

LAWS4112

LAWS4112 Corporations Law Contents

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1. Introduction and Administration

The course lecturers and tutors are:

* Ross Grantham
* Dr Vicky Comino
* Dr Radha Ivory

1. Course Aims

This course seeks to develop a theoretically informed account of modern company law and, in particular, to:

* Introduce you to corporate theory and the underlying principles that inform and support the corporate entity and allow it to function within the legal system;
* Familiarise you with the provisions concerning the formation, structures and operation of public and proprietary companies through programmed reading, lectures, tutorial exercises, and class discussion;
* Examine the rules affecting the structure and operation of the company, in light of theoetical conceptions of the company, to determine whether they permit appropriate interaction between the organs of the company, ensure good governance and protect members' interests;
* Develop your legal skills through legal writing, case analysis, statutory interpretation, problem solving, and the use of online materials and databases; and
* Encourage you to think critically about company law and theory.

The Corporations Act is edging towards being a complete code but is still a partial code. The act only makes sense if you consider background common law. Australian corporate law is complex, badly drafted, badly organised, badly thought through and it is a hog-podge of concepts and rules which date from 1844 up until today.

The basic concept of the Company dates back to the 1800’s – many core concepts are contained in the act but date back to the 1800’s. The language of membership, of being partners persists in the law even though company law and partnership law have diverged in the last century (this language is used to refer to shareholders).

Company law is inherently legalistic and based on a fiction model. At the core of Company law is a fiction and that fiction is a company. Companies do not exist in the sense that you cannot say there is a “company walking past” – companies are an abstract legal entity. You see people who represent, embody, work for the artificial legal entity. Problems arise where people forget that the Company, as far as the law is concerned, something that exists but in reality, companies do not exist. How do you apply a body of law (designed to apply to humans and natural beings) to something which does not have a real existence? A separate set of rules is needed to transform general law principles to apply to something that does not actually exist. To say companies do not exist does not mean that companies are not important – companies are the vehicle for the conduct of business.

As far as the law is concerned, a company is a company regardless of whether it is a small single owner company or a large company (e.g. Microsoft, BHP). How do we accommodate the fundamental practical differences between different companies into one legal concept – challenge! Company law is very flexible and allows the parties involved in companies to do anything they like with the company (e.g. way they are structured, who has control, who gets the benefit). Companies are therefore a useful business vehicle because they can be made to fit a particular business. Companies are also non-business entities (e.g. not for profit) – this reflects the same degree of flexibility.

The lectures will cover core themes and concepts and more detail will be found in the recommended readings and legislation.

1. Assessment
2. Essay – Client Advice
   * Released 20 March 2017
   * Due 24 April 2017
   * 40%
   * You will be given a set of instructions from large corporate client and must prepare advice for General Counsel
3. Final Exam
   * Open book
   * 60%
4. Overview
5. What is a Company?

*Salomon v A Salomon & Co* [1897] AC 22–This case provides the basic outline of the ‘company’ that we have today.

A company is a legal or juristic person, separate from the individuals (natural person) involved in its operations. A legal person may be of one of two types: natural persons (biological entities presumed to have full legal capacity). Natural persons are subject to the law because they are capable of bearing rights and duties and owing responsibilities. The law is principally directed at natural persons and natural persons are the law’s primary subject. However, natural persons are a category of legal persons and legal persons are the law’s principal concern is with legal persons. The other category of legal persons are juristic persons (artificial person). A very small part of the law deals with juristic persons – things that are people, are capable of bearing rights and duties, owning property, commencing litigation in their own name, being sued BUT which are not biological entities.

Some juristic persons are called corporations and others are called companies. The Queen is a corporation sole or the sovereign of sole – corporation made up of one person. Corporation aggregate is a corporation made up or involving a number of natural persons (e.g. UQ). UQ is a corporation by virtue of the University of Queensland Act 1998. We are not concerned with corporations and instead the course will focus on companies. The Corporations Act concerns registered companies. The Corporations Act does not deal with corporations because most corporations are created by separate act of Parliament.

One of the issues arising from the company being a corporate body is that it exists because the law says it exists. The closest a company gets to physical existence/manifestation is the certificate or incorporation issued by ASIC. The law applies to persons – when drafting laws in the past, we generally thought about the law applying to natural persons. How do those rules apply to something that does not exist in a physical sense? What does it mean to say that a company has committed a negligent act? A lot of company law concerns how the general law applies to something fundamentally different to the subject for which the law was initially drafted – the process by which laws designed for natural persons are transferred to apply juristic persons is called ‘attribution.’

Companies can incur obligations, be sued in their name, acquire rights, own property, pays tax and have a perpetual existence. They can be wound up, etc. but otherwise they cannot die in the same way that natural persons do. This means that if Bill Gates starts up a moderately successful computer business and then dies – if he was the business, then the business would die with him. Of course, he is not the business: the business is the company and therefore business can continue without him. It is also good for family businesses (e.g. granddad starts a business 60 years ago and dies – the business can be handed down to the successors).

Modern Registered companies also have the benefit of limited liability. If an investor invests $100 in the company and the company goes ‘belly up’ and is liable for $5 million, the investor is NOT liable for $5 million. The investor’s liability is exhausted by the $100 invested – the investor then knows exactly what his/her risks are (know the downsides and still get all the upsides). If the company profits instead of going bust, the investor gets a share in the profit (even though liability is limited to $100).

1. Company v Corporation

Corporations are a bigger concept. Companies are a form of corporate body. Today, the term ‘corporations’ is reserved for things that are not registered companies (e.g. universities, city councils, government owned corporations, the Queen, the Bishop, etc.). Corporations tend to be created either by a royal charter (i.e. document issued by sovereign saying you are a corporate body and have these rights and privileges) or more commonly, by an act of parliament.

**You can use the words company and corporations interchangeably but the word ‘company’ is used more commonly in Australia**. At the end of every company’s name, you are required to include the word ‘Limited’ as per the Corporations Act (and all other systems deriving from British Law). In the US, you are required to include the word ‘Incorporated’ – US law separated from UK law in the early 1800. These operate as warnings to the public. In Australia, if you are dealing with X Ltd, the state is warning you that you are dealing with an entity with limited liability. In the US, companies all have limited liability but what the state is warning you of is that the entity is an artificial person/incorporation. In addition, English company law derives from the law of partnership whereas US company law derives from the law of the old corporation.

1. Brief History of the Corporate Form
2. English History

The Corporations Act is dated 2001 but the basic concepts of the act date back to 1944. To understand why the act looks the way it does and why we have some peculiar provisions, the history is important. In Australia, we need to understand the fragile constitutional arrangements upon which the corporations act settled.

1205 – In 1205, Oxford was granted a royal charter because it made it easier for the university to own its land and regulate its own affairs. Charters gave the entity certain privileges. Churches in the medieval period were large land owners – it makes it easier for the church to own land if the church is a legal entity in its own right rather than the bishopowning the land subject to a trust in favour of the church. Most of these charters contain some sort of state granted privilege (right to regulate certain things happening within area or particular type of activity). Throughout the medieval period, corporations became more and more common because they were useful.

16th Century – During this period, there was the rise of the merchant of venturers. Britain started to expand through private ventures to new parts of the world – established companies (e.g. Russian Company was established to exploit resources in Russia and East India Company was established to exploit resources in India). The British Government granted the EIC a charter which gave the company exclusive rights to trade with India (pay government tax and royalty) and maintain civil order. As these companies evolved, they started to develop basis elements of a company: board of directors (regents), shares, internal governance arrangements and traded by virtue of a royal charter.

1711 – At this stage, the South Sea Company was formed. The war of Spanish succession was ongoing and so the Company could not venture to South America. There was an idea to buy all the national debt that the UK owed and refinance it – shares increased dramatically and this created an investment bubble. The investment bubble eventually burst and everybody lost lots of money and as a result shook the foundations of the British economy. After the bubble burst, parliament passed the ‘Bubble Act’ which outlawed companies.

