



High Court brings certainty for commercial leases

PricewaterhouseCoopers Legal has been successful in obtaining judgment in the High Court for its client, Gumland Property Holdings Pty Limited (Gumland).

In a unanimous decision, the High Court held that Gumland was entitled to judgment against Duffy Bros and others, for an amount of approximately \$2.5m (including interest) plus costs. The High Court Judgment covered a number of issues including:

- (a) breach of an essential term
- (b) availability of loss of bargain damages, and
- (c) liability of guarantors.

Importantly, the decision of the High Court provides greater commercial certainty to purchasers of a property who do not take an assignment of a lease but relies on rights under section 117 of the *Conveyancing Act 1919* (NSW).

The facts

Transit Management Pty Ltd (Transit) owned a shopping centre. Transit granted a lease over one of the shops in the centre to Duffy Bros (Lease). The term of the Lease was 15 years commencing in March 1993. In March 1994, several individuals gave guarantees with Transit in respect of Duffy Bros obligations under the Lease (the Guarantees).

By 1999 Duffy Bros was experiencing difficult trading conditions, and had fallen into arrears with rent and

outgoings. In March 1999 Transit and Duffy Bros entered into a deed providing for:

- Duffy Bros to sub-lease part of the Leased Premises, and
- a reduction in the rent payable by Duffy Bros subject to Duffy Bros not committing any further breaches.

The parties also affirmed the terms of the Lease (the Deed).

In December 1999, Duffy Bros sub-leased part of the Leased Premises. In September 2001 Transit agreed to transfer the shopping centre to Gumland.

In 2002 the sub-lessee decided unilaterally to pay only half the rent payable.

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Gumland notified Duffy Bros that the short fall in rent was a breach of the Lease and in August 2003 Gumland terminated the Lease.

Originating proceedings

Gumland sued Duffy Bros for:

- the arrears of rent up to the termination of the Lease
- the cost of reletting the Leased Premises after Termination, and
- the loss of bargain damages being the rent shortfall for the period from the date of termination of the Lease until the Lease expired.

They also sued the Guarantors for Duffy Bros obligations under the Lease

The Trial Judge gave judgment for Gumland against Duffy Bros. However, the Trial Judge dismissed the proceedings against the Guarantors.

Court of Appeal

Gumland appealed and the NSW Court of Appeal gave judgment to Gumland against Duffy Bros and the Guarantors for arrears of rent. However, the NSW Court of Appeal held that Gumland was not entitled to loss of bargain damages or reinstatement damages.



High Court decision

In a unanimous judgment of the High Court, their Honours held that Gumland was entitled to judgment against Duffy Bros and the Guarantors for the amount of about approximately \$2.5 million including loss of bargain damages and reinstatement damages (including interest).

The High Court Judgement covered a number of issues including:

Breach of an essential term

The High Court determined that:

- Duffy Bros was the Lessee and liable under the Lease for, the Leased

Premises. It was consistent with the Deed that once the Leased Premises was sub-leased, Duffy Bros should continue to pay the rent and outgoings.

- In a commercial lease the court must give effect to the obligations which the parties have accepted in writing. The term to pay the rent was not only expressed as essential but on a true construction of the Lease the term would be characterised as essential.
- Practically, if it was open to parties to agree that a particular term is essential and to agree on the consequences of breach it would

avoid arguments about whether the term in question was or was not essential independently of the parties' agreement and the consequences of breach.

Loss of Bargain Damages

The High Court had to determine whether a purchaser of a property can sue for Loss of Bargain Damages from a Lessee where the purchaser did not take an assignment of the Lease.

