IN THE COUNTY COURT OF VICTORIA

Revised
Not Restricted

AT MELBOURNE
CIVIL DIVISION
COMMERCIAL LIST
EXPEDITED CASES DIVISION

Case No. CI-07-03107

FERNBROOK SERVICES PTY LTD — Plaintiff

v.

EXINDA NETWORKS PTY LTD — Defendant

JUDGE:	HIS HONOUR JUDGE ANDERSON
WHERE HELD:	Melbourne
DATE OF HEARING:	23 - 26 March 2009
DATE OF JUDGMENT:	7 May 2009
CASE MAY BE CITED AS:	Fernbrook Services Pty Ltd v Exinda Networks Pty Ltd
MEDIUM NEUTRAL CITATION:	[2009] VCC 0352

REASONS FOR JUDGMENT

Catchwords: Contract – Agreement to provide consulting services to prepare a company for a trade sale – Whether plaintiff entitled to recover for work performed – Alleged representations constituted by plaintiff's silence on certain matters – Consultant working on project convicted of insider trading and serving a sentence of imprisonment by periodic detention – Plaintiff not the holder of an Australian financial services licence.

APPEARANCES:	Counsel	Solicitors
For the Plaintiff	Mr J. Catlin	Bleyer Lawyers
For the Defendant	Mr St.J. Hibble	Oakley Thompson

HIS HONOUR:

1 Exinda Networks Pty Ltd conducts a computer software business specialising in network services. The company was founded in 2001 by communication engineers, Con Nikolouzakis and Chris Siakos. In about August 2005, Exinda engaged Fernbrook Services Pty Ltd "*to provide consulting services to Exinda with a view to preparing Exinda for a trade sale and to manage Exinda through such a trade sale*".

2 Between August 2005 and February 2006, Fernbrook undertook consulting work for Exinda. The services were performed by consultants Mario Vecchio, Frank Maly and Richard Frawley. The consulting work included attempted capital raising, although no capital was raised and there was no trade sale of Exinda.

3 Notwithstanding that it performed work directed to these ends, Fernbrook was not the holder of an Australian financial services licence under the *Corporations Act* 2001. Further, in June 2005, Richard Frawley had been convicted of insider trading and sentenced to a term of two and a half years imprisonment which he was required to serve by way of periodic detention. Exinda alleged that Fernbrook should have disclosed these facts to it before the consulting agreement was entered into.

4 The following questions were raised for determination in the proceeding:

1. Did Fernbrook perform work pursuant to the consulting agreement for which Exinda was obliged to pay the sum of $193,200?

2. Was Exinda's obligation to pay consulting fees conditional upon Fernbrook raising the sum of about US$1 million during an interim round of capital raising?

3. Alternatively, was Exinda's liability limited to:

   a. payment of fees of $10,000 for each month of the consulting agreement; or

   b. as no capital raising was completed, must the unpaid consulting fees be converted to equity at the valuation agreed for the capital raising with any equity issued being of the same class as for the existing shareholders of Exinda?

4. Prior to entering into the consulting agreement did Fernbrook fail to inform Exinda that:

a. it did not hold an Australian financial services licence; and/or

b. Richard Frawley had been convicted of insider trading and was serving a term of imprisonment by periodic detention?

5. If "*yes*" to any part of 4, did any such failure on the part of Fernbrook:

a. constitute misleading and deceptive conduct entitling Exinda to claim damages; or

b. otherwise entitle Exinda to avoid its obligations under the consulting agreement?

Background facts

5 A written consulting agreement was apparently executed by the parties in July 2005. The consulting agreement was to "*commence on 1 August 2005, and continue for six months, or as otherwise agreed by the parties*". Each party had the right to terminate the agreement by giving one month's notice.

6 The agreement set out the services to be provided, both during the "*preparation*" phase and the "*sale process*" phase. During the preparation phase this included Fernbrook undertaking:

> " ... *a capital raising (of an indicative amount of US$1 million) according to an agreed budget and on an agreed valuation (indicative valuation of US$5 million) with a target timeframe for completion of 30 October 2005. This capital raising will be pitched to investors as an 'interim' round, prior to a more significant raising in 2006. Exinda and Fernbrook agree, however, that the focus is on a trade sale in the near term*".

