NEWSLETTER

cornwallstodart
ENHANCING SUCCESS

August 2013

Commercial Litigation Newsletter

Welcome to our August Commercial Litigation Newsletter

This quarter we have included news on:

- the importance of registration under the *Personal Property Securities Act 2009* (**PPSA**) and the decision in *Maiden Civil (P&E) Pty Ltd & Ors v Queensland Excavation Services Pty Ltd* [2013] NSWSC 852
- security for costs and the decision in *Madgwick v Kelly* [2013] FCAFC 61
- the importance of considering tax in commercial disputes
- the role of an expert in the context of *Smith v Gould* [2012] VSC 461
- retail leases and why it is important that landlords and tenants are aware of whether they have entered into a retail lease.

Please don't hesitate to contact us if you would like more information on any topic, whether covered in this newsletter or not. We hope you find the newsletter informative and useful.

*Click on image to view Paul's profile

Paul Buitendag
Partner and
Head of Commercial Litigation
Phone (direct) **+61 3 9608 2110**
Mobile **+61 424 331 122**
Email **p.buitendag@cornwalls.com.au**

The importance of registration under the PPSA –

Maiden Civil (P&E) Pty Ltd & Ors v Queensland Excavation Services Pty Ltd [2013] NSWSC 852

Background

The New South Wales Supreme Court recently handed down a decision relating to the first substantive priority dispute under the *Personal Property Securities Act 2009* (**PPSA**). Now, an owner of goods who creates a lease under the PPSA but fails to register their security interest under the Personal Property Securities Register (**PPSR**) will lose those goods to another party who has perfected their security interest over the same goods. Additionally, the lessor who fails to register their goods on a 'transitional register' (Northern Territory register) prior to the registration commencement time will not be afforded the 24-month temporary perfection.

Summary

In May 2010 Westpac and Esanda financed the lessor, Queensland Excavation Services Pty Ltd (**QES**), to purchase Caterpillars (a wheel loader and two excavators) (**Equipment**). QES and its financiers failed to register their interests in the Equipment on the Northern Territory register of motor vehicles prior to the commencement of the PPSR. Shortly after QES leased the Equipment to Maiden Civil (P&E) Pty Ltd (**Maiden**), whereby Maiden took possession of the Equipment and used it in civil construction works in the Northern Territory.

In March 2012, Maiden entered into a short-term loan agreement with Fast Financial Solutions Pty Ltd (**Fast**), which included a General Security Deed (**GSD**) granting a security interest over all of its assets including the Equipment. Fast then registered their security interest on the PPSR. Shortly thereafter, Fast became aware of a number of events of default under the GSD; hence Fast appointed receivers and managers of 'all of the company's assets', claiming possession of the Equipment.

Decision

The court found in favour of the receivers. The lease was found to be a PPS lease, meaning it was a lease of a serial numbered good for more than 90 days. Following New Zealand and Canadian case law, the court determined that Maiden as lessee had both a possessory interest and a proprietary interest in the Equipment, sufficient to enable them to grant a security interest in the property itself and not just in the leasehold interest.

As a result, QES as lessor/owner and Fast as holder of the perfected security interest had a competing interest in the Equipment. Ordinarily, QES would have had a superior security interest and attracted temporary perfection under the PPSA. However, in this instance QES failed to register the security interest under a 'transitional' register required in the Northern Territory. QES had also failed to register the security interest on the PPSR, leaving it with an unperfected security interest in the Equipment. Consequently, the receivers of Maiden were entitled to the Equipment, to sell and realise the value in order to satisfy the debt owing to Fast.

Impact

The case highlights the need for lessors to consider whether their agreement falls within 'PPS leases' or 'in substance security interests'. Property owners who lease their goods (and financiers of those goods) must be vigilant in registering their interests on the PPSR. It is also prudent for owners to bear in mind that the grace-period of 24 months for temporary perfection may not apply if the security interest was registrable on a transitional register but was not registered before the commencement date of the PPSR (30 January 2012). Owners may stand to lose their security interest in the goods for failing to perfect registration.

Security for costs – general principles and *Madgwick v Kelly* [2013] FCAFC 61

Introduction

A recent case has confirmed that security for costs can be ordered against individual applicants who do not have the backing of a litigation funder in a class action. Now, courts must expressly examine and undertake – particularly in a class action context – the balancing exercise of the costs burden on applicants.