To circumvent this law, people created partnerships. Deed of settlement companies were simply large partnerships – parliament could not take away the need for a vehicle to facilitate entrepreneurship and business. Partnerships up to that point had been 3-4 people working together with personal relationship. Deed of settlement companies involved thousands of partners and were technically partnerships. Being an incredibly large partnership posed many problems with the law – the law was not capable of regulating organisations with such large partner numbers.

After much debate, in 1844 England passed the first Companies Act – incorporation by registration (filling in a form and paying a small fee). In 1855, an act was passed which introduced the concept of limited liability. 1844 marks the beginning of the modern registered company. When parliament created the companies act in 1844, it was providing a mechanism by which companies could raise large amounts of capital to build roads, dams, etc. (capital intensive work) – in order to form a company, you had to have at least 50 members. At the same time, legislation was passed which said that partnerships could not have more than 50 partners.

Salomon v A Salomon & Co Ltd [1897] AC 22 – Mr Salomon managed to use the corporate form to establish himself as a company (bootmaker). Between 1844-1897, parliament had watered down the 50-member rule to 7 members (i.e. you needed 7 members to become a company). Mr Salomon sought to benefit from the limit of liability rules and as a result asked his five children, accountant and solicitor to take one share each.

Issue: The question to consider in this case was whether a sole trader use the corporate form.

Held: At the first instance and at the Court of Appeal, the court decided that you must have 7 people actively involved in the business. However, the House of Lords held that the act states that you must simply have 7 people who sign as members and take a share and if those requirements are met, a company can be created. At that point, companies became available to sole traders.

Commentary:In Australia, it is perfectly possible and legal for a company to have a sole director and shareholder (i.e. Joe’s Plumbing). Joe Pty Ltd and Joe are completely different people. If you have repair work done on your washing machine but it breaks again – do you have a claim against Joe or Joe’s Plumbing Pty Ltd? Your claim would be against the company – the company may be worth nothing (no assets) in which case, your claim is worthless. That is what limited liability is for – it moves the risk of liability from investors in the company to creditors of the company.

1. Australian History of Company Law

Australia was federated in 1901. Section 51(xx) of the Constitution states that the powers to regulate corporation’s rests with the state and not with federal parliament. Federal parliament’s powers have been interpreted as regulating foreign trade and companies already in existence. All the rules around creating companies and regulating their internal affairs are powers that the constitution vests in the state. From 1901 onwards, each state had its own company’s legislation and each piece of legislation was different. In the late 1980’s, there was an attempt to nationalise company law and a number of processes were invoked to achieve this objective. The first process was the Corporations Law and the scheme was to take the Corporations Act 1989 of the ACT and each state would adopt that legislation as its own corporation’s act. Part of that arraignments provided cross-vesting of jurisdiction so the federal court could exercise jurisdiction over state law. However, the HC found that this arrangement was unconstitutional.

The solution was for each state to defer its corporations power to federal parliament. For 5 years at a time, each state refers its corporations power to the federal parliament and the federal parliament then enacts the Commonwealthlegislation (applying nationally). This is a fragile constitutional arrangement since the referrals have to be renewed after 5 years.

Is having national company law a good thing? The most successful corporate jurisdiction in the world (the US) has a state based corporation’s regime. Should we allow competitive federalism (allow states to compete to have company registrations)?

During the late 1990’s and early 2000’s, there were two reform initiatives:

1. Corporate law simplification program – this program sought to make the laws simpler and user friendly. The program increased the volume of the act substantially
2. CLERP – Responsibility for company law was moved from the federal AG office to the Treasury because there was a perception that companies were about doing business (and the treasury deals with business)

The legislation has not been thoroughly reviewed and reformed in a long time. This is partly because no-one wants to touch the act because it invites questions as to whether a national act is desirable and whether Qld wants to continue to defer its power to the commonwealth. There are many provisions which have been added since the act was first enacted in 2001 – many of these changes stemmed from the Corporate Law Economic Reform Program (a lot of company law is about economic efficiency)

1. Stakeholders in the Company

**Shareholders** – provide money for the Company (invest). When they buy their shares, that money is used by the Company to carry out its business. Selling shares to the public is how companies on the stock exchange get the capital they need to do their business. Historically, and still largely today, there is a view that companies exist for the benefit of shareholders and the principal function of the company is to make profits for the shareholders and that is all.

**Directors** – people charged with managing and running the company. What that entails depends on the nature of the company. In Joe’s Plumbing, Joe is the director and is the person running the company (manager). The directors of BHP do not get involved in day to day operational matters. The CEO, CFO, CTO, COO (C Suite) are charged with day-to-day operations. The function of directors in large companies is strategic and is about governance and the directors keeping an eye of the C suite. The prevalent view in Australia is that the board monitors the management of the company but does not manage the company itself.

**Employees** – the company provides income and a sense of worth to employees. Historically, employees have not been regarded as a key stakeholder in the company.

**Creditors** – can mean the bank or a trade creditor (e.g. A orders a new photocopy machine and the terms of payment are that A has to pay within 30 days. The 30-day period is essentially the supplier extending A credit). Creditors are the persons wearing the losses because of the way limited liability operates.

**The Public** – We as a community are affected by the way companies, particularly larger ones, operate. Large corporates exercise influence over societies which is enormous – should the public have a say? Should the corporate law regime be designed to ensure that companies act responsibly in the public interest? In some way, companies should be accountable to the public.

**Relationship between Company and Stakeholders**

* The way this relationship is viewed is related to the question of who has the final say in a company. There are two ways to view this relationship
  + Typical finance capitalist analysis of company says that investors with money hire management to manage their money for them (shareholders hire directors to manage the company and therefore directors are the agents of the shareholders). On this view, the company should be run for the benefit of shareholders and shareholders should have the final say. This is the traditional view.
  + Entrepreneurial – On this view, someone with an idea is looking for finance. That finance could be shareholders or could be from a bank. This suggest that directors and management are the ones who should be in control and shareholders are just passive investors. Why would we give passive investors an active say in the way the business is run – they are typically short term (buy and sell according to the share price). It is the people who know about the business who should be in charge.
  + Cooperative – the milk processing plant is owned by the farmers who sell to the milk processing plant (both owners and customers).
* How you understand the relationship and what you think the relationship ought to be will provide a view about whether control of the company should lie.

1. Types of Companies
2. One size fits all – this is the standard Australian model (one basic concept)
   * Proprietary companies limited by shares
   * Proprietary companies unlimited by shares
   * Public companies limited by shares
   * Public companies limited by guarantees
   * Public companies unlimited by share capital
   * No liability public company (confined to pure mining companies)
   * Listed company
3. The corporate group

The main companies that the course will discuss are proprietary companies and public companies limited by shares (i.e. companies where company capital is divided up into shares). No liability companies are usually only found in the mining industry. Companies listed on the ASX are public companies who have chosen to list their shares for sale on the stock exchange. You can be a public company and not be listed or be a public company that is listed.

If you want to sell shares to the public to raise funds, then listing the company on the ASX is a good way to do so. The ASX has its own rules and the ASX is itself a limited liability company which is listed on its own exchange. If you want to list shares on the ASX, you must play by the rules of the ASX.

Small companies may opt to be proprietary companies – less regulations.

The law does not really recognise corporate groups but they exist everywhere. A corporate group is a situation where one company owns another company. The parent company owns all the shares in its subsidiaries. Corporate groups form for various reasons – sometimes subsidiaries reflect different divisions of the business (e.g. parent company may manufacture washing machines so subsidiaries may deal with different functions/parts to be manufactured).