7 It was agreed that the work, the subject of the consulting agreement, would be performed by Fernbrook through a director, Mario Vecchio and consultants Frank Maly and Richard Frawley. Vecchio, Maly and Frawley had all previously worked together with a very substantial American software company, Cisco Systems Inc., both in Australia and overseas.

8 The consulting agreement provided that "*a daily retainer for each of Frank Maly and Richard Frawley of AU$1,600*" would be paid and that "*the services of Mario Vecchio would be provided at no cost*". In addition, a success fee would be paid to Fernbrook "*on the sale of Exinda*" according to a sliding scale with no fee payable if the sale did not exceed US$5 million and 15 per cent if the sale price exceeded US$20 million.

9 The agreement recorded:

> "*Both parties acknowledge that Exinda has limited cash reserves. A capital raising, as noted above, will take place as a matter of priority. Until such time as the 'interim' capital raising is completed, Exinda will pay Fernbrook $10,000 per month. At the completion of the capital raising, Fernbrook will receive the balance of whatever is outstanding, and from then on be paid in full each month. Should a capital raising not be completed, the unpaid portion of the Fernbrook Consulting Fee will be held as a creditor by Exinda, pending conversion to equity at the valuation agreed for the capital raising. Any equity issued will be of the same class as for existing shareholders.*"

10 Vecchio, Maly and Frawley each had a technical background with experience in sales and marketing. They had no experience in accounting or banking and no financial qualifications although Frawley said that he had been involved in capital raising in the United States. Each of them did, however, have substantial contacts, both in Australia and the United States, including with what was described as "venture *capital*" companies who were looking to invest in new businesses, including companies like the defendant who were involved in new computer technology.

11 Exinda had previously attempted to raise capital through a company, Melbourne Capital Ltd. Melbourne Capital was the holder of a licence to deal in securities and an Australian financial services licence. As a result of capital raising activities carried out by Melbourne Capital for Exinda in 2004, Melbourne Capital, and its Managing Director Angus Edgar, had become shareholders in Exinda. By mid 2005, Melbourne Capital and Mr Edgar held approximately 28 per cent of the shares in Exinda.

12 In addition, during 2005 and until at least mid-2006, there was an ongoing consultancy arrangement between Exinda and Melbourne Capital. For "*an advisory fee of $3,000 per month*", Melbourne Capital would provide "*corporate advisory and business development services … utilising the services of Mr Chris Chambers and Mr Angus Edgar*". Mr Chambers was an associate director of Melbourne Capital. In a letter dated 19 September 2009 from Melbourne Capital to Exinda, Melbourne Capital was engaged for an initial period of 12 months to deliver certain services to Exinda "*in order to appropriately structure the company to source funds to facilitate the growth strategy of the group*". Since about 2002, Vecchio had given technical advice to Melbourne Capital. In early 2005, upon the recommendation of Edgar and chambers, Vecchio had performed consulting work for Exinda.

Exinda's obligation to pay consulting fees

13 Maly and Frawley commenced work under the consulting agreement on about 1 August 2005. Both were based in Sydney and although they made visits to Melbourne, where they consulted directly with representatives of Exinda and Melbourne Capital, most of the communication was by a telephone and email. Fernbrook did not render accounts for the services performed by Maly and Frawley during the life of the agreement. Although the consulting agreement on its face was to continue for six months, some limited work was performed in February 2006.

14 Exinda apparently then gave notice of termination of the agreement, although a copy of the notice was not tendered in evidence. The notice apparently gave as the reason for termination the fact that the "*work was not performed*". Fernbrook subsequently claimed payment of $193,200 from Exinda, being a total of 60.125 days for Frank Maly and 60 days for Richard Frawley at the agreed rate of $1,600 per day. These figures were apparently calculated in accordance with "timesheets" produced after the work was completed.

15 Both Maly and Frawley gave evidence that the timesheets were prepared approximately weekly using source documents such as meeting calendars maintained by each consultant. The timesheets set out, in respect of each day, the number of hours and a short description of the work performed. In addition, plaintiff's counsel, Mr Catlin, tendered in evidence copies of a number of draft documents produced during the course of the consulting agreement and volumes of email correspondence between Fernbrook's consultants and representatives of Exinda and Melbourne Capital.

