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No Priority for Commissioner in Company Liquidations through the Issue of Section 260-5 Notices

Corporate Senior Associate, Dahnia Mithiran, explains the decision of Bruton Holdings Pty Limited (In Liquidation) v Commissioner of Taxation.

The High Court has further clarified the law regarding the effect of section 260-5 notices served by the Commissioner on third parties who are required to make payments to a company in liquidation.

The effect of the decision is that the Commissioner cannot issue such a notice after a company has gone into liquidation in order to give himself a priority over other creditors for payment of a tax debt. Such a notice is void.

A section 260-5 notice is a notice served by the Commissioner on a third party who owes or may later owe money to the taxpayer who has a tax related debt to the Commissioner requiring that third party to pay that money to the Commissioner rather than the taxpayer.

The facts of the case were that the Commissioner served a section 260-5 notice on a firm of lawyers requiring that firm to pay money it held on trust for the relevant taxpayer on account of present and future legal costs. The relevant taxpayer was a company in liquidation that was a trustee of a charitable trust.

The Commissioner sought to gain a priority over other creditors of the company by issuing the section 260-5 notice to the firm of lawyers for that firm to pay the Commissioner rather than pay the balance of the funds after satisfaction of its lien for legal costs to the company in accordance with the obligations of the legal firm under the *Legal Profession Act*.

The *Corporations Act* provides, as relevant to this case, that:

- any attachment ... put in force against the property of the company after the passing of a resolution for voluntary winding up is void
- ... all debts and claims proved in a winding up rank equally and, if the property of the company is insufficient to meet them in full, they must be paid proportionately.

It was argued by the Commissioner that there was a conflict between the *Administration Act* which enabled it to issue the section 260-5 notice and the above provisions of the *Corporations Act* and therefore the provision of the *Administration Act* overrode the provisions of the *Corporations Act*.

The High Court said the critical question was whether these provisions of the *Corporations Act* could be diminished by the subsequent engagement of a section 260-5 notice. The High Court said these provisions were not so diminished.

First, the *Administration Act* had a regime for dealing with a company in liquidation so there was no conflict between the *Corporations Act* and the *Administration Act* which meant that a section 260-5 notice was not available to the Commissioner where a company was placed in liquidation.

Secondly, this conclusion was reinforced by the provisions of the *Corporations Act* which had the effect of binding the Crown in right of the Commonwealth.

The High Court also confirmed earlier authority that a section 260-5 notice was an attachment and therefore void where issued after the passing of a resolution for voluntary winding up.

APRA's Ban of Prominent Lawyer Overturned

Dispute Resolution Partner, Simon Morris, and Associate, Kyla Banton, discuss the recent decision of the Administrative Appeals Tribunal (constituted by Deputy President Justice Tamberlin and Member Frost) reversing a decision of the Australian Prudential Regulation Authority (APRA) http://www.austlii.edu.au/au/cases/cth/AATA/2009/601.html

The decision had disqualified Robert Stitt QC from acting as a director or senior manager of an Australian general insurance company. Accordingly, the disqualification of Mr Stitt is to be treated as if it never came into effect.

Mr Stitt was a non-executive director of HIH Insurance Limited and a member of the Audit and Human Resources sub-committees to the HIH Board. Mr Stitt is a Queen's Counsel and a member of the NSW Bar.

APRA disqualified Mr Stitt by administrative decision, exercising powers under the *Insurance Act* to disqualify persons from holding senior roles in APRA regulated organisations, on the basis that he was not a fit and proper person to hold such a role. The review of APRA's decision in the Administrative Appeals Tribunal (AAT) was a merits review.

After the exercise of its discretion to disqualify Mr Stitt, APRA's *Insurance Act* powers to disqualify as an exercise of administrative power, were removed by legislative amendment. The power to disqualify persons from holding senior roles in the Australian insurance industry is now to be undertaken judicially by the justices of the Federal Court.

APRA's disqualification of Mr Stitt was based on APRA's conclusions that Mr Stitt had, in the exercise of his duties, failed to act with due care and diligence. His lack of fitness was said to arise from a lack of competence. No suggestion was made that Mr Stitt's conduct was morally blameworthy.

The breaches of duty arose in the context of Mr Stitt's involvement in collective decisions of the HIH Board or sub-committees to the Board. The gravamen of APRA's case was that Mr Stitt was insufficiently diligent in performing his duties and that if he had been less trusting of management and more diligent in enquiring into the detail of matters, HIH may have avoided entering commercial transactions that, with the benefit of hindsight, APRA considered were not to HIH's commercial advantage.