The law sort of recognises groups:

* Definitions - section 46 defines a subsidiary
* Purposes of disclosing financial information and preparing audits of its accounts

but does not recognise groups when it comes to duties owed by directors. Therefore, as far as the law is concerned, the duties of the directors of subsidiary 2 are to subsidiary 2 only and the directors cannot take into account the wider interests of the group. In 1844, no-one had imagined that one company might own another – therefore the law does not officially recognise corporate groups.

If you bring a claim in negligence against sub-sub subsidiary 1 (whose assets is 1 delivery van) and the subsidiary hands over its assets to you, that is all you are entitled to. Your legal relationship is with sub-sub subsidiary 1 and so you cannot sue subsidiary 2 and you cannot sue the Parent Company. The effect of having multiple legal persons, each with limited liability can create problems.

E.g. In the US, taxi drivers used to run over people and were often sued. Hundreds of companies were incorporated and each company owned one cab. Therefore, when Cab No 12 runs over someone, a claim can be brought against that company (if they don’t have any money, then its unfortunate for the plaintiff). The same strategy is used for major shipping lines (1 ship company) so when a ship sinks in the Great Barrier Reef and pollutes it, that ship goes down but the other ships remain unaffected.

## Company Formation

Historically, a royal charter or act of parliament was required to form a company. In 1844, it was decided that anyone could create a company by filling out a form and paying an administration fee. These days, ASIC administers company formation.

1. Other Forms of Business Vehicle

**Sole Trader**: A one-person business that is not registered as a corporation. There are no special formalities except that if the business is carried on in a name other than their own, the trading name must be registered under the Business Names Act. Liability is personal and unlimited.

**Partnership**: Business is carried on by two or more owners, sharing in profits and losses. No particular formality is required. Partnership Act regulates the relationships in the absence of agreement. Partners have personal liability for all business debts and obligation, the right to participate in the management of the business, and an individual partner can bind the whole partnership.

**Joint Venture**: Contrasted to partnership. Structured by specific agreement to limit co-owners’ roles, liability and investment. Do not act as agents for each other and generally have a pre-determined outcome from the venture.

**Trust**: Describes the relationship where one person, the trustee, holds legal title to property for another person, the beneficiary. Often used as a means of splitting income for family businesses

1. Why use a Company?

The main advantages of a company as a vehicle for the business:

* *Limited Liability*: the debts of the company are its own and the members have no personal liability except as agreed. Limited liability transfers the risk of business failure from the company’s members to its creditors.
* *Perpetual succession*: A company’s existence continues indefinitely until it is brought to an end, notwithstanding changes in its owners or managers.
* *Transferability of ownership*: The owner’s interest is in the form of shares and it is considered a valuable right to transfer the shares.
* *Unlimited investors*: No limit on the number of investors in a company.
* *Contractual capacity*: A company can own property and enter into transactions and engage in legal proceedings in its own name.
* *Taxation*: Depending on the prevailing tax laws, companies pay income tax at a lower marginal rate than individuals

# **Economics and Corporate Governance**

We are concerned with how microeconomic analysis has shaped and influenced our understanding of the company and the way we govern, regulate and legislate for companies. We are not concerned with the theories itself. The Company is a vehicle for doing business and its primary function is one of economic activity. It is as much, if not more, an economic concept as a legal concept. For the Company to do its job, to be fit for its purpose – it must reflect its nature, role and rationale (must be fit for the purpose of making money). We need to understand the key economic design features of the system because the law is pursuing the ends of making companies more economically fit for purpose and to make them more efficient for generating wealth. In 1996, governmental responsibility was transferred from the office of the federal AG to the office of the Treasury. Companies are a treasury function and the treasury is about making money - this inter-governmental transition provides a key indicator of the role of companies in Australia as a profit-making entity rather than a legal concept.

## Corporate Governance

### What is corporate governance?

The emphasis has changed from company law towards corporate governance (governance of companies). Corporate governance is a concept which is bigger than the law. We are more concerned with regulating companies that are around rather than creating a neat company statute. Corporate governance expresses a concern with government and social company about making companies effective, efficient and making sure they act properly. Company law is part of corporate governance but are an increasingly small part – there are many other ways, apart from a legal rule, by which the company is governed.

Governance originally meant ‘person who steered the ship.’ Governance is about direction and about who makes decisions. Corporate governance has three aspects:

1. **Control Rights** – allocation of the right to decide. This tends to be legal because the allocation of control rights occurs as per the legislation or company constitution. The standard default rule for companies is Australia is that the board of the company has the power to manage the affairs of the company. This is not mandated and there are companies where there is a more democratic and participatory model but this is a rarer position. Why do we vest authority in a small group of people rather than an individual? Is there an operational advantage of vesting authority in this way?
2. **Accountability and Transparency** – this reflects the impact of the accountants and the idea that you cannot manage what you cannot measure. How can the board run the company effectively if the board does not know the company’s financial position and how can the rest of the people in the company be confident that the company is being run properly if there is not some degree of transparency about how decisions are made, who makes decisions and who is accountable for those decisions? The legal manifestation of the emphasis on accountability and transparency is disclosure. A lot of the Corporations Act and the codes of corporate conduct are taken up by mechanisms by which companies must disclose financial activities or corporate governance policies. This enables the market to decide whether the company is doing well. Some of the emphasis on accountability and transparency has also been laid at the doors of professional advisors (e.g. accounting firms as auditors) – gatekeepers which facilitate the operation of the market.
3. **Productivity and Efficiency** – in theory, a company that is better managed than another, ought to be worth more (higher share prices – since well managed companies should be more efficient and more productive). The market prices bad governance well since those companies die but it does not price good governance. How do we ensure companies have structures that enable them to make good business decisions so they can fulfil their core function of generating wealth.

Corporate governance does not concern day-to-day decision making. We are asking for example, whether the company should invest in market [X], should we diversify our portfolio or should we take an ethical stance and not invest in stock that use fossil fuels.

### Sources of corporate governance – hard law, soft law and markets

Corporate governance is either hard or soft. Hard means legislative rules, court decisions or more broadly, the law. It is of decreasing importance in one sense – the legislation is so complicated that many companies do not understand the law. The role of the courts is also limited because companies do not want to go to court – the court process is slow, public, expensive and run by people who know little about business. This is reflective of the fact that corporate litigation has plummeted over the last 30 years.

Soft corporate governance includes, for example, **codes of conduct**. The ASX code is aspirational and sets up general structures without being prescriptive but is highly influential. The codes are not legally binding and operate on a comply or explain basis. You either abide by the code or in your disclosure report to the public, explain why you have not complied. These codes exist worldwide. Even regulators are beginning to understand that you cannot create hard rules (law) to create ethical behaviour. You can punish bad behaviour but it is very difficult to impose positive duties. Codes impose peer assessment and are generated by industry groups – they are industry standards. In addition, the **stock exchange listing rules** are a type of soft corporate governance. To be listed on the stock exchange, you must sign a contract – that is binding since a contractual relationship is created between the parties. The ASX Listing Rules largely fulfil a function which otherwise would be fulfilled by legislation. There was some litigation in the UK, where the equivalent stock exchange listing rules were found to be subject to judicial review in an administrative sense because they performed a quasi-legislative function. The **accounting rules** inform accounts how to accurately reflect the company’s financial position in the company’s accounts. The corporations act contains lots of references to standard accounting practises.

### The central governance issue

The Great Depression occurred in 1929 and at the same time, Adolf Berle and Gardner Means (academics) studied companies in the US and found that the general paradigm that people thought of, no longer existed. The paradigm company was one in which several shareholders pooled their funds and hired someone to manage their funds for them. The shareholders have money and delegate their authority to the business management.