16 The plaintiff's witnesses described the work that they did initially, as developing a product and marketing strategy to make the operational side of Exinda more attractive to potential investors. The documents tendered in evidence, such as the Information Memorandum and the Product Requirement Document for the Service Delivery Point were not the subject of independent evidence as to its value in the process of preparing Exinda for a trade sale. The defendant's witnesses, in my view, tended to downplay the importance of these documents as a necessary part of making Exinda more marketable and the contribution that Exinda's and Melbourne Capital's representatives made to the development of these documents.

17 I was more persuaded by the evidence of the plaintiff's witnesses in this regard. The documents were developmental; their logic and significance was apparent from the contents and these facts were apparently recognised by Exinda and Melbourne Capital. The representatives of these companies were kept fully informed and involved in Fernbrook's work. The documents themselves were used in presentations to investors and this helped to develop Exinda's profile, particularly in the United States and amongst the venture capital industry and other potential investors. Exinda and Melbourne Capital participated in these processes without complaint or suggestion that the efforts of Fernbrook consultants would be better directed. I am satisfied that Maly and Frawley performed the work for which Fernbrook charged Exinda and that it was work directly relevant to the objectives of raising capital or preparing Exinda for a trade sale. Ordinarily therefore Exinda would be liable to pay the amount claimed

18 On 27 April 2006, there was an exchange of emails between Edgar and Anthony Bodin in relation to the outstanding amounts claimed by Fernbrook. Bodin was a 20 per cent shareholder in Exinda and its business development manager. He had been closely involved in the engagement of Fernbrook and the performance of the consulting work. In the email, Bodin said, "*So what is outstanding as I understand it is: 110 days, less 7.5 paid total $162,800 plus GST*". In response, Edgar suggested the option of Exinda making "*a cash payment of $50,000 plus $5,000 GST towards the invoice of $162,000, the balance to be converted into equity will be $112,800 plus a cash payment of the GST being $11,280*". Bodin said that he had "*no recollection*" of the email exchange. These discussions provide some limited support for the view that Exinda, and one of its major shareholders, recognised Exinda's liability to Fernbrook for monies outstanding under the consulting agreement.

Was the consulting agreement contingent upon a successful capital raising or trade sale?

19 The consulting agreement makes it clear that the task for Fernbrook was to prepare "*Exinda for a trade sale and to manage Exinda through such a trade sale*". The agreement anticipated that "*Fernbrook would work with and advise Exinda*" on a number of matters including undertaking a capital raising in the short-term of "*an indicative amount of US$1 million*" and an eventual "*trade sale*".

20 The consulting agreement noted that the "*capital raising*" would "*take place as a matter of priority*". The agreement indicated a "*target timeframe for completion of 30 October 2005*". The agreement provided that "*until such time as the 'interim' capital raising is completed, Exinda will pay Fernbrook $10,000 per month*". The agreement

did not, however, restrict Fernbrook's work to that level of activity, as it provided that "*at the completion of the capital raising, Fernbrook will receive the balance of whatever is outstanding, and from then on be paid in full each month*".

21 The agreement also anticipated the possibility that "*a capital raising [may] not be completed*", in which event "*the unpaid portion of the Fernbrook consulting fee will be held as a creditor by Exinda pending conversion to equity at the valuation agreed for the capital raising*". Fernbrook was to be compensated in respect of any trade sale by a "*success fee*" determined in accordance with a sliding scale.

22 So far as the written agreement is concerned, there is no basis for concluding that recovery by Fernbrook of the consulting fees was to depend upon a successful interim capital raising or a trade sale. In relation to a trade sale the "*success fee*" was to be payable pursuant to the consulting agreement to Fernbrook:

> "*even if a transaction is concluded after the term of this agreement where the acquirer is one that has been introduced by Fernbrook and where the sale takes place either as a direct result of the continuation of negotiations that commenced during Fernbrook's engagement, or otherwise as a result of negotiations that were recommenced within 9 (nine) months of Fernbrook's engagement*".

23 A similar arrangement applied if Fernbrook's consulting agreement were terminated prior to completion unless "*terminated by Exinda due to gross negligence or misconduct by Fernbrook*". In the circumstances, the written agreement does not support the defendant's contentions.