The Court held that:

- In determining the right to loss of bargain damages the High Court applied the tests for “touching and concerning the land” set out in the House of Lords in *P & A Swift Investments (A Firm) v Combined English Stores Group plc* [1989] AC 632 at 642 where Lord Aylmerton said that the relevant matters for consideration were:

“(1) the covenant benefits only the reversioner for time being, and if separated from the reversion ceases to be of benefit to the covenantee;

(2) the covenant affects the nature, quality, mode of user or value of the land of the reversioner;

(3) the covenant is not expressed to be personal (that is to say neither

being given only to a specific reversioner nor in respect of the obligations only of a specific tenant);

(4) the fact that a covenant is to pay a sum of money will not prevent it from touching and concerning the land so long as the three foregoing conditions are satisfied and the covenant is connected with something to be done on, to or in relation to the land.”

- The Lease satisfied the tests in *Swift’s Case* and that Gumland had right to sue for rent if it was not paid, and that it was an essential term of the Lease that Gumland had a right to terminate the Lease and sue for loss of bargain damages. Pursuant to the law the benefit of these rights were annexed and incident to, and liable to go with, the reversionary estate pursuant to s117 of the *Conveyancing Act*.
- The need for a lessor to recover loss of bargain damages from a lessee only arises when the commercial market is falling. If the market is static or rising, the lessor can re-enter against the defaulting lessee, recover arrears of rent, and promptly install a new tenant at the same or a higher rent.

- A lessor should not bear the risks of a falling market rather than their defaulting lessee, particularly where the parties explicitly placed that risk on the lessee. The law should not create the result of placing the risks of a falling market on a lessor, and of depriving them of the opportunity by agreement to allocate the risk otherwise.
- If the law did create this result it would have the effect of cutting down party autonomy, increasing the chance of disputes and reducing certainty.

Liability of Lease Guarantors to purchasers of the property

The High Court had to determine whether a guarantor’s covenant ran with the Demised Land.

The High Court determined that:

- In determining whether a guarantor’s covenant ran with the Demised Land the High Court applied the tests for “touching and concerning the land” as Stated in *Swift’s Case*.
- Where the covenant of a guarantor to guarantee payment of rent by a lessee touched and concerned the land, it ran with the land, and

could be enforced by a transferee of the reversion.

- The covenants in the Guarantees cannot be regarded as collateral obligations not affecting land.
- Once it is concluded that the tests are satisfied, the question of whether the benefit of the guarantee covenant is limited to arrears of rent or extends to loss of bargain damages depends on the language of the Guarantees. In this case the scope of the Guarantees extended to loss of bargain damages.

Conclusion

The decision of the High Court provides greater commercial certainty to purchasers of a property who do not take an assignment of a lease but relies on rights under section 117 of the *Conveyancing Act 1919 (NSW)*.

For further information on the impact of this case please contact your usual PricewaterhouseCoopers Legal adviser or



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PwC Legal team – integrated, innovative legal solutions

PricewaterhouseCoopers’ Legal multi-disciplinary approach differentiates us from other professional service providers in Australia by enabling us to provide truly integrated and innovative legal solutions.

Our Legal team works together with our Advisory, Assurance and Tax specialists to provide all-encompassing advice and solutions to our clients’ business issues – no matter how complex they are. We specialise in the areas of corporate and commercial, employment and industrial relations, property, corporate and regulatory litigation, tax controversy and environmental law. We focus on providing comprehensive advice and information for our clients that considers their specific business needs.

Roche Products Pty Limited v The Commissioner of Taxation: A bitter pill to swallow, but for whom?

A preliminary decision of significant interest to multinationals, particularly those in the pharmaceutical industry, was handed down on 2 April 2008 by Mr Justice Downes of the Administrative Appeals Tribunal (AAT). The Decision involves determination of the transfer prices for pharmaceutical products acquired by Roche Products Pty Limited (“Roche Australia”) from its parent company Roche Holdings Limited of Switzerland and other group companies (collectively, “Roche Basel”). This novel case disputed the exercise of the Commissioner’s

discretion in specific transfer pricing legislative provisions to determine arm’s length consideration.

Background

After conducting a transfer pricing review and audit for the income tax years 1992 to 2002, the ATO raised amended assessments in relation to the transfer prices of three of Roche Australia’s four divisions.