Summary

The object of security for costs is to indemnify a party for the costs of litigation. While the possibility of not being able to recover costs against the defendant is a risk the plaintiff assumes in commencing proceedings, a defendant – a compulsory party – does not have the same luxury of choice. It is for this reason that the defendant has a special claim to be indemnified against the plaintiff, which an order for security provides.

The court has inherent jurisdiction to make an order for security for costs. Jurisdiction is also conferred on the court by the *Corporations Act 2001*, Order 62 of the Supreme Court (General Civil Procedure) Rules 2005, the County Court Civil Procedure Rules 2008 and the Magistrates Court General Civil Procedure Rules 2010. Order 62 states the grounds on which the court may order that the plaintiff give security for the costs of the defendant and that the proceeding may be stayed until such security is given:

a. *the plaintiff is ordinarily resident out of Victoria;*

b. *the plaintiff is a corporation or (not being a plaintiff who sues in a representative capacity) sues, not for the plaintiff's own benefit, but for the benefit of some other person, and there is reason to believe that the plaintiff has insufficient assets in Victoria to pay the costs of the defendant if ordered to do so;*

c. *a proceeding by the plaintiff in another court for the same claim is pending;*

d. *subject to paragraph (2), the address of the plaintiff is not stated or is not stated correctly in the plaintiff's originating process;*[1]

e. *the plaintiff has changed his, her or its address after the commencement of the proceeding in order to avoid the consequences of the proceeding;*

f. *under any Act the Court may require security for costs.*

These grounds are not exhaustive and the court retains its unfettered discretion to make orders upon the examination of all the relevant circumstances. However, courts have stringently applied the principle that 'poverty is no bar to a litigant', effectively prohibiting security for costs orders being made against impecunious individual plaintiffs.

However, despite the long standing principle that security for costs will not be ordered against impecunious individual plaintiffs, the Full Court of the Federal Court in *Madgwick v Kelly* [2013] FCAFC 61 ordered that security for the respondent's costs be paid by impecunious applicants not backed by a litigation funder in a class action. The decision was principally based on the applicants' failure to establish that security for costs would stultify the litigation.

Background

A class action was brought on behalf of investors of Willmott Forests (forestry managed investment schemes). The primary judge found the representatives of the class (**Applicants**) would be unable to cover an adverse costs order for approximately $9.2 million.

The evidence tendered on behalf of the Applicants on the issue of whether an order for costs would stultify the litigation was a random survey of 50 known group members about their willingness and ability to contribute to a security pool. According to the results of the survey, 80% of the sample members could not afford $20,000 and were unwilling to contribute, and 65% would not remain part of the class action if they had to provide such security.

The primary court accepted the survey as adequate evidence that an order for security would stifle 'arguable claims' of the Applicants and group members.

On appeal, the Full Court held the positive factual finding on stultifying could not be drawn because:

- some 158 group members had average net assets worth $1.38 million, and 218 group members had average net assets of $187,523;
- the survey was not designed to calculate whether or not the known group members could afford to make a contribution to security or the willingness of the group to approach the matter on a pro rata basis (ie in proportion to their claims); and
- while it was open to the court to take '*reasonable unwillingness*' and inability to contribute to a fund into account, the survey result was not sufficient evidence of this.

The Full Court also noted the fact that the primary court failed to give adequate weight to the availability of litigation funding for

1 Paragraph 2 states that the court 'shall not require a plaintiff to give security by reason only of paragraph (1)(d) if in failing to state the plaintiff's address or to state the plaintiff's correct address the plaintiff acted innocently and without intention to deceive'

such claims. The court determined that it was not unreasonable to want to understand how the commercial litigation would be funded, because in this instance, investors with sufficient income or assets to enter into commercial investments now sought to engage in commercial litigation to address their claims. Absent evidence to this effect, it was not possible to conclude that the proceedings would be stifled by an order for security.

Impact

The case establishes that security for costs can be obtained by respondents in class actions where applicants do not have the backing of a litigation funder. However, in most instances, it will be necessary to prove that one or more of the exceptions apply to avoid the traditional rule protecting impecunious individual applicants. Where the respondents can establish that the applicants are suing for the benefit of others, or where the applicants fail to show that the litigation will be stifled, there is a reasonable prospect of security being ordered.