24 Alternatively, the defendant submitted that the evidence established a variation of the consulting agreement to the effect that nothing was to be payable by way of consulting fees to Fernbrook unless and until a successful capital raising had been completed. Exinda relied upon conversations between Vecchio and representatives of Exinda. The evidence does not, in my view, satisfy me that such an arrangement was reached.

25 Vecchio gave evidence that he had agreed to defer payment of the consulting fees until Exinda was in a position to pay but denied that Fernbrook had agreed to waive any entitlement to fees if the capital raising was unsuccessful. Vecchio said that he had discussed with Bodin the feasibility of taking payment in shares particularly if he were to become a long term employee of Exinda.

26 Bodin gave evidence that "*right through the whole project*" he had discussed with Vechhio and "*potentially*" Frawley that Fernbrook's fees could only be paid if there were a "*successful capital raising*". Bodin said that this was the understanding of the parties including "*before the signing of the agreement*".

27 I consider that there is no basis for concluding that the payment of Fernbrook's fees was to be contingent upon a successful capital raising. The consulting agreement clearly contemplated otherwise and I am not satisfied that any subsequent variation agreement was reached by the parties.

28 The agreement did provide that if a capital raising were not completed , that the unpaid fees would "*be held as a creditor by Exinda, pending conversion to equity at the valuation agreed for the capital raising*". In cross-examination, Vecchio agreed that there was "*no agreed valuation for capital raising*". The defendant's witnesses gave similar evidence.

29 The consulting agreement referred to "*a capital raising… on an agreed valuation (indicative valuation of US$5million)*". There would in my view be some basis for concluding that this figure of US$5million was "*the valuation agreed for the capital raising*", upon which basis Fernbrook's unpaid fees would be converted to equity in Exinda by the issue of shares "*of the same class as for existing shareholders*". However, in the face of evidence from both sides that there was "*no agreed valuation for capital raising*" and evidence of Nikolazakis that the targeted valuation was US$7million or A$10million, I do not consider that this conclusion is open and any entitlement by Fernbrook under the consulting agreement must be paid as a monetary amount.

Fernbrook's failure to hold an Australian financial services licence

30 The evidence is that Fernbrook has never held an Australian financial services licence and that Melbourne Capital was, at all material times, the holder of such a licence. During the course of evidence, plaintiff's counsel and its witnesses were at pains to suggest that Fernbrook's involvement was limited to technical issues relating to the sales and marketing aspects of Exinda and that, if approaches had been made to Fernbrook by potential investors, Exinda would have immediately been informed and it would be for Exinda or Melbourne Capital to accept responsibility to bring to fruition any arrangement by which equity in Exinda would be transferred to investors.

31 The evidence establishes, however, that Frawley in particular was directly engaged in approaching potential investors. His contacts amongst venture capitalist companies was one of the reasons he was engaged to work on the project. He prepared lists of

companies who were potential targets and made contact with, and presentations to, a number of venture capitalists.

32 In its defence at paragraph 9A, the defendant pleaded the provisions of s.925A of the *Corporations Act* 2001 as entitling it to rescind the consulting agreement and as a bar to recovery by Fernbrook. When the trial commenced, defendant's counsel Mr Hibble, indicated that this part of the pleading would not be relied upon on.

33 However the defendant, at trial, continued to rely upon the provisions of the Corporations Act in its pleadings pursuant to the *Trade Practices Act*. Exinda alleged that Fernbrook's failure to inform Exinda that it did not have an Australian financial services licence constituted misleading and deceptive conduct.

34 Fernbrook's counsel, Mr Catlin, submitted that the provision of "*financial services*", which gave rise to the obligation to hold the appropriate licence, should be construed narrowly and confined to advice relating to the provision of a "*financial product*". The submission rather begs the question, and it would in my view be surprising if a party engaged to "*work with and advise*" another company undertaking a capital raising and preparing for a trade sale, was not involved in giving advice in relation to a "*financial product*" and therefore was required to be the holder of an Australian financial services licence before it did so.

35 It is probably unnecessary for me to decide this issue. I am not satisfied that in the circumstances of this case, there was an obligation on the part of Fernbrook to inform Exinda that it was not the holder of an Australian financial services licence. Fernbrook was introduced to Exinda by Melbourne Capital. Melbourne Capital was the holder of the necessary licence. The tasks that Fernbrook was to perform included a range of essentially technical matters related to improving the products and marketing structure of Exinda.

