NEWSLETTER

cornwallstodart
ENHANCING SUCCESS

MAY 2012

Corporate & Commercial Newsletter

Welcome to our May Corporate & Commercial newsletter

Welcome to our May issue of the Corporate & Commercial team newsletter. This month we have included news on:

- directors' duties and the James Hardie and Centro decisions
- teething problems arising from the new PPS Register
- implications of the High Court's decision in *Roadshow Films Pty Ltd v iiNet Limited*
- proposed amendments to tax legislation that seek to impose personal liability on directors
- Cornwall Stodart's role in saving the ANZAC biscuit.

We hope you find the newsletter informative and useful. Please contact us should you require further information on any topic, whether covered in this newsletter or not.

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Directors' duties: in the spotlight again but have directors' legal obligations really changed?

Earlier this month, the High Court delivered judgment in the much anticipated James Hardie appeals.[1] Some commentators have argued that this decision and the high profile Centro[2] decision handed down last year have changed the corporate governance landscape for company officers.

Our view is that while these cases have brought a number of governance practices in corporate Australia into sharper focus, no new fundamental director and senior management duties have been established. Rather, the cases cement what courts have been consistently warning directors and senior management about for some time – that they have a positive obligation (undiminished by delegating responsibility) to:

a. vigilantly supervise their management teams and external consultants (including auditors) and take steps to test the reasonableness and accuracy of material put before them;
b. take action if they have concerns about the validity of financial information, management recommendations or company announcements and ensure that there are documented records supporting the action; and
c. carefully review records and ensure accurate record keeping at board level – the review of draft minutes for approval should not be seen as merely an administrative exercise but an important risk minimisation step for each and every officer.

The decisions

The James Hardie and Centro decisions turned heavily on their facts. However, they are worthy of a closer examination because the judgments provide useful guidance on the standards of enquiry expected of company officers.

[1] *Australian Securities and Investments Commission v MacDonald* (No 11) (2009) 256 ALR 199, and the Court of Appeal decision *Morley v Australian Securities and Investments Commission* (2010) 274 ALR 205

[2] *Australian Securities and Investments Commission v Healey* (2011) 278 ALR 618

James Hardie

The facts surrounding the James Hardie case were well publicised. ASIC alleged that the non-executive directors of James Hardie, negligently approved a draft press release confirming that a foundation established to deal with legacy asbestos claims would be able to meet all legitimate claims and provide certainty for people with such claims. In fact the foundation was substantially under-funded, by more than $1 billion. Although ASIC won the case at first instance, the NSW Supreme Court of Appeal ruled in favour of the former non-executive directors, saying it was ultimately not established that the directors had approved the press release.

Despite this, the court decided it was appropriate to determine whether a contravention had taken place on the assumption that ASIC established that the draft announcement had gone before the board and that the non-executive directors had approved it.

The court said the directors would have been in breach of their duties. In exercising due care and diligence, a non-executive director had to give independent consideration to the document and was not entitled to merely rely on management for its accuracy. The court said, 'the non-executive directors, with their familiarity with the importance of sufficiency of funding and whether an assurance of sufficiency could be given, could not properly accept the say-so of management...it was a matter for application of the directors' minds... The standard practice, if followed, would not relieve the directors from applying their own minds to whether such an important announcement was misleading.'[3] In other words, to discharge their duty it was incumbent on the board to consider the statements' accuracy. This obligation extended to overseas directors who were present and participated in the board meeting even though they did not have the press release to review.

Given the circumstances, it was not a particularly onerous task for a director to undertake. The decision also highlights that directors who are not in a position to make a decision should abstain.

Centro

The Centro case involved a breach of the statutory duty of care and diligence when the company's directors signed off on misstated annual accounts. The directors submitted that they had relied on the competence of the financial management team and the company's auditors, who had misrepresented the position of current liabilities by some $2 billion by classifying these liabilities as non-current. Their submissions of reliance failed because the directors either knew or ought to have known of the very significant short-term debt that was not disclosed in the accounts.

The directors had an obligation under the *Corporations Act 2001* (Cth) to declare whether in their opinion the financial statements complied with accounting standards and presented a true and fair view of the affairs of the company. This duty is not diminished by delegating responsibility. Their failure to inquire whether all debt was correctly classified amounted to a breach of their duty.

This decision should not concern the conscientious director. The court held that 'each director is expected to take a diligent and intelligent interest in the information available to him or her, to understand that information, and apply an enquiring mind to the responsibilities placed upon him or her.'[4] This means directors should at the very least review what is put before them. If information is lacking, directors must abstain from voting until all the information necessary is made available to make an informed decision.