The academic analysis found that this paradigm company did not reflect companies of the day. There were still shareholders who invested but there were many more shareholders and each shareholder might only invest a few thousand dollars. There was still a management group but because there were so many shareholders with such a small stake in the company, there was a disconnect between the ability of the shareholders as investors and notional owners of the business to control those to whom they delegated the running of the business. This marks the separation of ownership and control. The theory which says that in terms of accountability, the power of the directors to manage the director was being controlled by the power of the owners to remove the directors, no longer worked because the shareholders, in a practical sense (widely dispersed, small investments, limited expertise in matters of corporate governance). There was a separation between the ownership of the company and the control.

In a somewhat naïve response, the academics argued that this was not necessarily a bad thing provided that the directors had strong technical skills. Provided the directors can make better decisions, then the fact that the shareholders cannot control the directors may be a good thing. The directors can then make decisions for the benefit of the society (rather than being controlled by shareholders who just want a return on their money). Bearle and Means opened the internal workings of the company – prior to that, we did not understand why companies arose as opposed to other forms of business or what the internal governance dynamics were (company as a black box)

The solution proposed by Bearle and Means became known as ‘**managerialism**’ – emphasis on managers as being the ones in control and provided that we focus on making sure managers were appropriately skilled and honest, then the problem of ownership and control could be solved.

The separation of ownership and control as the corporate governance problem still exists today. Any large company (ASX 100 Company) will have thousands of shareholders. If your theory of accountability of the board is that the shareholders can act to discipline the board if the board does not do what they are supposed to do, then the problem that thousands of shareholders cannot act collectively (spread across world). Unless your stake in the business is enormous, it is not worth the effort to take an interest in the managerial activities. It is easier, if a shareholder is concerned or not happy with the level of the return, to sell shares and buy something else. Shareholders have a choice between voice (petition for board to be removed) and exit (sell shares). Prior to Bearle and Means, the assumption was that shareholders would exercise their voice however Bearle and Means highlighted that practically this was not possible and therefore shareholders were more likely to exit. Sudden exists of large numbers of shareholders is one cause of recessions and global financial crisis. Managerialism reached its high point in the 1950’s so the managerial team ran the company and shareholders simply obtained their returns.

In the 1970’s, things changed due to an oil shock that affected many companies around the world. This induced major recession and placed economies under strain, bad decisions were being made, and companies were worth more as a pile of assets that could be sold than they were as a growing concern. This gave rise to the corporate raider (carved up companies).

## The Company as a ‘Firm’

A firm means an economic activity and a company was a type of organisation for economic activity.

A has decided to make dishwashers as a business endeavour. A can either do so through a series of market transactions or by internalising production decisions.

Inputs = money to set up + employee + steel parts + motors + products must be sent to markets + persuade people that this dishwasher is better than others

A could ask the bank for some money, find an employee, find a parts supplier, engage a contractor for delivery purposes and hire a marketing company. A could enter into contracts with each of these suppliers and produce dishwashers. This is a viable but time consuming process – regular meetings with bank, bankrupt suppliers, etc. The time it takes to identify who A wants to contract with, what A wants to contract with them about, work out terms of contract and monitor performance of contract are transaction costs – these eat into A’s profits.

Alternately, A could organise some of the activities to ensure complete control over those activities but could internalise some functions. This may involve, for example, hiring a second-hand truck and using an employee to deliver the product instead of contracting with a courier or A might make motors. A might create operating divisions within its business (motor shop, delivery division, marketing division, etc.) Instead of obtaining money from the bank, A might seek alternate investors. This organisation incorporates whole series of productive functions where A makes all the decisions (e.g. how many trucks needed, how to design motors, what the marketing strategy will be).

That is the difference between market based organisations of productive activity and organisational activity within a company or as a company. One of the driving reasons to create a company is to save on transaction costs – companies get to size where benefits of internalizing decisions equal transaction costs of not internalising decisions (natural size of company). The Company is the internalisation of productive decisions (what is produced, when it is produced, at what cost) is determined by management and not market forces. On this model, the directors and C-suite make the decisions and the company profits depend on the kind of decisions made.

### The Agency Cost analysis of the Firm

The financial economists accepted that there is a separation of ownership and control and identified a cost involved in this model (from the perspective of the investors). When an investor invests, the investor delegates to the management decisions about productive functions. Investors expect a return on their investment and expect the director/management to make decisions which will benefit the shareholder. However, the director/management may make decisions which will benefit themselves. The problem is agency costs: costs of employing an agent. As soon as you delegate authority to someone else to act on your behalf, there is a risk that they will act in their own interests.

Acquiring investors means that the management, is in one sense, working for the investors – the director still has power to make decisions regarding production processes (control rights to make decisions) but must now, do this for the benefit of the shareholders. To the extent, A does not care about shareholders and takes action to benefit itself, that is a net cost on the economic activity (agency cost – cost of employing agent). This is a microeconomic analysis of Bearle and Means separation of ownership and control. The managers are in control but are not, in any practical sense, accountable to the shareholders and can therefore do as they like. The separation between ownership and control leads to agency costs (management and C-suite not acting for benefit of the shareholders).

### How to resolve this problem?

* Incentives – stock options (e.g. if you do well, the shareholders will give the director a million options which means the director can buy the shares at a point and a fixed price at the future and then sell the options). This worked and focused the attention of directors on the performance of the company however directors began manipulating the share price so that the directors made a huge profit when they sold their options.
* There is no overarching solution but there are some mechanisms in place.
* Market mechanisms - The market will reflect the poor management performance of a company by a low share price. People will realise that the share price is lower than the asset price of the company – then the company gets broken up and the assets are sold.
* There are also legal mechanisms (fiduciary duties) – directors have a positive obligation to act in the interests of the company.
* The codes of conduct are designed to set benchmarks and invoke peer pressure for what is and is not acceptable

### The Nexus of Contracts analysis of the firm

Some theorists argued that companies don’t exist as a legal juristic person. The company is not an entity but is a collective expression for all the contracts between all the stakeholders and all those involved in the company (e.g. suppliers, investors, marketing). Legally, it is a purely contractual analysis of the company. This is interesting because it effectively takes us back to ‘partnerships.’

This theory is highly influential and has manifested in various aspects of the corporation’s act and corporate law economic reform program of early 2000’s. The contractual analysis can also tell us what the parties entitlements ought to be because all the contracts are slightly differne.t the Contract between the board and the bank will state that the bank will lend money and be paid back with interests. The contract with investors will be more complicated (“we will be invested and our investment will be represented by [X number] of shares and you will run the company for our benefit to produce the biggest return for us. To enable you to produce the biggest return for us, we will give you a high degree of autonomy but reserve the right to oust you”). In theory, employees should be treated no differently than any other input. Employees should be treated no differently than investors because they invest cash and labour. Whether employees are treated differently depends on political and ideological grounds.

From the early 1980’s onwards there is the rise of neoliberalism (finance, capitalist model). The shareholders and investors are identified as the key player (they put money in, hire everyone else and company is run for their benefit). This is justified on the basis that if we run the company for the benefit of investors, we benefit everyone else. Suppose the company has a revenue stream of $100 and must pay out all the various contractors – at the end of the chain are the shareholders. The more that you benefit the shareholders, the more you guarantee that everyone else ahead of them in the que gets paid. Shareholders are the residual risk bear and bear the risk of there being no profit but get the benefit of everything left over after all fixed claimants are paid.

The Company is a web or connection of contracts between the various inputs and stakeholders. The key contract is between the investors and everyone else – shareholders get paid last but keep what is left (everyone driven to maximise the value of the Company as an economic entity).