Don't forget tax when assessing your damages

Tax is rarely at the forefront of people's minds when they are attempting to resolve a dispute. However a party to a commercial dispute ignores tax at their peril. Australian courts have long followed the principle, first recognised in *British Transport Commission v Gourley*,[2] that courts should take the tax treatment of any damages payment into account when assessing and awarding damages.

For example, a plaintiff who conducts a business, and who has suffered loss due to a defendant's conduct, is likely to have paid less tax as a consequence of that loss. Similarly, when damages are awarded to a plaintiff, they will probably pay tax on the damages awarded. A court will take these factors into account and award damages with a view to the plaintiff's net (after tax) position.

What is the tax treatment of damages?

There are three possibilities. The damages may be:

1. tax free in the hands of the recipient;
2. taxed under the capital gains tax (**CGT**) provisions; or
3. taxed as ordinary income at the recipient's relevant tax rate.

It will be relatively rare for damages to be tax-free to a recipient. The relevant exemption, contained in section 118-37 of the *Income Tax Assessment Act 1997* (Cth), only applies to capital amounts paid as compensation to individuals for wrongs or injuries or illnesses suffered personally or in their occupation.

Business entities cannot access this concession, so any damages they receive will generally be taxed under the CGT provisions (in the case of capital amounts) or will be assessable as ordinary income (if the amount is a revenue receipt). CGT treatment will typically result in a better tax outcome because, depending on a party's circumstances, the recipient may be able to reduce any capital gain using the CGT general discount or small business CGT concessions.

Whether damages are a capital or revenue amount will depend on what the damages are replacing. For example, if damages are paid as compensation for lost trading profits, they will be taxed as ordinary income because the trading profits would have been ordinary income. By contrast, if damages are paid to compensate for the loss of a capital asset, they will be a capital amount and assessed under the CGT provisions. However, the capital/revenue distinction is a notoriously difficult area of tax law and the tax treatment of damages will not always be clear.

Getting it wrong can leave a plaintiff out of pocket

Because there is no 'bright line' test for determining the tax treatment of a particular damages amount, parties might reach different views about how the amount will be treated. If this happens, the court will typically reach a view on the tax treatment when it awards damages.

However, any view reached by the court is not binding on the Australian Taxation Office when it actually assesses the recipient for tax. This is demonstrated by the decision in *Commissioner of Taxation v Sydney Refractive Surgery Centre Pty Ltd*.[3] In that case, the taxpayer had been awarded damages in a New South Wales Supreme Court defamation action. When awarding damages, the court had concluded that the amount would not be assessable to the plaintiff as ordinary income. However, the Commissioner of Taxation (**Commissioner**) later took the view that the damages were ordinary income when assessing the plaintiff for tax. The practical consequence of this view was that the plaintiff would not receive full compensation for its loss. Although the plaintiff successfully argued that the damages were not ordinary income in federal courts, the courts accepted that the Commissioner was not in any way bound by the Supreme Court's view of the tax treatment.

2 [1956] AC 185

3 [2008] FCAFC 190

The decision serves as a reminder that a party might not receive appropriate compensation if either the litigants or the court assesses damages on the basis of incorrect tax treatment.

Practical strategies where the tax treatment is unclear

A plaintiff can take practical steps to avoid these difficulties. If the tax treatment of damages is in dispute, or is otherwise unclear, a plaintiff could seek an order that it be indemnified for any tax payable on the damages. This was the approach adopted in *BestCare Foods v Origin Energy*,[4] with the court observing that it was the quickest and cheapest way to avoid 'substantial argument on and decision of a very difficult point'. Such an approach protects the plaintiff's position without requiring a trial court to reach a view on tax treatment that will not be binding on the Commissioner in any event.

A plaintiff could also request an indemnity when negotiating a settlement to a dispute. If the parties disagree on the tax treatment, the defendant may want procedures for resolving the disagreement before granting an indemnity. Such procedures could involve the plaintiff applying for a private ruling from the Commissioner, and agreeing to object against an adverse ruling if the defendant wishes to challenge the Commissioner's view.

Comment

Parties to a dispute should consider tax when assessing their damages. Australian courts take the tax treatment of any damages payment into account when assessing and awarding damages. Parties can take practical steps where the tax treatment of damages is in dispute or is otherwise unclear.