The lessons and state of play

These judgments do not significantly alter the current state of play. Courts have been consistently warning directors to remain vigilant in their surveillance of what management is doing.

However, it is important to clarify that the judgments do not stand for the proposition that directors can never rely on the advice of management or external consultants.

In the Centro case, there was simply no inquiry at all. There may be cases where directors are compelled to rely on management and may be entitled to do so, but the extent to which they can justifiably rely on advice will depend on the circumstances. This will depend, in part, on the importance of the decision being made and whether the results of the directors' inquiry would satisfy a reasonable person in their position. Reliance ceases to be reasonable when a director is aware of circumstances that would cause a person in their position to question what he or she is being told. The mistakes in the Centro case were so obvious that the directors could not simply accept the advice of management and the auditors. As for the directors of James Hardie, the magnitude and importance of the press release should have set them on an independent path of enquiry to test the veracity of its contents.

The lessons to be learnt from the James Hardie and Centro decisions are:

- ensure that as a director you have read and properly understood documentation upon which you are asked to make a decision; and

[3] Court of Appeal decision *Morley v Australian Securities and Investments Commission* (2010) 274 ALR 205, 359

[4] *Australian Securities and Investments Commission v Healey* (2011) 278 ALR 618, 626

- always make further enquiries when appropriate and based on the gravity of the decision being made, so you are not merely acting as a 'rubber stamp'.

Pitfalls of the Personal Property Securities Register

It is almost four months since the commencement of the *Personal Property Securities Act 2009* (**PPSA** or **Act**) and the initial teething problems experienced with the PPS Register established under the Act continue unabated. A quick snapshot of the problems includes:

- approximately 6,000 charges registered on the ASIC Register of Company Charges failed to migrate to the PPS Register;
- more than 38,000 satisfied charges appear on the PPS Register as current/unsatisfied charges, when in fact they were satisfied before 30 January 2012;

- charges registered on the ASIC Register with more than one chargee were migrated to the PPS Register with only one chargee;
- some security interests over specific assets have been wrongly registered as all-asset securities (ie the old fixed and floating charge) in the migration process; and
- in order to obtain a full list of the security interests registered against a company, you need to search against an ACN, ABN and the company name. Each search may produce different results.

The ability for registrations to be made now without supporting documentation also means that many people are making registrations that are far broader than they are entitled to.

A practical example

Recently we acted for the purchaser in a $50M company acquisition that was financed by one of the major banks. The transaction was held up by mistaken and incorrect registrations on the PPS Register.

Approximately 200 registrations were made against our client, with several registrations claiming to be over 'all present and after acquired property' of the company (now known as 'APAPs' and previously referred to as fixed and floating charges). The bank was not willing provide finance unless all APAPs registered over our client were removed.

Most of the APAPs registered were incorrect and should have been limited to specific assets (previously referred to as fixed charges). During the migration process these fixed charges were mistakenly registered as APAPs on the PPS Register. We were able to provide the bank at settlement with copies of all contracts that demonstrated the nature of the fixed asset securities.

There were also several APAPs registered over our client that had been incorrectly registered after the commencement of the PPS Register by several parties who were only entitled to register against specific assets. We were able to negotiate with those parties to sign an acknowledgement that they did not have an APAP over our client and that the security interest held was limited to specific assets.

Ordinarily we would expect the banks to require an undertaking from a party who incorrectly registered a security interest, that they would amend the registration within a defined period. The PPSA also provides a formal mechanism, called an 'amendment demand', which requires parties to amend incorrect registrations before the end of 5 business days after the day the demand is given.

The bank was willing to depart from this practice and accept written acknowledgements from those parties that their registered security interests were incorrect and that their security was limited to specific assets only.

You must be proactive

Clearly a lot of confusion has been created by the incorrect migration of old registrations and from parties making inaccurate registrations since the commencement of the PPS Register.

So what should you do?

If you are proposing to undertake any business transaction involving finance, it is essential that you audit the security interests that have been registered against you and your business as soon as possible.

We can arrange PPS Register searches for you and your business, assist you in reviewing the search results and rectifying incorrect registrations. A proactive approach to investigating and curing incorrect registrations is critical to obtaining bank finance in a timely and cost effective manner.

