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PRICEWATERHOUSECOOPERS LEGAL



Early Stage Venture Capital Limited Partnerships

Unlocking the opportunities of global challenges

As the effects of the global credit crunch begin to take their toll on the private equity investment model, the industry is starting to explore alternative methods of capital raising and investment, so as not to miss the opportunities which the current equity market affords.

One of the strategies considered by private equity firms is investment in small and medium sized enterprises with strong growth potential, in the early stages of their business life cycle.

For the venture capital sector, the opportunities presented by the global challenges of climate change and the resulting increase in clean technology innovation are significant. The challenge of addressing environmental damage is gathering international political momentum as an issue which is vital to the future quality of life on our planet. The political alliances of voters and the commercial

decisions of consumers are being influenced more and more by a consideration of the impact those decisions will have on the environment.

As a result, the commercialisation of clean technologies which seek to address aspects of the climate change challenge is certain to be one of the major growth drivers of developed economies such as Australia and the United States. The role of the venture capital sector in this endeavour is crucial.

Recent changes to the way investors of early stage funds are encouraged by the federal government (namely through the implementation of the Early Stage Venture Capital Limited Partnership (ESVCLP) program) are likely to increase the attraction of early stage venture capital investment for both the private equity sector and the venture capital sector.

The ESVCLP program replaces the Pooled Development Funds (PDF) program and is aimed at stimulating Australia's early stage venture capital sector by allowing generous tax concessions

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for funds meeting the registration and investment criteria set out in the *Venture Capital Act 2002* (Cth) (the Act).

What is an ESVCLP?

An ESVCLP is a venture capital fund, legally structured as a limited partnership and registered with Innovation Australia in accordance with the Act.

Limited partnerships are the preferred structure for venture capital investors internationally, because of the flexibility of the ‘flow-through’ taxation position and the limited liability of investors.

The benefits of ESVCLPs

Unlike PDFs, which were a corporate vehicle, an ESVCLP will have flow-through tax treatment, i.e. the ESVCLP will not be taxed at the partnership level. In addition, income distributions and capital gains earned as a result of investment in an ESVCLP will be exempt from tax in Australia in the hands of both domestic and foreign partners.

Tax losses by ESVCLPs, however, will not flow through to nor will be deductible by partners.

The tax-free treatment is a significant legislative incentive which has the potential to both considerably increase a fund’s internal rate of return and assist it to attract a wider pool of investors.

What does ‘early stage’ mean?

An ESVCLP must be registered with Innovation Australia and have its partnership deed and investment plan approved before it commences its investment activities. It is vital to ensure that these documents clearly disclose the partnership’s focus on early stage investment.

The Act does not specifically define ‘early stage’, however it does provide that ESVCLPs may invest in entities whose gross assets are up to \$50 million at the time of the first investment. This is, arguably, quite a high threshold, indicative of an entity further along its business life cycle than one which would ordinarily be considered to be ‘early stage’, and therefore opens up a significant range of investment options.

In determining the extent to which an investment plan focuses on early stage venture capital, Innovation Australia



will have regard to a number of key indicators including:

- the stage of development of the proposed investee entities
- the level of technology in the entity
- the proportions of intellectual property to total assets of the entity
- the levels of risk and return of the entity
- the amount of tangible assets and collateral against which borrowings may be secured by the entity
- the partnership’s investment hold strategy, and
- whether or not the investment plan is connected with any other investment plans which would result in the partnership exceeding the

financial investment limitations set out in the Act.

It is important to ensure the partnership deed and the investment plan not only address the specific legal requirements of the Act, but also have regard to the policy which underlies the legislation and the areas of discretion Innovation Australia has over the registration process.

What it takes to qualify

There are also a number of legislative requirements which determine both the financial structure of ESVCLP investments and the nature of the investee entities. Among those requirements are:

- ESVCLPs may only invest in entities whose predominant activity consists of eligible activities. Activities which are not eligible include property development, land ownership, banking, providing capital to others, leasing, factoring, securitisation, insurance, construction, acquisition of infrastructure or related facilities, and making investments directed at deriving income in the nature of interest, rents, dividends, royalties or lease payments.