The Tribunal rejected each and every one of APRA's contentions and expressly found that Mr Stitt did not act in a manner other than one which was competent and diligent.

On one level the case of Mr Stitt is a simple one. APRA asserted deficiencies in conduct which it contended told against Mr Stitt's competence in commercial matters and justified disqualification. The Tribunal found those allegations were without foundation and that on proper analysis Mr Stitt's conduct was both competent and diligent. However the case does raise some points of general application and interest in the exercise of banning powers whether they be judicial or administrative.

APRA's allegation that Mr Stitt ought to have conducted himself in the various ways alleged by APRA necessarily involves an allegation that he has fallen from some normative standard. The Tribunal's reasons disclose that where the conduct said to ground disqualification is reflected in a standard known to the law, for example a director's duty of care and diligence, then that is the standard which is to be applied. The Tribunal's reasons affirm the decision in *Vines v ASIC* that past contraventions do not of themselves create any presumption against a person's fitness and propriety, and stand for the proposition that a person will not be lacking in competence so as to be unfit if their conduct meets relevant normative standards. Should the outcome have been otherwise, the exercise of the discretion to disqualify would be vulnerable to idiosyncratic decision making.

The Tribunal's reasons uphold the distinction between executive and non-executive directors when considering questions of duty and standards of conduct. In responding to the general contention that Mr Stitt was too accepting of management, the Tribunal noted that as a non-executive director, Mr Stitt was not involved in the everyday management of the business and that the information provided to the non-executive Board of HIH was not frank and open and did not disclose all matters necessary for a proper examination of the business of the Board. The Tribunal found that the evidence did not disclose that Mr Stitt knew or ought to have known of the management misconduct so as to arouse suspicion requiring closer scrutiny.

APRA's case dealt with decisions to approve or advance transactions which, with the benefit of hindsight, APRA considered were not to HIH's benefit. In that context, the Tribunal warned of the dangers of "hindsight bias" – that is, distortions when matters subsequent to the conduct emerge and consequences are seen more clearly. The Tribunal cited the decision of Senior Member Taylor in the matter of *Abbott v APRA* (also a matter where an APRA disqualification of an HIH non-executive director was overturned) that *"Conduct that occurs without the benefit of hindsight must be evaluated with a proper and realistic regard to the subjective knowledge, belief and intentions of the persons involved"*.

The observation about the dangers inherent in hindsight reasoning are not the only common features in the matters of *Abbott* and *Stitt.*

In each matter APRA's conclusions that directors' duties had been contravened were grounded in material before the HIH Royal Commission even though, having regard to the same evidence the HIH Royal Commissioner, Justice Neville Owen, expressly did not find breaches of duty. In the case of Mr Abbott, APRA's contentions had, prior to the Tribunal hearing, already been dismissed in separate Court proceedings.

Having regard to the material relied on by APRA, the Royal Commissioner had concluded that HIH's corporate governance was undesirable. In large part APRA adopted the factual basis for the Royal Commissioner's criticisms of HIH's management practices to ground breaches of directors' duty. At this level the rejection by the Tribunal of APRA's contentions illustrates that the principles underpinning concepts of corporate governance are theoretically distinct from those underpinning the content of directors' fiduciary obligations. Corporate governance is about collective processes whereas directors' duties are directed to individual behaviours. Corporate governance commonly is directed to articulating best practice standards and is aspirational, whereas directors' duties are about setting minimum standards of individual conduct.

While APRA's case against Mr Stitt did not include any adverse contention as to any blameworthy aspect of his character, Mr Stitt's application was supported by a body of evidence attesting to his integrity and professional competence, experience and diligence in the legal profession and insurance industry. That evidence was uncontradicted by APRA and found by the Tribunal to be "particularly impressive" bespeaking of a person who in business affairs had a track record of competence such that, if APRA's contentions had been made out, they would have been out of character.

Mr Abbott also relied on a body of evidence from persons attesting to his reputation for competence and integrity in business affairs. Having regard to that evidence Senior Member Taylor SC held *"This evidence bespeaks Mr Abbott's extensive and creditable career both in legal practice and in his corporate and business life. It testifies to his long standing and enduring capacity and reputation for honesty and competence"*. As with Mr Stitt, APRA did not challenge this evidence.

While the evidence about Mr Stitt's and Mr Abbott's competence and integrity in business affairs were ultimately not relevant to the Tribunal's decisions, the treatment of the evidence and the apparent willingness of the Tribunal to rely on the material can be contrasted with the weight given by Justice Gzell to material relevant to character of former James Hardie directors in his recent decision imposing periods of disqualification from managing corporations and pecuniary penalties on those directors.

