns, it is not possible to conclude that the commercial decision they reached was incorrect. The internal review of the Skase group, first considered by the board in June 1988, had drawn attention to some serious liquidity problems, but had been generally optimistic about future profitability. Tricontinental was exposed to the Skase group to the extent of $223.56m, and any attempt to call in its major loans must have had drastic consequences for the group's viability. On the other hand, if directors had probed the security question, they might have been reminded of the assignment of call proceeds, and insisted on its retention.
Although the Commission feels unable to condemn directors for granting the three-year extensions that Mr Skase had sought, the concerns felt by directors at this time throw into sharp relief their extraordinary conduct in approving a fresh loan, in December 1988, for the refurbishment of a hotel in Hawaii. The Commission finds it impossible to understand how directors could have been persuaded to lend a further $25m to the Skase group for a project about which they knew so little, where the takeout arrangements were quite vague, and the security was a charge to be taken over units in the hotel in question which was owned by a foreign 'limited partnership'. It would be difficult to imagine a more uncertain type of security. Directors had previously been told, at a board meeting, that there was no additional security available to cover its exposure to the Skase group.

Since none of the directors could remember approving this facility, although Mr Smith recalled at some stage discussing it with Mr Johns, the Commission is left with no explanation as to why they would have pursued such a dangerous course.

Of all the transactions looked at by the Commission, this is the one which, on the surface, seems to provide the strongest evidence of a failure by directors to exercise the degree of care and diligence required by s229(2) of the Companies Code. However, the Commission does not recommend that proceedings be taken. This is partly for reasons which are dealt with in more detail in chapter 15 of vol 2 of this report, and partly because, in the particular case, it might be difficult to establish beyond reasonable doubt that the three directors did actually approve the facility. It is one thing for the Commission to be satisfied on the balance of probabilities, in the light of its examination of this and many other transactions. It would be a different matter to establish the approvals beyond reasonable doubt, particularly when this transaction is looked at in isolation.

The Commission does not believe that there is much substance in the criticism made of the extension of this facility, for reasons already given in relation to
the three-year extension of the first facility. Nor is the Commission satisfied that there was any enforcement action which could usefully have been taken once these facilities fell into default.

83 Mr Johns must accept responsibility for failing to point out to directors that, in granting the three-year extension of facility 1, they were forgoing Tricontinental's assured takeout.

84 He must also accept the major responsibility for proposing the extraordinary facility 2. He was the account manager, he negotiated the structure of the facility and he gave it his approval.