Your illegal downloading is being monitored – implications of Hollywood's copyright action against iiNet Limited

iiNet Limited's (**iiNet**) narrow escape from liability for online copyright infringement by its customers may inspire policy reform leading to greater obligations on internet service providers (**ISPs**) as future technical advancements allow them to accurately and reasonably prevent infringement. Until then internet users should not presume that they will always be free to download illegally. Warning emails from ISPs and possible disconnection remain a real possibility in the future. Read on.

Background

In *Roadshow Films Pty Lt v iiNet Limited*, a group of thirty four Australian and US film and television companies (**Studios**) alleged that the ISP, iiNet, authorised its customers' primary infringement of the Studios' copyright through the illegal downloading and sharing of content via BitTorrent or peer-to-peer networks. The Studios claimed that iiNet had received credible information of customers' copyright infringement and had failed to enforce the terms of its agreements with the customers through a system of warnings, suspensions and terminations, thereby 'authorising' the infringing activity.

The decision

On 20 April, the High Court held that iiNet had no direct power to prevent its customers from using the BitTorrent system to infringe copyright in the Studios' films or to block access to their films, which were made available online. The only practical course of action for iiNet would have been to terminate its contractual relationships with the customers and this would create several other issues including the cost to the ISP of administering warnings and terminations, the lack of a genuine resolution of the infringement problem due to customers being able simply to engage alternative ISPs and wrongful termination exposing ISPs to liability.

What does this mean for Australian internet users?

For now, there is no immediate impact on the average internet user in Australia. However, your illegal downloading of films can be, and is being, monitored. The internet is not the anonymous landscape that many presume it to be. Copyright owners can identify the IP address being used to download illegal content and can pass this information on to the ISP, or indeed to the Australian Federal Police or the FBI depending on the scale of the problem.

On the facts of the current case, it was not reasonable for iiNet to terminate the accounts of allegedly infringing customers. iiNet appeared 'indifferent' to the complaints of the Studios. This indifference was a reflection on the reality of the situation – iiNet did not have the technical ability to control customers' activities and the evidence of infringing conduct provided to iiNet by the film studios was inadequate. iiNet's indifference did not, on this occasion, amount to 'authorisation' of infringement.

However, in the future, technological advances will make it feasible for ISPs to monitor and control users' activities. Also, copyright owners will be alert to the need to furnish ISPs with adequate evidence of infringement by users. At some point ISPs are going to have sufficient ability and information to prevent infringing conduct by users. A failure to do so could mean that the ISP is deemed to have authorised the infringing conduct.

Where to now for copyright holders?

The decision is not a disaster for copyright owners. It still means that ISPs will, in the future, need to work with the copyright owners to prevent illegal downloads. Copyright owners will need to provide adequate information to ISPs about the allegedly infringing conduct. There will need to be an agreement on who bears the cost of sending out warning letters and monitoring user conduct. This could mean higher prices for Australian consumers. The copyright owners will also need to indemnify the ISPs in case they get it wrong and terminate an account that has not actually been engaging in infringing conduct.

Copyright owners need to look at why Australians illegally download films or TV series. Frequently, the motivation is to obtain access to content which is not yet available here. Making legal downloads available at a reasonable cost and within a shorter time period after release overseas will help remove the need for users to download illegally.

Will users be disconnected?

Repeat offenders – people who continue illegally to download films or TV series following warning notices – should be

disconnected. In the future, if lobbying from the Studios is successful, we are likely to see a regime where the accounts of repeat offenders can be terminated. ISPs may be compelled to cooperate with the copyright owners, otherwise they could well be held liable themselves for authorising infringement.

New legislation seeks to impose personal liability on directors

On 19 October 2011, we sent an alert regarding the *Tax Laws Amendment (2011 Measures No 8) Bill 2011*, which proposed to amend the tax law by making directors personally liable for unpaid superannuation guarantee contributions.

In late 2011 the House of Representatives Standing Committee on Economics published a report recommending that Schedule 3 of the Bill (which provided for director penalties in relation to unpaid superannuation entitlements) be deleted and further consultation undertaken. In response to this the federal government withdrew Schedule 3 and the rest of the Bill passed into law.

Unfortunately, this reprieve for directors appears to have been short lived.

On 18 April 2012 the government released exposure draft *Tax Laws Amendment (2012 Measures No 2) Bill 2012: Companies' non-compliance with PAYG withholding and superannuation guarantee obligations* for public comment. This Bill also seeks to extend the current direct liability regime for superannuation contributions and imposes further penalties for phoenix activity. Public comment closed on 2 May 2012.