In calculating the transfer price adjustments in the amended assessments, the ATO used a

Transactional Net Margin method (TNMM). The ATO acknowledged that there was an absence of good comparables in the Australian market to support the transfer prices of product acquired by Roche Australia from its overseas group companies. In quantifying the adjustments in the amended assessments, the ATO considered the functions being performed by Roche Australia in respect of the resale of the products in Australia and sought to benchmark their profit against the profit earned by independent companies from similar activities. The ATO aggregated the returns from the various functional components to calculate an appropriate gross margin. Applying the TNMM resulted in the ATO issuing revised assessments, increasing Roche Australia’s taxable income over the audit period by approximately \$130 million.

Roche Australia argued that the assessments were excessive. In the Ethical Pharmaceutical Division, between 1996 and 2003, a number of products were sold by Roche Basel to independent wholesalers of generic

pharmaceutical products in Australia, such as Alphapharm Pty Limited. Roche Australia used a Comparable Uncontrolled Price (CUP) method to argue that the prices paid by Roche Australia for the product were comparable to the price paid by the Australian independent wholesalers. Roche Australia used the gross margin on the products for which it had a CUP as a benchmark of the gross margin of its other products for which it had no direct price comparison (non-CUP products). Roche Australia argued that because the gross margin on its CUP products approximated the gross margin on its non-CUP products, no adjustment to transfer prices in the Ethical Pharmaceutical Division was warranted.

In relation to the Consumer Division, the ATO sought to adjust only the prices of fully finished products acquired by Roche Australia from overseas group companies. Roche Australia argued that the transfer prices of these products should be looked at in light of the performance of the Consumer Division as a whole, and that when transfer prices were analysed at the divisional level, no adjustments were warranted.

In relation to the Diagnostics Division, the ATO applied TNMM to the results

Decision Quick Notes

- For Transfer Pricing, transactional pricing models may be more appropriate than TNMM
- Internal comparables within a global group likely to carry more weight in an Australian Court
- Experts should be versed in the Australian context of Transfer Pricing
- Transfer prices resulting in a loss may, in some circumstances, be pricing at arm’s length
- Companies should consider documenting commercial reasons for pricing decisions
- Analysis of prices involves looking at each year separately including gross profit margin for each year

of the division as a whole. Roche Australia argued that the losses of this division were not due to excessive transfer pricing of products acquired from overseas group companies, but were a result of local market conditions. Roche Australia argued that no adjustments were warranted.

Independent US transfer pricing experts were used by both parties to support their respective positions.

Decision

In his preliminary decision, Mr Justice Downes found that Roche Australia had overpaid approximately \$59 million for its ethical pharmaceutical products over the period and that Roche Australia's taxable income should be increased accordingly. No adjustments were proposed to the Consumer Division or Diagnostics Division.

In calculating the adjustments to the ethical pharmaceutical products, Mr Justice Downes concluded that an arm's length price for pharmaceuticals would have yielded Roche Australia a gross margin of at least 40 percent throughout its product range. His conclusion was based on the finding that the prices for the generic sales to Alphapharm Pty Limited were generally negotiated to yield a gross profit

margin of 40 percent to Alphapharm Pty Limited.

Commentary

In an area renowned for its complexity and subjectivity, the preliminary decision in this case probably raises more questions than it answers. However, as this is a novel case in Australia considering whether the economic process used to set or review transfer prices is in accordance with the provisions of Division 13 of the 1936 *Income Tax Assessment Act*, the decision has significant implications for taxpayers and the ATO. Being a preliminary decision of a tribunal, any conclusions drawn from the case must be considered with this in mind.

Some of the significant implications for corporations arising out of the decision follow.