- The size of the ESVCLP fund must be between \$10 million and \$100 million.
- No single partner's interest in an ESVCLP may exceed 30% of the total committed capital, subject to exceptions which include superannuation funds.

In addition, ESVCLPs are required to lodge quarterly and annual reports with Innovation Australia.

What types of securities can an ESVCLP acquire?

In making an investment, an ESVCLP may acquire the following kinds of securities:

- shares in a company
- units in a unit trust
- options (including warrants), and
- convertible notes, provided they are not debt interests.

It is noteworthy that a PDF was not permitted to acquire convertible notes or units in a unit trust.

Generally, venture capital funds will make their first investment in an investee entity by way of convertible note. Acquiring a convertible note minimises the risk associated with early stage investments by giving the

investor the opportunity to conduct further due diligence on the entity to determine whether or not it wishes to convert the note into equity securities. At the same time, the investor retains an entitlement to receive the fixed or floating interest rate as well as an option to have its investment repaid on maturity of the note. An ESVCLP now has this investment option.

In addition, an ESVCLP may make a loan to a proposed investee entity whether or not it holds an existing security in that entity, provided the loan is repaid within six (6) months. This gives an ESVCLP the option to make its initial investment by way of pure debt, rather than by convertible note.

How much can an ESVCLP invest in one group?

The total amount an ESVCLP invests in interests (including debt and equity interests) of an entity, and any associate or other member of the same wholly-owned group of that entity, must not exceed 30% of the total committed capital of the ESVCLP.

The divestiture rule

ESVCLPs cannot hold investments in an investee entity whose gross assets together with the assets of an

associate of, or a member of the same wholly-owned group as, the investee entity exceeds \$250 million.

Once this limit is exceeded, the partnership must dispose of the investment within 6 months of the end of the partnership's income year in which the limit was exceeded. Innovation Australia may extend the divestiture period by an additional 3 months on request of the general partner.

Investments in entities which exceed the \$250 million threshold but demonstrate the potential for significant additional growth may be transferred to a related purchase structure.

Conclusion

The new ESVCLP investment vehicle brings the Australian venture capital industry one step closer to having a world-class venture capital investment vehicle. The ESVCLP model compares favourably with the PDF model and represents a compelling proposition for investors prepared to focus on early stage investment opportunities with high growth potential in eligible activities.

The first ESVCLP was registered in January 2008, merely 6 weeks after the introduction of the necessary legislation amending the New South Wales partnership legislation, and the interest in this new investment vehicle has been significant. As the market familiarises itself with the benefits of the new regime, the ESVCLP is bound to become the preferred vehicle for venture capital investment.

For further information on the ESVCLP program please contact your usual PricewaterhouseCoopers Legal adviser, or:



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Proposed amendments to the Australian Securities Exchange listing rules

Proposed amendment

The Australian Securities Exchange (ASX) has recently proposed amendments to its listing rules. The proposed amendments are a result of internal rule reviews conducted by the ASX over the past year.

When will the proposed amendments be effective?

The ASX invited comments on the proposed amendments. Once the changes have been finalised, taking into account any feedback received, any requisite changes to the listing rules will be exposed in draft form.

At this stage it is anticipated that the rule changes will be effected in the second half of 2008.

Outline of proposed amendments

The proposed amendments cover four key subjects, namely:

- share purchase plans
- strategic investment vehicles
- capital raisings by small to medium sized enterprises (SMEs), and
- listing eligibility requirements.

Share Purchase Plans

It is proposed that companies offering share purchase plans (SPPs) will be required to ensure that the SPP is open to all shareholders who appear on the register on the business day prior to the announcement of the SPP. The current listing rules do not set any timetable requirements for SPPs.

The day prior to the announcement will be nominated as the record date for eligibility to participate in the SPP and only existing holders registered on the record date will be eligible for the plan.