In both matters, despite APRA's disqualifications being overturned by the AAT, the absence of statutory basis for awarding costs meant that neither Stitt nor Abbott recovered legal costs of the disqualification process. There would seem no proper theoretic basis for this. Administrative proceedings of this type are, in terms of cost and approach, no different from Court proceedings. It is anomalous that under the new statutory regime these same matters would be litigated in the Federal Court and a cost order would follow the event, whereas the resolution of the same issues in the Administrative Appeals Tribunal does not attract a cost penalty for the unsuccessful party.

The absence in Tribunals of a general discretion to award costs limits access to justice in complex administrative processes to those with the financial backing to pursue their rights. This is surely inconsistent with and undermining of the intent of Commonwealth and State Tribunals to provide fair, just, economical, informal and quick merits review.

Simon Morris and Kyla Banton acted for Robert Stitt and Charles Abbott in the review of APRA's decision by the Administrative Appeals Tribunal.

Restraints of Trade in Franchise Agreements

Corporate Lawyer, Emma-Jane Clark, analyses the recent Supreme Court of Queensland decision of EzyDVD Pty Ltd v Lahrs Investments Qld Pty Ltd and the difficulties that may present for a franchisor in seeking to obtain an injunction to enforce restraint of trade provisions.

On 13 August 2009, the Chief Justice of the Supreme Court of Queensland dismissed a franchisor's application for an injunction to enforce restraint of trade provisions pursuant to a franchise agreement. The franchisor sought an injunction, as immediately following termination of the franchise agreement, the franchisee established a similar business as the business conducted pursuant to the franchise agreement, from the same premises. This case demonstrates the difficulties a franchisor may contend with in seeking to enforce restraint of trade provisions and also the importance of ensuring it is clear what the franchisor is seeking to protect in enforcing the restraint.

The respondent, Lahrs Investment Pty Ltd (Franchisee) signed a franchise agreement with the applicant, EzyDVD Pty Ltd (Franchisor). The agreement granted the Franchisee a right to operate an EzyDVD store together with a licence to use the Franchisor's confidential information and intellectual property in connection with the operation of a retail DVD business from a shopping centre store.

Restraint of trade provisions

The franchise agreement contained provisions which provided for acknowledgment from the Franchisee, that as it was going to be obtaining confidential information and intellectual property of the Franchisor for the purpose of conducting the business, that it was reasonable they be bound by restraint of trade provisions. Such provisions provided that on termination or expiration of the franchise agreement, the Franchisee be restrained from operating a similar business for a period of 6 months from termination or expiry of the agreement, within a 5km radius from the store the Franchisee was licensed to operate from, and within a 1km radius from any other EzyDVD store across Australia.

The Franchisor's confidential information and intellectual property

The franchise agreement made provision to protect the Franchisor's confidential information and intellectual property upon the termination of the agreement. The confidential information and intellectual property it sought to protect included a handbook and particular computer software and database material provided to the Franchisee. Evidence was provided that in conducting its business, the Franchisor would arrange for the Franchisee to be set up with "MYOB Retail Manager" software and a tailored software application of the Franchisors. The tailored package integrated with the MYOB software and would allow the Franchisor and Franchisee to communicate electronically to update database information and provide the Franchisee access to what was known as the "EzyDVD Titles Database" which contained information that was confidential to the Franchisor.

The contractual regime to protect the Franchisor's information and property

The franchise agreement contained provisions which provided that on termination or expiration of the franchise agreement, at the election of the Franchisor, the Franchisor's confidential information and intellectual property had to be destroyed or returned to the Franchisor. Other provisions included that the information and property is only to be used for the purpose of running the business pursuant to the agreement.

Alleged breach of the restraint

After a year and a half, the franchise agreement was terminated. Immediately after the termination, View DVD Pty Ltd (View DVD), the fourth respondent in the matter, began conducting a similar business from the same store that the Franchisee had conducted the EzyDVD business. The sole director and shareholder of View DVD was Mr Lahrs, a director and shareholder of the Franchisee.

Were the restraint of trade provisions reasonable in the circumstances?

Evidence was given by the respondents that when the franchise agreement was terminated, the Franchisor's confidential information and intellectual property were returned to the Franchisor. Accordingly, the respondents argued that the restraint was not reasonable in the circumstances given there was a contractual regime in place to protect the Franchisor's confidential information and intellectual property and it had been complied with.

Furthermore, Mr Lahrs gave evidence that in establishing the new business, View DVD entered into a contract with Network Video for a complete DVD titles database, and where the database from Network Video was deficient, he would manually insert the additional DVD titles using descriptors he had used when he operated the former EzyDVD business. Additional evidence provided that he also contacted MYOB for an accounting package to suit the new business.