The taxation scheme

The Commissioner relied upon on two alternative bases to support the assessments – Division 13 of the *Income Tax Assessment Act* and Article 9 of the Double Tax Agreement (DTA) between Australia and Switzerland. In his preliminary decision, Mr Justice Downes acknowledged that both parties accepted that Division 13 and

the relevant Article of the DTA achieved the same result. Consequently he was not required to consider whether the Associated Enterprise Article in the Double Tax Treaties confers power on the Commissioner to assess income tax. Nevertheless, Mr Justice Downes proceeded to comment to the effect that, in his view, a Double Tax Treaty does not impose a right to tax. This is consistent with the approach of the full Federal Court in recent cases.

Dealing at arm's length

The application of the transfer pricing provisions requires that the parties were not dealing at arm's length. Roche Australia accepted that it was not dealing at arm's length with Roche Basel in relation to the acquisition of product and so there was no need for there to be evidence introduced nor for Mr Justice Downes to decide the issue.

Transfer pricing methodologies and experts

Mr Justice Downes reinforced the difficulties in finding appropriate comparables in the Australian market. He commented that he believed the analytical approaches undertaken by the expert economists were "coloured by their United States experience". Mr Justice Downes was particularly

concerned to note that none of the experts had been asked to address the specific provisions of the *Income Tax Assessment Act* nor the Article of the relevant Double Tax Treaty.

In considering Mr Justice Downes' summation of the evidence of the experts, it seems that he has a preference for the transactional methods over a profit method such as TNMM, even though he applies the same gross margin to all of Roche Australia's pharmaceutical products to arrive at the final adjustment. In particular, his comments in respect of Dr Wright's application of TNMM suggest that he does not consider a range of profit outcomes calculated from a number of broad comparables to be persuasive in supporting an arm's length price of a product.

For the ATO and most taxpayers, the TNMM has evolved as the transfer pricing method of choice over the years. Based on the preliminary decision in this case, taxpayers may need to look for and analyse whether evidence of internal comparables exist within the global group, as such evidence is likely to carry more weight in an Australian Court of Law than a TNMM analysis based on a number of atypical comparables.

It has also been the practice of the ATO to use comparables in different industries, due to the lack of comparables in the same or similar industry to the tested party. It is understood that the ATO argues that functionality is paramount such that if the functional profile is the same, this overrides any difference in industry dynamics of either the tested party or the comparable that potentially could influence the profit outcome. However, Mr Justice Downes casts doubt on this approach in his comments, criticising the approach of Dr Wright who used advertising agents as comparables for the marketing aspect of the sales and marketing function of Roche Australia's pharma division.

Separate years

Mr Justice Downes makes it clear that the focus in determining arm's length prices must be on the separate prices in each of the years under consideration. Mr Justice Downes concluded that "It accordingly seems to me to be necessary to look at each year separately and to the gross profit margin for each year." Based on this comment, it could be concluded that taking an average over a three or five year period is not in accordance with the application of Division 13. However

it is noted that Mr Justice Downes decision is based on determining a gross margin of 40% for all ethical pharmaceutical products and applying it across all years in dispute.

A further point to note arising under this heading is that when calculating the ultimate adjustment, where the gross margin of Roche Australia exceeded 40% in a year (as it did for Roche Australia in the 1998 year) the excess was not offset against the adjustment in the years when the gross margin was less than 40% gross margin.

Although a 40% gross margin was found to be an arm's length gross margin in this case, it should not be seen as providing a benchmark for the broader pharmaceutical industry. However, corporates should investigate closely possible internal comparables and review their gross margins in light of any dealings with third parties.

Losses

Mr Justice Downes recommended "standing back and looking at the canvas" when looking at transfer prices. Just because a transfer price results in a loss does not necessarily mean that the transfer price is not arm's length. This was particularly

important in relation to the Diagnostic Division, where Mr Justice Downes was satisfied that the poor operating results of the division were a result of commercial factors, not transfer prices. In particular, Mr Justice Downes was clearly concerned that one of the problems of TNMM is that in analysing the performance of a division or company "it inevitably attributes any loss to the pricing. After all it is certainly true that there are companies that make losses for reasons other than the prices for which they acquire their stock. The Australian operations for multinational companies are not necessarily excluded from this". Again this is an important reminder to taxpayers of the importance of documenting contemporaneously the commercial reasons for pricing decisions in their transfer pricing analysis.