Proposed changes

The current version of the Bill proposes to render directors liable for more than the compulsory superannuation guarantee contribution of 9%. Instead, directors will be liable for a superannuation guarantee charge. This superannuation guarantee charge is comprised of 9% of each employee's total salary or wages plus interest calculated from the beginning of the quarter in which the contribution was due, until the later of the lodgement of a superannuation guarantee statement outlining the shortfall amount or the 28th day of the second month after the relevant quarter (ie 28 August for the quarter ending 28 June) plus an administration fee of $20 per quarter for each employee.

The Bill grants the Commissioner the power to issue a notice of unpaid liabilities and to commence proceedings to recover that amount after 21 days. The amount will be recovered as a director penalty when a superannuation guarantee contribution is unpaid and unreported for three months.

Within the 21 day period, directors can prevent the director penalty by:

- paying the liability;
- causing the company to pay the liability;
- appointing an administrator; or
- commencing winding up of the company.

Placing the company into external administration after the three months will not prevent personal liability against the director.

Currently, a director can extinguish potential personal liability by appointing an administrator or beginning the winding up of the company before the 21 day period **following the service of a director penalty notice**. The Bill provides that a director's personal liability can only be prevented by external administration if the administration occurs within three months of the **due date of the unpaid debt** (for new directors the company must be placed in external administration within 3 months of their becoming a director).

Corporate & Commercial Success Story

Saving the cookie from crumbling

'This was a difficult but extremely rewarding transaction. The dedication and performance of the Cornwall Stodart team was outstanding and I am immensely proud of their efforts.'

'The hard work was worth it in the end. 170 employees remained employed and the iconic Anzac biscuit was saved.'

Gideon Meltzer and **Levent Shevki**
Partners, Corporate & Commercial

Our client

Our client is a private company owned and controlled by a consortium of private investors and several Executive Managers formerly employed by a struggling biscuit manufacturer. The company's ambition was to acquire the business of the manufacturer to enable continuing trade and long term sustainability.

Their ambition

The business purchased is the fourth largest biscuit manufacturer in Australia, with 170 employees and product lines that are staples within the Australian home, including the iconic Anzac biscuit.

Shortly after the company went into voluntary administration, our Mergers & Acquisitions team, led by Gid Meltzer and Lev Shevki, worked rigorously with multiple stakeholders to get the deal across the line in order for the company to recommence operations within the critical timeframe required for the transaction to be successful.

Our role was not confined to the usual orchestrating and finalising of the sale and purchase of the business and assets. It was essential that suppliers, customers and other key stakeholders were managed to ensure the business had their support in recommencing its operations. We also drew upon the experience and expertise of our Reconstruction & Insolvency team in dealing with the insolvency law issues that arose.

Enhancing their success

Through the extremely hard work and determination of our Mergers & Acquisitions team, the deal was finalised within 8 days of the company being put into voluntary administration. This limited the impact on the business' dedicated employees, and enabled the business to retain all 170 of its staff with immediate effect.

The speed at which this deal was co-ordinated also ensured that the majority of the company's perishable stock was saved from wastage.

Behind the headlines

The urgent nature of this transaction required our team to work extremely long hours in the office and off-site in order to deal with the changing issues that arose and to bring the deal to a close.

The transaction changed its form on the eve of the settlement due to certain complexities that arose. Following intense negotiations with the administrators and an ensuing proposal (preparation of which lasted well into the early hours of the morning), our team implemented practical solutions that enabled the transaction to be completed successfully.

The deal was finalised late in the evening on Friday 9 March 2012, in time for the business to recommence production of their famous Anzac biscuits and play its part in keeping the Anzac tradition alive.

Corporate & Commercial Team Member Profile

Michael Kohn, Partner and Head of Revenue Law

Michael has over 25 years' experience in revenue law. As a qualified chartered accountant, he was a tax partner in one of the top four international accounting firms. Michael has been instrumental in expanding the tax practice of our firm, incorporating existing expertise in areas including tax litigation, corporate advisory, not for profit, private equity, banking and finance, and property.

His expertise includes private equity, trust law and corporate reorganisations, as well as revenue law and in particular: taxation of companies, trusts, individuals and charitable organisations; tax controversies, audits and investigations; tax risk assessment and management; goods and services tax and transfer pricing.

Michael advises on a range of taxation matters involving clients with diverse commercial profiles, including small to medium enterprises, and large national and international companies. His clients operate across various industries, including retail, property, construction and finance.

His expertise in tax litigation in particular has assisted our firm in becoming a highly sought-after resource for clients facing the intrusion of the ATO into their affairs. Such intrusions are becoming more frequent, in the face of the current Australian tax landscape and the Commissioner's increasingly broad powers.

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