4 [2012] NSWSC 574

The role of an expert in the context of *Smith v Gould*

Background

The objective of an expert witness is to assist the judge by providing an informed opinion based on the expert's skill, expertise and training in the field in which that person is giving evidence. While each party may engage an expert witness who supports each of their particular claims, the *Civil Procedure Act 2010*, Order 44 of the *Supreme Court (General Civil Procedure) Rules 2005* and the Expert Code of Conduct impose explicit obligations and duties upon an expert witness.

The case of *Smith v Gould* [2012] VSC 461 highlighted the shortcomings of an expert who was unable to provide assistance to the court in determining the value of a private company.

Facts

Geoffrey Smith applied to the Supreme Court of Victoria seeking an adjustment of property interests under the *Property Law Act 1958* following the breakdown of a domestic relationship of 14 years with Mr Robert Gould, 14 years his senior. The divisible property pool included a number of properties in the Toorak and South Yarra area, bank accounts and a substantial collection of artwork, some of which included artwork by leading Australian artists.

Prior to the commencement of the relationship, Mr Gould with his mother established Gould Galleries in South Yarra, which continues today to be a successful commercial art gallery. Mr Gould met Mr Smith when Mr Smith was a fine arts student at the University of Melbourne. Mr Smith went on to establish a career at the National Gallery of Victoria, specialising in modern Australian art, and is now the Chairman of Sotheby's Australia.

In this particular application, the court may make an order adjusting the interests of the divisible property on the basis that it is just and equitable having regard to a number of matters, including any financial and non-financial contributions brought to the relationship.

In order for the court to determine an appropriate adjustment, it must first identify and value the property of the parties to the relationship, second evaluate and balance the parties' respective contributions and third determine the orders required to sufficiently recognise and compensate the plaintiff's contributions.

Mr Smith alleged that his non-financial contribution was in his

scholarship and expertise in modern Australian art, which he alleged increased the value of Gould Galleries and therefore the equity of Mr Gould in Dukville Pty Ltd.

The major dispute between the parties concerned the valuation of Dukville. Mr Gould held half of the shares in Dukville, which held all of the units in the E & R Gould Unit Trust, for whose benefit Edrob Nominees Pty Ltd operated the business that was Gould Galleries.

Expert evidence

The court relies on expert evidence to assist in their determining of the value of a private company. His Honour Justice Dixon considered that, in theory, the most commonly accepted methodology for the valuation of a business is based on its cash flow. Here, the expert engaged by Mr Smith conducted the valuation based on a hypothetical liquidation. His Honour considered this was the incorrect approach, given that the hypothetical purchaser of the shares was looking at the profit and earning capacity of Gould Galleries rather than winding up the company.

His Honour stated that in attempting to evaluate the contributions made by Mr Smith to Gould Galleries, the manner in which the assets of the gallery were acquired and built up is a critical consideration, which is why earnings-based methodology is preferred. His Honour considered that valuation is a matter for expertise and one which the court should not conduct its own enquiry on or to seek to inform itself about.

The Smith expert was not asked by his client to express an opinion on the value of Dukville. The expert's enquiry was limited and the expert was unable to conclude that the income and expenses of Gould Galleries had been fully and accurately disclosed, in particular whether the level of stock held by Gould Galleries had been correctly disclosed in the financial years ending 2002 to 2004.

His Honour considered that the expert was in breach of the Expert Code of Conduct because he failed to address the 'real issues that his expertise, as opposed to his instructions, should have directed'. His Honour stated that it was incumbent upon the expert to have sought proper instructions to establish a suitable figure for maintainable earnings.

His Honour also said there was a failure of Mr Smith's advisers to direct the expert to the proper questions to be considered in the proceeding. Further, because the expert failed to 'pay anything more than lip service to the Expert Code of Conduct', his Honour was unable to rely on any expert opinion as to the proper value of the Gould Galleries business at any of the relevant dates.

Comment

His Honour's comments indicate that legal advisers ought to take considerable care in instructing and engaging an expert, having full regard to an expert's duties and obligations to the court.

It is also the responsibility of a legal adviser to educate a client on the role of the expert witness and the expert's obligations and duties owed to the court. Further, the legal adviser should ensure that clear and proper instructions are provided, allowing for an expert to not be limited or stifled by the perimeter of the instructions given, in order to avoid jeopardising the admissibility of the expert's evidence.

When are leased premises 'retail premises'?