These comments could also cause the ATO some hesitation in immediately presuming that losses incurred by a company with cross-border intercompany transactions are due to transfer pricing practices that are not arm's length.

Conclusion

The preliminary decision appears to reinforce the view that Australia's

transfer pricing legislation is transactional and that profit methods such as TNMM do not sit as comfortably with the legislation as they do with DTAs. It will not be until there is further judicial comment either on appeal of the Roche case (which appears to be likely) or a new case dealing with Division 13 that the application of Mr Justice Downes' comments will become clearer.

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Making the most of Transitional Termination Payments (TTP) under “simpler super”

Background

Employers frequently make payments to departing employees that are triggered as a result of employment terminating in a variety of circumstances including corporate restructuring, sale of business, outsourcing and off-shoring. The kinds of payments involved include pay in lieu of notice, redundancy and ex gratia payments. Up until 1 July 2007 such payments could be made tax efficiently, with cash payments subject to lower tax rates, and some payments rolled over into superannuation being exempt from PAYG tax. Since 1 July 2007, new laws mean employers and employees may need to avoid terminating contracts and other workplace arrangements in order to preserve the tax effectiveness of certain termination payments.

The “simpler super” changes

On 1 July 2007 major changes were made to the taxation of superannuation

under the “simpler super” regime. The changes removed the ability of a number of employees to have employment termination payments, known as Life Benefit Termination Payments (LBTPs), paid tax efficiently under pre-existing rules. Under transitional grandfathering provisions, some employees continue to be covered by pre-existing rules and are able to receive tax efficient LBTPs. To qualify for grandfathering, an employee must have a LBTP entitlement arising from a written contract, law, instrument or workplace agreement in existence just before 10 May 2006, and the LBTP must be paid between 1 July 2007 and 30 June 2012.

Implications for employees and employers

For many employees, including those who entered into new contracts of employment after 10 May 2006, the ability to receive tax efficient LBTPs has been lost. Those employees who qualify for, and are aware of,

an entitlement to grandfathered LBTPs, will wish to preserve such entitlement. An entitlement to grandfathering may be lost if the contract, agreement or award entitling an employee to LBTPs is replaced or terminated, or the applicable LBTP provisions are varied.

For employers of employees with entitlements to grandfathered LBTPs, it will be important to be aware of the entitlement and ensure that they do not unintentionally remove their employees’ grandfathering entitlements.

Life Benefit Termination Payments (LBTP)

LBTPs are payments made by an employer to an employee as a result of the employee’s employment being terminated for any reason apart from death. LBTPs include:

- payments in lieu of notice
- redundancy compensation in excess of the tax free amount
- unused sick leave entitlements (required to be paid out)
- payments for unused rostered days off
- ex-gratia payments or ‘golden handshakes’.

LBTPs do **not** include other entitlements arising separately from termination, or which already receive tax free status, such as:

- payments for unused annual or long service leave entitlements
- salary, wages or allowances
- payments in consideration for a restraint of trade
- compensation for personal injury
- the tax free portion of bona fide redundancy and approved early retirement scheme payments.

Generally, payments must be made within 12 months of termination to qualify as an LBTP. Payments outside 12 months may be taxed as ordinary income at marginal rates, unless special circumstances apply.

Transitional Termination Payments (TTP)

From 1 July 2007, LBTPs are either paid under the new regime, in which case they fall in the category of Employment Termination Payments (ETPs), or under transitional grandfathering rules, in which case they are known as Transitional Termination Payments (TTPs).

For an LBTP to be a TTP (and qualify for grandfathering) it must arise out of:

- a written contract
- an Australian or foreign law, or instrument under such law, or
- a workplace agreement under the *Workplace Relations Act 1996*,

in force just before 10 May 2006, and remaining in force. The TTP must be received by the employee between 1 July 2007 and 30 June 2012.