The Franchisor argued that Mr Lahr's conduct, as set out above, exemplified that it was reasonable to enforce the restraint provisions given the confidential information that was retained in his head and subsequently used by Mr Lahrs, although the contractual obligations were discharged by the first respondent.

Court's analysis and decision

The Court concluded that because the Franchisor's case was argued on the basis that the restraint was reasonable to protect the Franchisor's confidential information and intellectual property and not by reference to other considerations such as protection of goodwill, that it was not reasonable for the Franchisor to rely on the restraint provisions in addition to the contractual regime.

In coming to such conclusion, the Court gave particular regard to evidence that the customers of the Franchisee's store were passing traffic and mostly one-off customers and that the information on the data base was constantly being updated. Accordingly, the Court said that such information had short term applicability and given the nature of the customers it was unreasonable to add this particular restraint.

This case highlights the difficulties a franchisor may face in attempting to enforce restraint of trade provisions against a franchisee. As demonstrated in this case, if there are alternate contractual provisions that can be relied on to protect the franchisor's confidential information and intellectual property then it may be unwise to justify a restraint of trade provision on the grounds set out above. The court's finding of fact that customers were passers by who did not return for repeat business seems at odds with common sense and may have limited application in other cases.

Guylian Loses Trade Mark Fight re Seahorse Chocolates

Dispute Resolution Partner, Tom Griffith, discusses the recent decision of the Federal Court in Guylian v Registrar of Trade Marks.

Chocolatier Guylian has been unsuccessful in its attempt to register a trade mark over the shape of its Seahorse Chocolates. The Federal Court (Justice Sundberg) concluded that the seahorse shape was not capable of distinguishing Guylian's goods from the goods of other persons. There were three major issues in the case:

- Whether the seahorse shape was "inherently adapted" to distinguish it as goods of Guylian (section 41(3) of the *Trade Marks Act 1995*);
- Given some degree of inherent adaptation, does, or will, the seahorse shape distinguish Guylian's goods by reason of the combination of the extent of the adaptation, the use of the trade mark and other circumstances (section 41(5));
- If the trade mark is not sufficiently "inherently adapted" whether, because of the extent to which the applicant had used the trade mark before the filing date, it did distinguish the designated goods or services as being those of the applicant (section 41(6)).

An earlier decision *Kenman Kandy* offered some hope to Guylian in its quest to protect the seahorse shape as a trade mark. In that case the trade mark applicant successfully sought trade mark protection over a bug-shaped novelty chocolate. The bug bore no resemblance to any actual species of bug or insect, and was according to the Court in that case a concocted shape. Justice Sundberg accepted Guylian's submission that the fact that the seahorse shape bore resemblance to an actual animal or creature did not thereby bar it from registration on the basis of it being inherently adapted. Guylian submitted that its seahorse shape had an unusually stocky build and that the tail of the seahorse curls backwards, forming an "S" shape rather than forwards, as in nature. Justice Sundberg accepted the seahorse had these distinguishing features but was satisfied that the shape as a whole was not so unique or imaginative that other traders, using the seahorse shape for its ordinary signification would be able to avoid potentially infringing the mark if it were registered.

A key relevant factor to the Court in refusing to grant the statutory monopoly conferred by a trade mark was the potential for confusion amongst consumers and competitors. Justice Sundberg took account of the likelihood that other traders, acting with proper motives, would think of the shape and wish to use the shape or one substantially identical or deceptively similar.

There was evidence before the Court that other chocolatiers had indeed marketed and sold chocolates in the shape of seashell chocolates from at least the mid 1990s and the Court concluded that those chocolatiers might, as at the priority date in 2002, have wished to make chocolates in the shape of a seahorse or other marine creatures.

There was also evidence before the Court that other rival chocolate companies currently sold other seahorse shaped chocolates, although those seahorses had forward-curling tails and less stocky builds than the Guylian seahorse.

Guylian relied on survey evidence in support of its attempts to establish that, if not sufficiently adapted for the purposes of section 41(3) of the Act, its proposed trade mark fell under either section 41(5) or section 41(6) of the Act. The survey was conducted by AC Nielsen and showed that just over 40% of respondents associated Guylian with the seahorse shape. Justice Sundberg noted that the survey was conducted on-line and that respondents were asked to respond to two dimensional images rather than a three dimensional shape. His Honour noted that Guylian's market research expert had attributed the respondents' association between the image and the brand or manufacturer to more than just the shape itself. Other factors such as colour and perception of texture came into play.