36 Fernbrook was directly involved in capital raising and contacted many potential investors and made presentations to a number of interested parties. It is clear that Melbourne Capital, particularly through Chambers actively participated at all stages, including in the preparation of the information memorandum and other significant documents. In the circumstances, it could not be said that Fernbrook's failure to volunteer the fact that it did not have an Australian financial services licence constituted misleading or deceptive conduct or that there was reliance upon that fact by Exinda.

Richard Frawley's involvement in the project

37 The consulting agreement foreshadowed that Richard Frawley would be made available to work on the project for a minimum of "*two days per week*". On 30 May 2005, Frawley had pleaded guilty to a charge of insider trading involving the purchase of 253,500 ordinary shares in JNA Telecommunications Limited between 21 May and 15 July 1998 in breach of s.1002G(2)(a) and s.13011(1)(a) of the *Corporations Act* 2001. Frawley was sentenced to a term of two and a half years' imprisonment to be served by way of periodic detention commencing on 2 July 2005 with release on security on a Recognizance Release Order after he had served 20 months of the sentence. A Pecuniary Penalty Order of $586,000.77 was also made.

38 The defendant alleged that Fernbrook did not make Exinda aware of the fact that Frawley had been convicted and was serving a term of periodic detention. Exinda said that, if it had been aware of this fact, it would not have entered into the agreement. In the plaintiff's further amended defence to counterclaim and reply to defence, it is alleged in paragraph 6 that "*the defendant was informed by the plaintiff in relation to Richard Frawley being charged with the offence of insider trading*", although the pleading does not say specifically that this was prior to the consulting agreement being entered into.

39 Vecchio gave evidence that he had told Chambers that Frawley had an insider trading conviction. In cross-examination, Vecchio said that he had told both Edgar and Chambers, being the "*persons who had introduced us to Exinda*". He said that Edgar and Chambers told him that they had passed the information on to Exinda. Vecchio said that later, in 2006, he told Bodin about the conviction. He said he did not deliberately withhold the information and did not regard the fact that Frawley was serving periodic detention as relevant because the work Frawley was doing for the defendant was "*only technical due diligence*".

40 Chambers was not called to give evidence. Although Mr Catlin indicated in his opening that Chambers would be called on behalf of the plaintiff, that statement depended upon the plaintiff being able to subpoena Chambers. The plaintiff left it too late to do so. The defendant might have called Chambers. It said it did not, because it did not need to. Whilst this explanation in unconvincing, I see no basis to draw any inferences following the failure of Chambers to be called as a witness by either party. Edgar gave evidence that he was not aware of Frawley's insider trading conviction prior to the consulting agreement being entered into. In "*Late 2005 or early 2006*" he had been told by Vecchio or Exinda. Bodin said that he found out about Frawley's

conviction after Chambers told him, some months after Fernbrook had been engaged.

41 On the evidence, I am satisfied that at or about the time the consulting agreement was entered into, no one from Fernbrook told anyone from Melbourne Capital or Exinda that Frawley had recently been convicted of insider trading or was serving a term of periodic detention. Vecchio's evidence on critical points was unconvincing. He appeared to tailor his evidence to what he perceived to offer the best forensic advantage for the plaintiff. He was unspecific about the occasions on which he allegedly informed Chambers and Edgar of the conviction.

42 The evidence of the defendant's witnesses was that the defendant would not have entered into the consulting agreement if it had been aware of Frawley's conviction and the fact that he was serving a sentence of periodic detention. Edgar said that he would not have referred Fernbrook to Exinda because Frawley's conviction reflected poorly on the company and it would have lacked credibility with investors. Nikolouzakis said that having Frawley work for Exinda would have been detrimental to the company's ability to raise capital because Exinda's reputation was a key selling point. Siakos and Bodin gave similar evidence and suggested the involvement of Frawley would have affected the perceptions of potential investors.