The proposed amendment will reinforce the intended purpose of the SPP as a mechanism to reward existing long-term shareholders, reduce the incentive for sellers to short-sell or fail to settle in order to qualify for the SPP, and it will ensure confidence and certainty

in trading for companies that have announced an SPP.

Strategic investment vehicles

Certain investment companies which would otherwise be ineligible to list or remain listed on the ASX because they have a majority of their assets in cash (thereby exceeding the threshold percentage of assets which can be held as cash as required by the listing rules) will be eligible for listing.

It is proposed that investment companies which have a substantial amount of assets (at least \$500 million), a track record of successful investment and active management of strategic assets will no longer be prohibited from listing. Directors and key management of the vehicle will need to have appropriate experience in prior funds under management.

The ASX has formed the view that it is possible to update the listing rules to allow investors the opportunity to invest in well-run listed investment vehicles, while continuing to achieve the goals of investor certainty and corporate governance standards.

The investment vehicles will be subject to specific disclosure requirements, which will enhance transparency.

Capital raisings

Under the proposed amendments, companies with a market capitalisation of \$100 million or less, SMEs will be able to obtain a shareholder mandate at their annual general meetings to make placements of up to 25% of the amount of issued capital for a period of up to 12 months from the date of the annual general meeting.

Currently, the listing rules state that a listed company cannot issue ordinary shares amounting to more than 15% of the ordinary securities on issue 12 months earlier, unless it obtains shareholder approval or one of the exceptions to the rule applies.

While still ensuring that a proposed issue of shares is favoured by existing owners, the amendment recognises that companies at earlier stages of development tend to be relatively small in size and have a proportionately higher demand for capital, when compared to more mature companies. SMEs therefore tend to consistently demand capital in excess of the 15% limit.

Shareholders will still determine whether companies are empowered to issue shares in excess of 15% (up to a maximum of 25%), but without the need to call a general meeting each



time. This will ensure that there will be none of the delays usually associated with the requirement to hold a general meeting. There will also be greater certainty where the capital raising is needed for an acquisition, and there will be a smaller risk of SMEs being exposed to possible changes in market conditions.

Listing eligibility requirements – initial spread requirement

Under the proposed amendments, companies seeking to be listed will be required to have 200 shareholders each with holdings of at least \$2,000 worth of shares.

The current listing rules state that, in order to be listed, entities must have at least 400 shareholders each with holdings of at least \$2,000 worth of shares. This spread requirement is regarded by many as the most difficult hurdle for companies seeking to be listed on the ASX and the ASX believes the requirement is an unnecessary barrier to entry for smaller companies.

The benefit of the proposed amendment is the removal of the onerous burden on SMEs to obtain 400 shareholders and the potential increase in the number of subscribers who are able to take a larger stake in the company.

The proposal also seeks to increase the minimum net tangible asset size from \$2 million to \$4 million.

Listing eligibility requirements – removal of the 20c rule

Companies seeking to be listed on the ASX will no longer be subject to the requirement that the issue price of all securities (except options) for which the entity seeks quotation must be at least 20 cents at the time of initial listing.

The 20 cent rule was originally introduced to limit paper proliferation in the market.

The proposed amendment will bring the ASX listing rules in line with many other major international exchanges in relation to setting a minimum issue price.

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Release of Draft Trade Practices amendments in relation to cartel behaviour

On 11 January 2008, Chris Bowen, the Minister for Competition Policy and Consumer Affairs, released the exposure draft *Trade Practices Amendment (Cartel Conduct and other Measures) Bill 2008* (the Draft Legislation), with an accompanying discussion paper. The Draft Legislation sets out proposed reforms to the *Trade Practices Act* (the Act) in

relation to cartel behaviour which were recommended by the Dawson Report in 2003. While the Bill has not yet been introduced into Parliament and may be amended as the result of public consultation, it is likely that any final bill will be substantially similar to the Draft Legislation. It is expected that the Bill will be introduced to Parliament later this year.