The Court also took into consideration that Guylian used other shapes on Guylian's packaging such as seashells, in combination with the seahorse, and that Guylian also relied on its "Guylian" trade mark and stylised "G" lettering in its packaging.

Summons for Public Examinations have Extraterritorial Effect

The significant increase in the number of companies passing into liquidation in the current economic climate has focussed Courts on whether they can summons a non-resident. Dispute Resolution Associate, Justin Le Blond, examines the position.

It is in this climate that there has been an increasing need to clarify whether persons (with knowledge about the examinable affairs of a company) who reside or have absconded overseas can be issued with a summons for examination by an Australian Court. The Full Court of the Federal Court of Australia in Western Australia recently gave judgment in *Waller v Freehills (Waller)*, and upheld that Australian Courts have powers to issue summons for examination under sections 596A and 596B of the *Corporations Act 2001 (Cth) (Corporations Act)* extraterritorially.

In *Waller*, it was argued by the plaintiff that:

- a proper construction of rule 11.4 of the *Federal Court (Corporations) Rules* did not authorise service of any summons for examination outside the jurisdiction of the Commonwealth of Australia;
- sections 596A and 596B of the *Corporations Act* could not provide a source of statutory jurisdiction for the Court to summons a non-resident of Australia to appear before it and be examined on the basis that the *Corporations Act* did not have extraterritorial effect;
- there was a presumption that the legislation was intended to operate territorially.

In considering the weight of these arguments, the Full Court turned to Lockhart J's observations in *Re Deposit* which held that *"the rules of the High Court, of this Court and of all the Australian Supreme Courts contain provisions for the service of process outside the jurisdiction"*. Reference was also made to Order 8 of the Federal Court Rules which *"gives the Court power to assume jurisdiction over persons not resident in Australia by authorising the service of the court's process on those persons, in circumstances where there is a connecting factor between the subject matter of the proceeding involving the non-resident, and Australia"*.

The Full Court considered that legislation which operates extraterritorially may be an additional source of power that gives the Court the ability to assert jurisdiction over non-residents, citing UK case, *Re Seagull Manufacturing Co Ltd (in liq) (Re Seagull)*, as authority. *Re Seagull* held that there is a well-established presumption that legislation is intended to operate territorially but that such a presumption could be displaced if it was clear that there was a parliamentary intention that the legislation should apply extraterritorially.

Applying the approach in *Re Seagull*, the Federal Court found that Parliament had intended by the enactment of section 5 of the *Corporations Act* definition of "jurisdiction" to displace the presumption that the *Corporations Act* was only to apply territorially and that there was nothing in the tenor of sections 596A and 596B to suggest that Parliament should not give the provisions extraterritorial effect.

Accordingly, the Full Court held that:

- the language within sections 596A and 596B was wide enough to apply to persons regardless of their residency;
- there were policy considerations to suggest that Parliament legislated to give sections 596A and 596B extraterritorial effect; and
- the *Corporations Act* expressly modified the territorial reach of certain other provisions, which could only be construed that sections 596A and 596B apply extraterritorially.

Seeking the assistance of a foreign Court in relation to an external administration matter

Australian Courts have the statutory power to *"request … a Court of a country other than Australia, that has jurisdiction in external administration matters to act in aid of, and be auxiliary to, it in an external administration matter"*, pursuant to section 581(4) of the *Corporations Act*.

Justice Barrett of the Supreme Court of New South Wales in *Re HIH Insurance Ltd* held that a letter of request should be directed to a foreign Court if three conditions are first satisfied:

1. the situation is within section 581(4) of the *Corporations Act*
2. there is some good substantive reason for the request
3. there is utility in the request in the sense that the foreign Court is likely to accept and act upon the request if it is made.

A recent NSW Supreme Court decision in *McGrath and Anor as Liquidators of HIH Insurance Ltd* approved the above factors of consideration and subsequently made an order, pursuant to section 581(4) of the *Corporations Act*, to request the High Court of Hong Kong to act in aid of, and be auxiliary to, the NSW Supreme Court in relation to summoning a person for examination.

Conclusion

The *Waller* decision confirmed the Court's power to issue a summons for examination to a person who resides outside the jurisdiction of Australia irrespective of whether they are an Australian citizen or not. The Full Court recognised that the intention of Parliament would be undermined if it was held that sections 596A and 596B could not be applied extraterritorially.

Accordingly, the decision of *Waller* acts as a warning to directors and officers of Australian companies that Australian Courts will ensure that they remain accountable for their involvement in Australian companies, notwithstanding geographical constraints.

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