### Other analysis of the firm

1. Transaction Cost
2. Team Production
3. Director Primary
4. Stakeholderism (Enlightened shareholder value)

## Enlightened Shareholder Value Model

**Companies Act 2006 (UK)**

***172 Duty to promote the success of the company***

1. *A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to —*
2. *the likely consequences of any decision in the long term,*
3. *the interests of the company's employees,*
4. *the need to foster the company's business relationships with suppliers, customers and others,*
5. *the impact of the company's operations on the community and the environment,*
6. *the desirability of the company maintaining a reputation for high standards of business conduct, and*
7. *the need to act fairly as between members of the company.*

The directors must run the company for the benefit of its members (shareholders and investors) but the directors can consider a number of other factors. Section 172 of the UK legislation is an example of this. Similarly, s 181 of the Corporations Act achieves the same effect despite not being as explicit. The directors fundamental task is to make money for the shareholders but you need to pay trade creditors, keep employees happy, etc in the process of doing so.

In the 1970’s, the Ford Company produced a car called the Pinto. In testing, Ford discovered that in relatively low speed, rear end impact, the car exploded. The executives at Ford worked out the probability of accidents occurring and potential compensation and compared those to the profits they would continue to make. It was cheaper to compensate those who were injured than it was to fix the problem and so Ford did not tell anyone about it.

## The Purpose and Mechanisms of Regulating Companies

### Why do we regulate companies?

There have been many attempts to explain why we regulate companies. Some of this has to do with the fact that companies are big and the state becomes frightened of them. Others hold the view that the economic and social power vests din large companies must be controlled in the same way that the power of government must be controlled by general democratic considerations.

In the Treasury’s view, the aim of doing so is to create an efficient vehicle for business, bring investment to Australia and provide jobs for Australians. Are we concerned that companies act as good citizens? Should companies have an obligation to look after the communities and societies in which they exist? There are no complete answers to these questions.

We have allowed companies to aggregate huge amounts of wealth and power. There are only 5 major motor vehicle manufacturers in the world and 5 who control the coffee bean industry in the world. Are we concerned about the legitimacy of the power that these entities hold and should they be subject to democratic oversight? Or, are they simply a series of private contracts (which would suggest no interference is warranted)?

### Is Company law enabling OR mandatory?

Is the Corporations Act there to control companies OR to facilitate business and make business more efficient. At the moment, it is a bit of both – the legislation reflects both views. The Corporations Law is an accretion of changes dating from 1884. When Company law is reformed, there is no attempt to make the legislation coherent and consistent. Company law is about what works in practise not what works in theory.

### How do we regulate Companies?

Today, we have moved away from ‘command and control’ toward ‘responsive regulation’ or ‘proceduralisation.’ Command and control is a system whereby if you do something wrong, you are punished – some aspects of the legislation still reflect this position.

Responsive Regulation is not about directing companies and instead try to create structures and processes that bring about regulatory objectives but in an indirect way.

E.g. Directors conflicts of interest – 50 years ago, the rules said that there shall not be a conflict of interest and if there was, the director lost his/her profits. Sections 191-195 state that conflicts must be disclosed to the board and the board can then decide whether the director can participate in the decision making. The new approach acknowledges that conflicts of interest occur and focus on managing conflicts – process of disclosure and ability to seek exemption from ASIC.

Corporate law today is less direct, not command and control and aims to achieve regulatory controls not by direct command but by encouragement, incentives and processes which enable the parties to achieve what they want to while at the same time, processes addressing concerns.

### Who regulates companies?

**ASIC** has two main functions: registry (registers companies) and law enforcement (sues directors). ASIC has been under lots of pressure because its enforcement record has been law and industry feels that ASIC has been using the money it obtains from its registry function to fund its law enforcement function and industry feels that is unconstitutional. Parliament seems to have agreed and federal legislation has been introduced to stop ASIC using money from registering companies to enforce corporate law. This reflects the political ideology that it is more important to do business than to be honest.

**Self-regulation** – Company law has always allowed those involved to tailor the internal governance rules to suit the business. As a shareholder, when you buy your shares and sign the Company’s constitution, you agree to be bound by a majority decision. Companies have tremendous capacity to mould its internal governance processes to serve the purposes for which the Company exists. Anglo-Australian company law is a one-size fits all model which applies to small and large companies. The way that is accommodated is by allowing companies to mould their internal rules.

**The Courts** –The role of the courts has declined massively in the last 20-30 years for a number of reasons. Commercial litigation is expensive, public and unpredictable. Justice Hayne has suggested that the case management approach (court manages litigation process) puts people off because it is time consuming and the parties are no longer in control of the process. There has also been a huge rise in ADR – these are regarded as much superior to courts (quick, private and parties are in control of what happens). These days, there are relatively few matters of core corporate law that go before the court. Company lawyers are transaction lawyers – make things happen (create structure that works for everybody) – and never need to go to court.

# Corporate Personality and Corporate Liability

This topic will consider corporations as sources of risk – economic and sociological. Are insiders exposed to claims from people outside the company? Does protecting entrepreneurs who operate through a limited liability company expose the community to risks of abuse? What is the relationship between corporations law and the interests of justice?

## Characteristics of Companies

1. Separate legal identity (SEP doctrine) – a legal person that comes into existence through registration with ASIC. It ceases to exist when it is deregistered and not before. The Company can function as a legal person once created because it is recognised as separate from its owners (shareholders) and its managers (directors).
2. Legal capacity s 124(1) CA 2001 – The Company has the same rights as a natural person but the company can do things that are only possible for a body corporate to do (e.g. issue shares in itself).
3. Limited Liability ss 9, 516 CA 2001 - The companies rights and obligations are its own but members enjoy a privilege of limited liability. Limited liability is optional and not all companies are established on this basis.

### Separate Entity Principle

*A new person comes into being upon incorporating with rights and liabilities that are separate from those of its members and managers.*

This concept applies to ‘one-person’ companies as well. A company can be established with one member who is also the sole director (s 114 CA 2001). That company will benefit from the separate entity principle and will be treated as a separate legal person from the one person behind it.

Salomon v Salomon [1897] AC 22 – The Separate Entity Principle has its origins in this case.

**Facts:** Mr S was a bootmaker and for a time, he had a successful business. Part of his wealth was derived from having contracts with the government to make boots (British Crown). At some point, Mr S decided to take advantage of the UK Companies Act 1862 and incorporated a company called Salomon & Co Ltd. He ensured that he was the majority shareholder and managing director. Mr S owned 20,001 shares and his family members held a further 6 shares between them but held those shares as his nominee. Effectively, Mr S was the only person in control of the company. Mr S arranged for the company to buy his boot making business and the company purchased it at an over value (i.e. paid too much for the business). The Company got the business, goodwill, equipment and contracts and Mr S acquired shares in the business, cash, some of the businesses debts were discharged and he was the beneficiary of debentures. These debentures were secured by a charge over the company’s property in favour of Mr S.

Workers strikes affected Mr Salomon’s business and it got into financial difficult. To salvage the company, Mr S arranged for the company to borrow money from Mr B. Mr B was given a security over Mr S’ debentures. The emergency finance failed and Mr B appointed a receiver. The liquidator discovered that there was only $6000 available to satisfy all claims. This would be sufficient to pay Mr B but not the unsecured creditors, especially because Mr Salomon, with his charge was first in the queue.

Issue: Was Mr S entitled to priority under the debenture ahead of the other unsecured creditors.

The liquidator argued that Mr S was in complete control of the company and the company was acting as his agent and therefore as its principal, Mr S was required to indemnity the company and therefore pay out the creditors. The court of first instance was persuaded by the liquidator and held that the company was a device being used to defraud the creditors and therefore the separate legal principle could not be upheld. The court of appeal found that the company was a sham – the formation of the company, the contractor purchased the business an issuing of debentures to Mr S were a scheme to enable him to carry on a business with limited liability and recover ahead of genuine creditors.