This article outlines the main changes set out in the Draft Legislation, and the implications for corporations and individuals.

Introduction of two categories of cartel behaviour

The most significant change to the Act resulting from the Draft Legislation will be the introduction of two categories of cartel offences – criminal cartel offences and civil cartel offences.

A person will commit a criminal cartel offence if:

- they make a contract or arrangement or arrive at an understanding, with the intention of dishonestly obtaining a benefit, and the agreement or understanding contains a cartel provision, or
- an agreement or understanding contains a cartel provision and the person gives effect to the cartel provision with the intention of dishonestly obtaining a benefit.

A person will commit a civil cartel offence if they make or give effect to a contract, arrangement or understanding with a competitor which contains a cartel provision. For a civil cartel offence, there is no requirement

to prove that the person did so with the intention of dishonestly obtaining a benefit.

For both a criminal cartel offence and a civil cartel offence, “cartel provision” is defined as being a provision of a contract, arrangement or understanding which relates to:

1. price fixing
2. restricting outputs in the production and supply chain
3. allocating customers, suppliers or territories, or
4. bid rigging

by parties who are or would be in competition with each other.

What does “dishonestly obtaining a benefit” mean?

The question of whether a benefit has been obtained dishonestly will be determined in accordance with the definition of “dishonesty” in the *Commonwealth Criminal Code Act 1995* and the *Corporations Act 2001*. Accordingly, the prosecution would need to prove that something was dishonest according to ordinary people’s standards, and was known by the defendant to be dishonest according to ordinary people’s standards.

The Draft Legislation also provides that a corporation may be found guilty of an offence even if obtaining the benefit is impossible and/or the other parties have been acquitted of the offence.

Penalties

The Draft Legislation proposes that the penalties for civil cartel offences would be a fine of \$500,000. For corporations the proposed fine is the greater of \$10 million or 3 times the value of the benefit obtained from the cartel behaviour by the body corporate and its related body corporates, or, if that value cannot be determined, 10% of the annual turnover of the body corporate and any related bodies corporate for the period of 12 months ending at the end of the month in which the act or omission occurred.

It is proposed that the penalties for criminal cartel offences would be 5 years' jail and/or a fine of \$220,000 for a person. For corporations, the same fine applies as for civil cartel offences mentioned above.

It would still be possible for private actions to be brought to recover damages or seek injunctions, banning orders or other remedies.



Proposed procedures for criminal cartel offences

The Draft Legislation and a draft memorandum of understanding between the Australian Competition and Consumer Commission (ACCC) and the Director of Public Prosecutions (DPP), sets out that the ACCC would investigate all cartel behaviour, and would then determine whether to refer the matter to the DPP for prosecution. In deciding whether to do so, the ACCC would look at the duration and market impact of the cartel conduct, the detriment caused to the public and whether the corporations or people in question had any previous convictions for cartel behaviour. It has been made clear in the discussion paper that a criminal offence is only intended to distinguish the most serious types of cartel conduct.

The discussion paper calls for public comment on how the ACCC should distinguish between criminal and civil cartel behaviour.

Other issues dealt with in the Draft Legislation

The Draft Legislation maintains the current exception from cartel prohibitions for arrangements between related body corporates, and incorporates:

- a joint venture defence from the civil prohibitions where the arrangement does not have the purpose or effect of substantially lessening competition, and
- an exception for collective bargaining arrangements about which the ACCC has been notified and a collective bargaining notice is in force.

Implications

The proposed Draft Legislation will have a significant impact on individuals found guilty of engaging in cartel behaviour, as it will increase the penalty to a jail term. It is important to note that the Draft Legislation, if passed in its current form, will be retrospective, and

will apply to contracts, arrangements or understandings which contain a cartel provision and were entered into prior to the commencement of the legislation.