43 Divergent Capital wrote to Exinda on 1 March 2006 offering to invest in the company. They noted, as one of the "*negatives*" following their review of Exinda, that:

> "*Our background checks have revealed that Richard Frawley has been convicted of a corporate crime within the IT industry. This is both unsettling to Divergent and poses the risk of negative aspersions being placed on the company and future by investors, potential acquirers and the media. As indicated above we do not feel that any of these negatives are insurmountable but they do present definite risks which we as an investor need to take into account and work together with you to solve*".

44 No one from Divergent Capital was called to give evidence in the proceeding and in those circumstances it is difficult to give much weight to the views expressed in the letter.

45 The consulting agreement foreshadowed that Richard Frawley would work on the project for Fernbrook for a minimum of two days per week and Fernbrook would be paid a daily retainer in respect of his services of $1,600. Exinda asserts that Fernbrook should have disclosed both the fact of Frawley's conviction and that he

was serving a sentence of periodic detention, and that in the absence of such disclosure, the consulting agreement should be set aside and Exinda should not be liable for the costs of the work performed by Fernbrook pursuant to the agreement. Exinda submits that the fact that it would not have entered into the consulting agreement is sufficient basis for it to demonstrate that it had suffered loss and damage.

46 There are circumstances in which mere silence would be sufficient to attract the operation of s.52 of the *Trade Practices Act* 1974. This is not a case, in my view, where Fernbrook remained silent in the face of specific questions or a conversation in which the context demanded that disclosure be made by Fernbrook. The statements by Exinda's witnesses, that Exinda would not have entered the agreement if the facts concerning Frawley had been known, are of limited value. It is more likely, in my view, that the parties would have accommodated any perceived embarrassment that exposure of Frawley's conviction and sentence would have caused, by redefining his role.

47 Vecchio, Maly and Frawley had each worked with Cisco Systems Inc. They were engaged to assist with the task of capital raising and a trade sale, not because of any financial expertise but because of their experience in the marketing and sale of software products and, more particularly, their contacts within the industry – including amongst potential investors. Very little evidence was led before me as to what Exinda was told or already knew about Frawley before it committed to the consulting agreement. The most important factors appear to have been statements that Frawley and Maly had wide contacts and, with relatively little effort, could raise significant sums of capital.

48 Frawley worked with representatives of Melbourne Capital and Exinda for over six months. The evidence of the exact time when the representatives of Melbourne Capital and Exinda found out that Frawley had been convicted and was subject to a sentence of periodic detention is unclear. Bodin said that Chambers had told him of the conviction "*several months into the project*". It is not clear at what stage this was and whether Exinda continued to have Fernbrook perform the services under the consulting agreement and for there to be regular on-going contact between Melbourne Capital and Exinda representatives with Frawley and for Frawley to continue making contact with venture capitalists with a view to persuading them to invest in Exinda.

49 Defendant's counsel, Mr Hibble, submitted that the circumstances of Frawley's conviction were "*highly relevant to the project that Exinda had engaged Fernbrook to*

complete". He submitted that "*Frawley (through Fernbrook) was engaged by Exinda to do work in the same country, in the same industry, for the same purpose as that which led to his conviction for insider trading*".

50 In my view, this analysis ignores the essence of Frawley's offending which was his dishonest use of particular information of which he had been made aware through his employment that gave him an advantage in purchasing shares in the company on the Australian Stock Exchange. Whilst it is possible to conceive of circumstances in which Frawley might dishonestly have misused information obtained during the course of the consulting agreement with Exinda, the circumstances are quite dissimilar to those which led to his conviction and sentence of imprisonment.

51 My conclusions in relation to this cause of action are as follows:

a. I consider it more likely than not that Fernbrook did not tell Melbourne Capital or Exinda of Frawley's conviction or sentence to periodic detention before the consulting agreement was entered into.

b. I am not, however, satisfied in the circumstances of this case that Fernbrook's failure to advise Exinda of the facts concerning Frawley constituted misleading and deceptive conduct.

c. I am not satisfied that Exinda would not have entered into the consulting agreement in similar terms, even if they had been made aware of the position in relation to Frawley.

Orders

52 In the circumstances, there will be judgment for the plaintiff against the defendant for $193,200. I will hear the parties further on the question of interest and costs.

Certificate

I certify that these 12 pages are a true copy of the reasons for decision of His Honour Judge Anderson delivered on 7 May 2009.

Dated: 7 May 2009.

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Julien Lowy
Associate to His Honour Judge Anderson