The House of Lords found in favour of Mr S – provided the formalities of incorporation were observed, it was not contrary to the intention of the Companies Act for a trader to benefit from limited liability. Once the company was validly incorporated, it became a separate legal person from its shareholders, members and directors and was not an agent of the members and further, the members were not liable for the debts of teh Company except to the extent provided by legislation.

The decision in Salomon was applied in Prest v Petrodel Resources

### Significance of SEP

By the time of federation, the Australian colonies had adopted a version of the UK Companies Act. Salomon’s case clarified the meaning of the Companies Act and established that a Company is a legal person separate from its participants with the capacity to limit its member’s liability to contribute to the company’s debts. For small and medium sized enterprises and public v private companies, it laid the foundations of the conceptual distinctions we used today. Small or even micro-businesses can be separate legal entities if they are operated through that corporate form. The distinction between proprietary and public companies developed: s 114

The Separate Entity Principle has many consequences for how the Company can operate as a business enterprise. Recognising a Company as a legal person enables it to have corporate capacity under s 124. Companies may contract from their controllers: Lee v Lee’s Air Farming

***Lee v Lee’s Air Farming***: In this case, the business was involved in aerial top dressing. The managing director, shareholder and employee of the business was killed in carrying out one of these operations. His widow claimed workers compensation under a statutory scheme. The issue was whether the deceased, as the managing director and shareholder of the company could be a worker (i.e. employed by the company). The courts held that the deceased was a worker because the company was a separate legal entity from him as a manager, shareholder and as an employee. Therefore, Mr Lee and the Company could enter into contractual relations, including an employment relation.

Companies own their own property separately from the managers and members.

***Macaura v Northern Assurance Company***: In this case, Mr M had transferred his interest in a timber plantation to a company that he controlled. He failed to transfer the insurance policy that protected the timber so when the timber was destroyed by fire, the insurance company refused to pay him the claim. Mr M did not have an insurable interest. The issue was whether Mr M was the owner of the timber – the timber belonged to the company but the company was controlled by him. The courts found that the timber was owned by the company itself and not Mr M. Therefore Mr M did not have an insurable interest and could not recover.

The shareholders in a company do not own property in the Company although they are called owners of the Company. A share is essentially a chose in action – a personal interest against the company and is a claim against the company issued to specific persons who contribute equity capital in consideration for those interests. The Company owns its own property and owning a share does not mean owning a stake in the Company property.

Sometimes the separate entity principal benefits the Company and other times it does not. Since the Company is a separate legal entity, it continues in time until it is deregistered (perpetual succession). This means that if the managing director/owner of the Company dies the Company itself continues in time.

Importantly, the separate entity principle enables asset partitioning and divides the rights and obligations of the people behind the company and the company itself. This partitioning supports the limited liability doctrine. The SEP justifies limited liability.

## Limited Liability

The limited liability principle is related but distinct from the idea that a Company is a legal person in its own right. The basic concept is that the members, usually shareholders, are not personally liable for the Company’s debts. Sections 9 and 516 of the Corporations Act govern this principle.

A member’s liability is limited to the amount of their initial investment. Limited liability is a potential benefit for investors in the Company and is a limitation on the investor’s risk. Companies need not be established on the basis of limited liability and the law provides different options for managing liability through the corporate form.

Some Companies can be established on the basis that the member’s liability is limited on the basis of a guarantee (limited to the amount that the members guarantee to contribute to the property of the Company if it is wound up). The members guarantee to some extent the Company’s debts. Companies limited by guarantee are less popular than Companies limited by shares because the a share gives an entitlement to participate in dividends but a guarantee is just a promise to pay the Company’s debts up to a certain amount.

The Company can also be established on the basis of unlimited liability – members have no limit on their liability to contribute to the Company’s debts.

The no liability Company is often used for Mining Companies and provides that there is no statutory right to an unpaid call on shares. Shares can be partly paid (e.g. pay a small amount per week) but for a no liability company, there is no obligation to pay even the promised amounts that have not yet been paid. Limited liability means that shareholders must pay the amount promised (if shares are paid in segments) and not just the portion of the amount already paid. For a no liability company, there is no liability to pay any amount unpaid on the shares. There is useful for mining enterprises because there is a high risk that the enterprise might not amount to anything (e.g. do not find coal).

The effect of the limited liability principle is that there is a legislative transfer of risks from insiders in an enterprise to outsiders. If the Company incurs a debt, causes harm or the business fails, the costs are borne by the creditors.

Why is it socially acceptable to protect the interests of investors over those of creditors?

**SEE RECOMMENDED READINGS**

* Limited liability promotes economic efficiency – people would bargain for limited liability when contracting with Corporations. The law sets limited liability as a default or opt in rule.
* Limited liability is the result of effective lobbying by investors

## Corporate Capacity

Companies carry on business and other activities because the law confers on them the capacity to do things with legal effect (e.g. enter contracts). In addition, Companies can issue shares in itself or issue debentures and other things that only a legal person can do: s 124(1). A Company may choose to limit its own capacity: s 125. Section 125 provides that those decisions/limitations have no impact upon the validity of any act in breach of that limitation.

Corporations have the powers of legal and natural persons and act with capacities that can be limited for their own purposes but those limitations have little effect for outsiders.

1. Corporate Groups

A Corporate Group is **NOT** a type of Company. A Corporate Group is a number of Companies which are associated through common or interlocking shareholding allied or unified control or capacity to control (***Walker v Wimborne***). Companies can be shareholders in other Companies. They may buy Companies (takeover) purchasing all or most of the shares in the enterprise - this grants the Company control over that enterprise through voting power and voting rights associated with share-holdership. Corporations can incorporate other companies and can also purchase Companies ‘off the shelf’. Companies can create multiple subsidiaries and any of those subsidiaries can create or acquire other firms – this creates a Corporate Group. The Company’s in the Corporate Group may do separate things but more frequently, Company’s in a Corporate Group operate as a single economic unit spread over multiple enterprises.

This can enable different parts of the business to be managed more discretely and each Company within the Corporate Group should benefit or enable the other Companies which own it to benefit from limited liability. The Group form can enable international investment: some countries make it a condition of operation that a new entity be established in which there is collaboration between local owners and the foreign investor.

Since a Corporate Group is not a type of Company, the law has difficulty in deciding how to deal with the increase of transferred risk throughout the enterprise. At law, each Company within the Corporate Group is a separate legal entity – veil of incorporation hangs between each Company. The Corporations Act regulates Corporate Groups in certain situations. Corporate Groups can be dysfunctional and can be used to insulate the parent from the cost of high risk activities that are carried out by subsidiary firms. Corporate Groups can be in-transparent and it can be difficult to know who they are doing business with: ***Quintese Case***

The ability of Companies to operate through Corporate Groups and the limited exceptions to the separate entity and limited liability principle mean that there is an increase in moral hazard.

### Subsidiaries: sections 46-47

Subsidiaries are defined in sections 46-47 and there are 4 tests to determine if Company 1 is a subsidiary of a holding company (Company 2). Only one of these tests needs to be satisfied fro Company 1 to be classed as a subsidiary.

1. Company 2 controls the composition of the board of Company 1
   1. S 47 deems control to exist when Company 2 can appoint or remove all or a majority of the subsidiary’s board
2. Company 2 is in a position to cast or control the casting of more than 50% of all the votes that could be case at Company 1’s general meeting
3. Company 2 holds more than 50% of Company 1’s issued share capital
4. Company 1 is a subsidiary of another subsidiary of Company 2

### Related Companies: Section 50

Section 50 defines sets of Companies as Related Companies. Where a body corporate is:

* A holding company of another body corporate, or
* A subsidiary of another body corporate; or
* A subsidiary of a holding company of another body corporate;

then all the companies are related to each other.

There are some distinct situations in which the Corporations Act states that a Corporate Group of Related Company relationship existing is important.