Companies, company officers and employees should always be vigilant in identifying potential cartel behaviour. However, the Draft Legislation, if introduced, will increase the importance of doing so even further. If you are concerned about the possible effect of any proposed contract, agreement or understanding, we would be happy to review the arrangement and advise if it risks constituting cartel behaviour, and on ways of avoiding this risk.

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When is immediate dismissal justified?

A manager who was summarily dismissed after responding dishonestly to her former employer (Employer) about her pattern of attendance at work, has lost all of her claims against her Employer in the Federal Court (Court) and was ordered by the Court to pay her Employer's legal costs.

Background

The manager was employed on 6 February 2006 and summarily dismissed on 30 June 2006. She claimed that the circumstances leading to her dismissal were due to her inability, as a result of her family responsibilities, to come to work any earlier than around 9am on most days. The manager had two young sons whose care and transportation to school were a shared responsibility between her and her husband. She argued that her Employer knew about her family responsibilities, but disregarded the difficulties this created for her.

The manager's employment contract required her to attend for work between the hours of 9am and 5pm each day. However, due to the senior nature of her position, it was expected

that she work additional hours outside of the standard office hours.

Just prior to her dismissal, the Managing Director (MD) of her Employer had asked the manager to provide a record of her daily attendance at the Employer's premises over the last three weeks and to note her time of arrival, lunch break duration and departure time. This request was motivated by the MD's (and other employees') concerns over the manager's poor pattern of attendance at work. A log kept by one employee for a certain period disclosed a general pattern that the manager arrived more often than not substantially later than 9am, never before that time, and left not long after 5pm, and that occasionally she was absent for quite lengthy periods at lunch.

The manager responded to the MD's request, stating that she could not provide the information as she did not maintain a log of such times. However, she assured the MD that she generally arrived at 9am (or at 8.15am for 8.30 meetings) and departed at 5.20pm with a 20 minute lunch break, with some exceptions, but assured him that these were not excessive and did not

result in her working less than a full week. The manager also stated that she was "perplexed and concerned" by the request.

A meeting was held on 30 June between the manager, the MD and another employee, during which the manager was challenged about her response and accused of lying. Her employment was terminated without notice shortly after the meeting. The manager alleged that, shortly after her termination, she was assaulted and battered by the MD when he grabbed her by her sleeve and pulled her away from a conversation with another senior manager, and she was escorted to her office and away from the premises.

Claims

The manager made several claims against her Employer in respect of her dismissal, including:

- breaches of the *Workplace Relations Act 1996* (Cth) (the Act), alleging unlawful termination on the ground of family responsibilities and certain provisions in respect of providing notice of absences taken as sick leave and carers leave – these claims were later discontinued

- breach of contract by reason of summary dismissal (ie failure to provide 8 weeks notice in writing or make a payment in lieu thereof)
- breach of contract by reason of failure to follow the performance counselling guidelines contained in the policy document *Staff Guidelines*
- breach of contract by failing to observe an implied term of mutual trust and confidence
- discrimination on the ground of her family responsibilities in breach of the *Sex Discrimination Act 1984* (Cth), and
- assault and battery.

The manager failed in all her claims.

Breach of contract – failure to provide notice (or pay in lieu)

The Court held that there was no breach of contract by the manager's Employer in failing to provide 8 weeks notice of termination, or payment in lieu of that notice.

The Court held that the manager's response to the MD was intentionally dishonest and was an act of knowing and "wilful misconduct". This was sufficient to justify her summary dismissal under her

contract of employment, which allowed for summary dismissal on the basis of “serious, wilful or persistent misconduct”.

The manager not only sought damages for breach of contract representing 8 weeks notice, but a further 8 week payment for the loss of any opportunity to proceed through the performance counselling process and damages for loss of a chance to remain in employment.

The Court was satisfied, that even if the Employer had not been able to summarily dismiss the manager under her contract of employment, it would have done so with notice. The Court held that either way, the manager would not have remained in employment. Consequently, there was no basis for her to claim damages for loss of a chance to remain in employment.