The *Retail Leases Act 2003* (Vic) (**Act**) applies to leases of retail premises. The purpose of the Act is to increase certainty and fairness between landlords and tenants, and to provide dispute resolution mechanisms for resolving disputes.

It is important for landlords and tenants to be aware of whether their leases are governed by the Act.

'Retail premises' is defined by s 4(1) of the Act:

> In this Act, retail premises means premises, not including any area intended for use as a residence, that under the terms of the lease relating to the premises are used, or are to be used, wholly or predominantly for—

(a) the sale or hire of goods by retail or the retail provision of services; or

(b) the carrying on of a specified business or a specified kind of business that the Minister determines under section 5 is a business to which this paragraph applies.

The Act does not apply to leases:

- where the amount payable under the lease is more than $1,000,000 per annum excluding GST;
- where the tenant is a listed corporation or the subsidiary of one;
- where the tenant is operating a business on behalf of the landlord or as the landlord's agent;
- for less than one year; or
- that the Minister has determined do not come within the Act.

Ultimate consumer test

Whether premises are retail premises is determined by what the courts describe as the ultimate consumer test. That is, the provision of an item or service to the ultimate consumer for fee or reward. The end user may be a member of the public, but not necessarily so.

The Act applies to both retail provision of goods and services.

The provision of goods or services does not need to be for profit.

The Act applies to a broad range of leases, not just the obvious example of shops that supply consumer goods.

Types of businesses that have been held to be retail premises outside the standard retail shop include:

- bars, restaurants, cafes, nightclubs;
- petrol stations;
- car rental outlets;
- post offices and banks;
- car repairers;
- dancing schools, gymnasiums, tennis courts;
- professionals such as conveyancers, architects and medical specialists;
- hotels;
- serviced apartments;
- community services where premises were hired to consumers such as playgroups, mental health support groups and community groups.

A recent decision has confirmed the broad coverage of the Act. In *Fitzroy Dental Pty Ltd v Metropolitan Management Pty Ltd* [2013] VSC 344, Justice Croft applied the ultimate consumer test and found that a conference centre was retail premises. The conference centre was available to conference providers to hire. It was held that the conference providers were the ultimate consumers in a retail transaction with the conference centre. It did not matter that the conference providers were also providing services to the conference attendees.

How is the use of the premises determined?

Issues can arise regarding whether the use of the premises is that specified in the lease or the actual use made of the premises. The Act focuses on the use specified in the lease, but this may not be determinative.

Conclusion

It is important for landlords and tenants to be aware of whether their lease is regulated under the Act because there are a number of requirements, particularly for landlords, that need to be complied with if the Act applies. Landlords and tenants should be aware that the Act applies in a broad range of situations outside the common understanding of a 'retail' shop.

Cornwalls' Commercial Litigation Team Member Profile

Jarrod Munro, Partner, Commercial Litigation

Jarrod is the newest Partner in our Commercial Litigation team, having been promoted to the partnership on 1 July 2013.

Jarrod began his legal career in Perth, Western Australia, where he worked for around four years. He has also practised for a short time in Queensland, and is admitted to practise in New South Wales. In 2007 Jarrod was admitted to practise law in Victoria and, since then, has worked almost exclusively in the area of commercial litigation. He has substantial experience in running large scale litigation, with a focus on insolvency and bankruptcy, retail and commercial leasing disputes, construction disputes and banking and finance disputes.

Jarrod has particular expertise in the legal issues surrounding statutory demands, having acted for parties both applying for and resisting applications to set aside statutory demands on many occasions. He also has particular expertise in the legal issues surrounding commercial and retail leases during insolvency administrations.

In 2011 Cornwall Stodart became responsible for reviewing and updating the *Lexis Nexis Australian Corporation Law – Principles & Practice (External Administration)* loose-leaf volume on a quarterly basis. Jarrod is one of the co-authors involved in this process.

Jarrod Munro
Partner, Commercial Litigation
Phone (direct) **+61 3 9608 2139**
Mobile **+61 409 908 808**
Email **j.munro@cornwalls.com.au**

Want to republish any of this newsletter?

If you would like to republish any part of this newsletter in your staff newsletter or elsewhere please contact our Marketing team on **+61 3 9608 2168**

Disclaimer

This newsletter is intended to provide general information on legal issues and should not be relied upon as a substitute for specific legal or other professional advice.

Images

All images are used courtesy of www.freedigitalphotos.net