* Insolvent trading provisions: s 588V-588X – The Holding Company has a duty to prevent insolvent trading of its subsidiaries and a duty between directors and companies (s 588G).
* Directors duties: s 187 - Directors of subsidiaries may benefit from the fact that they are in a Holding Company or a Related Companies because directors actions in the interests of the holding Company in certain circumstances will be in compliance with the directors duty to the subsidiary
* Liquidator’s power: s571 –power to pool the assets of a group of companies

Financial assistance provisions also apply to Holding Companies and there are requirements of disclosure of the directors remuneration that apply to the subsidiary and controlled entities.

### Controlled Entities: Section 50AA

The concept of a controlled entity is wider than that of a subsidiary: s 46. Entity 1 controls Entity 2 if E1 has the capacity to determine the outcome of decisions about E2’s financial or operating policies: s50AA (1). In deciding whether this test is met, the court must take into account the practical influence exerted by E1 and any practise or pattern of behaviour affecting E2.

### Entity v Company

The definition in section 50AA is broader than the definitions in Sections 46-47 due to the use of the word ‘Entity’. The concept of a controlled entity was introduced to remedy the narrowness of section 46 and 47. Section 46 did not capture situations in which C2 was in control of C1, in fact but not as a matter of law and didn’t apply to entities (i.e. unincorporated entities like trusts). This enabled risky practises like off-balance sheet accounting.

We are thinking about the balance of risk – does risk get transferred to outsiders or located inside the firm. One of the justifications for transferring risk outside of the Company is that there is transparency (people know what they are investing in and who they are doing business with).

The concept of control is relevant to determine whether the parties are related for the purposes of the Related Party Transactions provisions in Chapter 2E. They place limits on certain types of transactions between companies and apply for reporting purposes. The concept of control is also relevant because companies have a duty to prepare consolidated financial statements with respect to these controlled entities. The concept of control is also relevant to determine whether a propriety company is large or small – there is a difference between proprietary companies that are large or small (assets, revenue, and number of employees). The law has taken the position that the larger the proprietary company, the greater the reporting obligations it should have. In determining whether the asset, revenue and employee tests are met, the law includes the entities that a company controls.

The concepts of subsidiary-holding Company are linked to the concept of Related Companies and are used for particular purposes. For other purposes, the Corporations Act uses the concept of Controlled Entities. The Corporations Act does not contain a general definition of Corporate Group and does not provide a general set of regulations for group companies.

## Piercing the Corporate Veil

* Exceptions to separate entity and limited liability principles (veil piercing)

In between the Company and its members and directors, is the corporate veil. Inside the corporate veil are limited liability and the separate entity doctrine. The corporate veil is a metaphor. Incorporation is treated as a curtain which hangs between the Company and its members and directors – it protects their identities, hides their motivations for incorporation and partitions their assets from those of the Company. The Company is a separate entity from its members and directors and their liability for corporate conduct is limited.

Piercing the Corporate Veil means that the courts disregard the separate legal personality of the Company and for limited purposes, ascribe the Company’s rights and liabilities to the members or directors or they reveal their identities. The Company and its managers and owners are treated as one.

The Corporations Act creates one important exception – the insolvent trading provision (588G/V). Directors and Holding Companies have duties to stop the Companies they manage and control from engaging in insolvent trading. Insolvent trading occurs when a Company incurs a debt while it is insolvent or as a consequence of incurring that debt, the Company becomes insolvent; there are reasonable grounds for suspecting insolvency and the Holding Company or Directors should have been aware or would have been aware that there were grounds for suspicion. Solvency is defined in section 95A(1) and a company who is not solvent is insolvent (s 95A(2)). The duties kick in if there is a breach and the Company is being wound up in liquidation. The liquidator can ask the court to order the directors or Holding Company to contribute to the assets available to the Company’s creditors. The Corporate Veil is pierced to the benefit of the creditors.

The common law also contains some rules about when the corporate personality will be disregarded and when the director’s, shareholders and companies liabilities will all be treated as one. The courts are debating which of the cases involve genuine corporate veil piercing and whether all of these exceptions taken together can lead to some kind of doctrine as to when the Separate Legal Entity will not be accepted.

### Fraud (and facades)

Fraud unravels everything and courts will lift the veil of a Company that is used to perpetrate a fraud.

***Re Darby*** – In this case, a Company promoter was liable to account for profits for a fraud perpetrated by the Company he helped set up. The company was set up as a vehicle for committing a fraud against the public. It had purchased a mining license at an over value from another company owned by Darby. Darby then asked members of the public to buy shares in the company that held the mining license. Since it was overvalued and because of how Darby profited and his particular knowledge, the court found that fraud existed.

Sometimes courts have found that the establishment or use of a company is a mere facade.

***Adams v Cpae Industries*** – the facade argument succeeded in this case.

***Prest v Prestodel*** – the ‘sham doctrine’ was questioned in this case. What is a sham?

The facade/sham is questionable but fraud definitely unravels everything. What is the difference between fraud and the SEP to hide identities and shield obligations?

### Avoiding Existing Obligations

The Courts have lifted the veil of incorporation that are used to evade members existing duties to third parties.

***Gilford Motor Co v Horne*** – Horne was the MD of Gilford Motor Co and his contract with the Company contained a 6 year non-compete clause. Three years into his company, he resigned and looked for business among the motor company’s customers (clear breach). To avoid his obligation to the company, Horne established another company through which to conduct his independent business. The court issued an injunction against Horne and the company that he created. The second company was a mere cloak or sham.

***Jones v Lipmon*** – A company was used to avoid specific performance for a contract for the sale of land.

Both these cases were affirmed in ***Prest v Prestodel*** – (UK divorce case) The wife in the matter sought disclosure of her husband’s financial position who was the sole owner of a number of offshore companies which held property beneficially owned by him. The wife could only obtain this information if the courts pierced the corporate veil. There was debate about the existence of any general principle to link up the situations in which the courts had pierced the corporate veil. READ THIS CASE. Each judge took a slightly different nuanced approach as to what general principle linked all the cases but accepted *Gilford* as an example of genuine veil piercing and agreed that there was no relevant evasion on the facts of this case.

Sumtiem J – limited principle which applies when a person is under an existing legal obligation or liability or subject to an existing legal restriction which he deliberately evades or whose enforcement he deliberately frustrates by interposing a company under his control.

### Subservient Companies as Agents

If a Company is financially or operationally subservient to its owners or if there is a sufficient relationship of commercial intimacy, the courts may conclude that the company is an agent for that legal or natural person.

***Smith, Stone and Knight; DHN*** – The veil was pierced to benefit the P Company. Its subsidiary had premises which were being resumed by the city council. The council was refusing to compensate the company on the basis that the lease was too short (lease from parent company). The court found that the subsidiary carried on business for the parent company and so the parent company was entitled to compensation. The court found that the subsidiary was the agent of the holding company and the holding company was able to receive compensation that it otherwise would not be entitled to. Justice Atkinson listed 6 factors:

1. Were profits of business treated as profits of parent company
2. Did parent appoint persons carrying on business
3. Was parent the head and brains of the trading venture
4. Did parent govern the venture, decide what should be done and what capital should be embarked on
5. Did parent make profit by its skill and direction
6. Was the parent in effectual and consistent control

There is a tension between this case and Salomon Case. This case has received a mixed reaction and judges have expressed doubts about whether it is compatible with the SEP. Judges have sought to distinguish the cases they have been confronted with case of Smith, Stone and Knight – purpose of piercing corporate veil in Smith case was to benefit the parent company but in other cases, it is to impose liability on them.

Courts have refined the 6 criteria mentioned above and refused to find a sufficient relationship of commercial intimacy existed in the cases they have dealt with.