[Breach of contract – failure to follow the Staff Guidelines](#)

The Court held that there was no breach of the manager’s contract by her Employer for failing to follow the performance counselling guidelines (contained in the *Staff Guidelines*).

The manager had argued that the *Staff Guidelines* were incorporated



by reference into her contract of employment, making them contractually binding not only on her, but also on her Employer. In determining whether the *Staff Guidelines* had been so incorporated, the Court considered the following factors “for” incorporation:

- the employment contract provided that the *Staff Guidelines* “governed” the manager’s employment, and
- provided that she agreed “to be bound by” the Employer’s policies.

On the other hand, the Court considered that the following circumstances mitigated against incorporation:

- the employment contract provided that “you acknowledge and accept that it is the prerogative of [the Employer] to vary, change or terminate existing [Employer] policies as well as devise and introduce new policies” – the Court stated that it was difficult to see “much mutuality in such a document”
- the policies were provided to the manager on the commencement of her employment but were not matters to which she committed herself with knowledge at the time she signed the employment contract, and
- the language of the *Staff Guidelines* was in parts aspirational, as opposed to contractual. In particular, the steps to be taken under the performance counselling guidelines were “available for selection depending on circumstances” which, the Court held, disqualified them from being contractual and that there was no invariable requirement for the guidelines to be followed, much less a contractual requirement to this effect.

The Court noted that even if the procedures for performance counselling had been incorporated into the manager’s employment contract, the reason for her dismissal was not one which could have been performance managed.

[Breach of contract by failing to observe an implied term of mutual trust and confidence](#)

The Court held that there was no term of mutual trust of confidence implied into the manager’s employment contract. The manager had relied upon the existence of such a term to support a claim for damages arising from the circumstances of her dismissal, in that she alleged they were distressing and humiliating. The Court applied the case of *Addis v Gramophone Company Ltd* [1909] AC 488, holding that general damages were not available for the manner of a dismissal.

[Discrimination claim](#)

The Court held that the manager’s dismissal had nothing to do with her family responsibilities or any characteristic attributed or imputed (whether generally or particularly) to persons in her position as a working mother.

In finding that there was no discrimination, the Court noted that the manager's hours of work were clearly set out in her employment contract, that her position was one of senior management and the requirement to work additional hours was clearly foreshadowed, which must have been apparent to her at the time she accepted the position. The Court held that the obligation was on the manager, prior to accepting employment, to assess whether she would be able to meet the requirement for additional work outside the 9am to 5pm, whilst discharging her family responsibilities.

Assault and battery

The manager did not provide any evidence sufficient to support her claims of assault and battery by the MD.

Costs order

The Employer made an application for costs, including indemnity costs, for the amount of \$203,909.89. The Employer's claim for indemnity costs was made on the basis that it had made an offer of compromise in the amount of \$30,506.22 to the manager to settle the matter relatively early on in the proceedings, which she had refused.

A party will usually only be entitled to recover "party/party" costs (if at all), which can be substantially less than what the party may have actually spent. Indemnity costs are all costs, including legal fees, charges, disbursements and expenses, incurred by a party to litigation in undertaking proceedings, provided that those costs have not been unreasonably incurred or are not of an unreasonable amount.

In this case, the Court held that in the circumstances, it was "very imprudent" and unreasonable of the manager to not have accepted the Employer's offer. Accordingly, it awarded costs on an indemnity basis from the last day on which it was open to the manager to accept the Employer's offer, including costs under s824 of the Act (which prohibits the payment of costs, except in limited circumstances, for matters arising under the Act). Costs prior to that date were awarded in accordance with the *Federal Magistrate Court Rules 2001 (Cth)* (where the proceedings had initially commenced).

Lessons for employers

The decision demonstrates that, while it is usually available in limited circumstances, immediate dismissal can occur if:

- the employee's behaviour is sufficiently serious, and
- the behaviour relates to dishonesty or lying – particularly in relation to senior employees.

Employers should exercise their right to immediately dismiss an employee only after careful consideration of the facts and after obtaining professional advice.

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