A TTP may have two components, the taxable component (arising out of service post 30 June 1983) and tax free component (arising out of service pre 30 June 1983). The taxable component is taxed at 15% up to the low rate threshold (2007/08 \$140,000) and 30% thereafter up to \$1 million.

The major benefit of a TTP is that some or all of the payment may be rolled over, PAYG tax free, into superannuation.

The new regime

Under the new regime ETPs:

- must be taken in a cash lump sum
- cannot be rolled over into superannuation



- are not subject to tax on any Tax Free Component (arising out of service pre 30 June 1983) with the remainder being concessional tax at 31.5% up to a limit of \$140,000, with the balance taxed at 46.5%.

ATO's interpretative decision

Recently the Australian Tax Office (ATO) issued an interpretative decision about when LBTPs will qualify for grandfathering. If the ATO's view is adopted by the courts, an employee's eligibility to favourable tax treatment under grandfathering, may be lost

if the contract, agreement or award entitling an employee to a LBTP is replaced, even if the employee's LBTP entitlement is mirrored in a new instrument. Although no court has yet been asked to determine the issue, given the ATO's view, employers should be careful when dealing with instruments that entitle employees to TTPs to ensure that they do not, unintentionally, disentitle employees to grandfathered LBTPs.

When a TTP entitlement may be lost

The following are examples of situations where an employee's TTP entitlement may be lost:

- a new employment contract being created or coming into force as a result of an employee's:
 - promotion
 - demotion
 - transfer
 - secondment
 - new role
- the applicable agreement or award expiring (although in many cases, despite expiry the TTP entitlement will remain in place)
- the applicable agreement or award being terminated



PwC LegalUpdates

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Our recent LegalUpdates have included:

4/4/08 – On Thursday 3/4/08, the NSW Government Planning Minister, Frank Sartor, released 3 draft exposure bills outlining important and comprehensive changes to the New South Wales planning and strata management systems.

For more information contact Mark Swan (02 8266 6651) or Andrew Peterson (02 8266 6681) or your local PwC Legal adviser.

- a new contract, agreement or award applying to an employee as a result of:
 - restructuring
 - business acquisition
 - sale
 - outsourcing
 - merger
 - liquidation
 - receivership
 - administration.

Practical steps to retain the TTP entitlement

Employers should review existing contracts, agreements and awards which entitle employees to LBTPs, to determine if such employees are eligible to TTPs. Where TTP entitlements exist, there may be resistance from employees to new contracts or agreements being created (or possibly even variations being entered into) which may disentitle them to TTPs. Employers will need to determine if TTP entitlements can be retained while achieving their business objectives. Where loss of TTP entitlements is unavoidable, employers may find themselves under pressure from employees to provide an additional benefit to make up for the benefit of TTPs being lost.

Employers should review their existing Human Resource practices applicable to employees with TTP entitlements, to ensure that they do not unintentionally disentitle employees to TTPs. The most common scenario where this may occur is where an employee's terms of employment are being varied. Common practice may be to replace an employment contract or agreement with a new one. However this may result in an employee's TTP entitlements being lost. Employers should consider changing their practices to ensure that, where practicable, variations to employment terms are entered into rather than replacements. For example, if an employee is being seconded, a secondment letter could be created containing terms specific to the secondment, which refers to and does not replace the core employment terms in the original contract (including the TTP). In addition, rather than replacing an employment contract or agreement where it has become outdated, or where an employee's position has changed, a variation could be entered into which replaces the out of date or irrelevant provisions but does not affect the TTP entitlement.

Conclusion

While the direct benefit of tax efficient TTPs goes to departing employees, there are often flow on benefits to the employer. Employees can depart employment with the maximum possible net payment at no extra cost to the employer. While it will not always be possible to retain TTP entitlements, employers should be mindful whenever a TTP entitlement may be lost and consider any alternatives to reduce the risk. Where uncertainty exists about whether a TTP entitlement exists, may be lost, or could be retained, employers should seek expert advice.

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