***Briggs v James Hardy*** – The judge found that the proposition that the corporate veil may be pierced where one company exercises complete dominance and control over another is too simplistic. The law pays scant attention to the commercial reality that every Holding Company has the potential, and more often than not, in fact, does exercise complete control over the subsidiary. This case was referred to by Adams v Cape Industry.

***Bird v Cameron*** – how relevant are the 6 factors (one judge held that profit factor was most important)

In recent competition law cases, the courts have expanded the list and looked at detailed aspects of how the companies work alone and together and generally found no agency relationship.

## Corporate Thought and Action

In ***Meridan Global Funds***, the Privy Council grappled with the issue of how companies incur obligations. The PC noted that companies exist because of rules and act through rules. Corporate behaviour is human behaviour and a single person can have multiple roles in a single company – which of those human acts counts as a corporate act?

### How do we model corporate action?

* Primary liability – companies act by identifying them with certain individuals (people who can be considered the directing mind and will of the company). This is justified by the level of power and control that person has within the firm. It is right to treat that individual’s thoughts and actions as those of the company because of their significant managerial authority within the company.

***Tesco Supermarket*** – the House of Lords was asked whether the corporate owner of a supermarket chain could be imputed with the criminal negligence of one of its employees. The supermarket store manager had failed to properly display a sign and the company was charged with a breach of the Trade Descriptions Act. The Company defended the charges arguing (1) it was a different person to the store manager and (2) it had exercised due diligence to prevent the store manager’s offense. The House of Lords agreed and on the first argument, the court found that the Company was not liable (it was not the store manager) and the store manager was not senior enough in the Company to be its directing mind and will.

* Secondary (vicarious) liability – Companies can appoint people to be their agent/employee and if that agent/employee does the wrong thing, the Company may be liable. This rule is used commonly in tort matters and for some statutory offences.
* Holistic Liability – the Company is treated itself as the one doing the action. The Company is held to act through its collective decision making mechanism (policies, procedures and even corporate culture).

Meridan Global Funds – the PC distinguished between three situations:

1. Primary rules of attribution are found in the international governance rules (constitution and Corporations Act)
2. General rules on agency
3. Special rules of attribution (in some situations the legislature has recognised holistic liability)

Meridan is authority for the view that legislation must be interpreted to determine which rules are at issue and therefore which models of liability will apply. In Meridan, the court considered the person in the effective capacity to act in the role of a financial trader (legislation designed to create accountability for financial conduct).

## Corporate Groups and Corporate Torts

Companies can be attributed with civil and criminal wrongs of their stakeholders – corporate veil is not necessarily being pierced (treating entity as one which can incur its own obligations). Corporate and tortious liability are important practical considerations for Companies and are important sources of risk. They raise important questions about the nature of the company and the best method of regulation.

A Company can commit a tort directly, through its directing mind and will or vicariously, through its agents or employees. A tort is a type of wrong and sounds in a claim for damages. A tort is an involuntarily incurred obligation (in contrast with a contract) and can lead to arguments about the justice of respecting the separate entity principle in these situations – should the courts pierce the corporate veil if the company cannot pay but the person responsible can meet the damages claim. The usual arguments about the assumption of risk in commercial arrangements are not quite relevant. In some situations, it is not possible to even insure against certain risks.

***Briggs v James Hardie*** – A had been employed by a Company that was a subsidiary of another Company that profited from making asbestos. Health problems associated with asbestos don’t reveal themselves for many years (statute of limitations had expired and the person was seeking to recover from the parent company). The judge noted that there were law and economic arguments in favour of piercing the corporate veil and recognised that there was an unequal opportunity in determining whether or not to enter into that contractual relationship (employment) out of which the injury arose. An employee does not have that much input into how the business is conducted and whether reasonable care will be taken for his or her safety and for that reason, it could be argued that it is wrong to protect the employer against the tort victim’s claim.

The judge was unable to recognise a general principle to pierce the corporate veil to favour tort victims of subsidiaries that were underfunded to meet the claim or to disregard the statute of limitations.

This case is illustrative of a general problem of long tail liability – negligence by Company, personal injury to large group of people evidence of which will not become apparent for many years due to the latency period of the injury involved. The Company in these cases is on notice that potential claims may arise in the future but is unable to determine when or how many (cannot quantify future liabilities it may face) but there are third parties (without any choice on their part), have been exposed to serious risks.

The corporate veil still applies and that means that a company can re-organise to minimise or avoid future unascertained liabilities: Adams v Cape Industries. Provided the Company is not avoiding existing legal obligations, it seems that it is permissible for companies to reorganise to manage future latent risks.

“It is not an abuse to cause a legal liability to be incurred by the Company or rely on the fact that a liability is the company’s – this is what incorporation is all about.”

Courts have gotten around their unwillingness to pierce the corporate veil by recognising direct obligations by Parent Companies to some outsiders in some tort cases. The Parent Company may itself owe a duty of care to the third party – that liability will arise where there is a high degree of control over the subsidiary’s day to day operations such that the Parent Company can be regarded as directly owing that duty of care to that person (***CSR v Wren***)

To the present point in time, parliament has been unwilling to pierce the corporate veil (has not recognised tort claimants for underfunded subsidiary).

### Corporate Crime

A crime is conduct that is prohibited on pain of conviction or sentence/conduct that requires condemnation or censor.

Traditionally, courts found it difficult to impose criminal liability on companies because they had to soul to damn and no body to jail. This changed over time with greater recognition of the social risks that companies can pose to outsiders. The US took the most radical approach by holding companies strictly vicariously liable for federal offences by its employees or agents (not even enough for a company to show it did what it could to avoid the offence).

In Australia, at common law, companies can be liable for crimes of intent via the directing mind and will primary liability doctrine. For regulatory offences, the courts have been more willing to use the principles of vicarious liability – regulatory offences constructed as being lesser crimes (often do not have a fault element).

For crimes of intent, the corporation is only liable if the directing mind and will committed the offence. The House of Law in Tesco is not clear who the directing mind and will but agree that it is someone very senior. Are directors of large companies likely to be involved in the day to day activities that give rise to typical corporate crimes like corruption? If not, does that mean that the perpetrators that we want to prosecute will be effectively immune?

Countries should impose liability on their companies for certain types of transnational crimes (international law). Australia took the lead in saying that the directing mind and will doctrine is not good enough. For some offences (particularly those giving effect to international treaties, criminal code), a company can be liable if its employees/agents/officers committed the physical elements and if the Company authorised or permitted the wrongdoing (i.e. conduct of board, high managerial agent and culture of company). If the Company’s corporate culture was actively deviant or non-compliant then the Corporation is liable.

In practise, a difficulty has been that these offences have only ever been interpreted by a judge once so we do not know how broad the concept of corporate culture is or what a high managerial agent is. If the prosecutor is unwilling to rely on these principles, do we have a situation of effective immunity? Australia has been criticised for being a nation unwilling to prosecute corporations for crimes.

The UK faced similar criticisms and introduced the UK Bribery Act 2010 – included provisions that made commercial enterprises liable for offences of associated persons if they had failed to be diligent in preventing that wrongdoing. The UK statute included in its list of associated persons, subsidiaries. The Cth Criminal Code seems to only apply to single companies – if corporate operations are being carried out amongst corporate groups, perhaps across borders, is the Cth Criminal Code effective?

# Corporate Structure and Governance

## What is Corporate Governance?

It means that way that the directors of listed companies are encouraged to act in the best interests of the company, meaning the shareholders as a whole.

The analysis of corporate governance by John Farrar – in his analysis, there is a recognition that corporate governance is an increasingly complex amalgam of legal and self regulation. At the core, is legal regulation which is made up of the Corporations Act and case law and around the core, there are different systems of self regulation of varying degrees of soft law and hard. In the first place, we have things like the Stock Exchange listing requirements and ongoing requirements and statements of accounting practise (hybrids/hard-soft law). Next we have codes of conduct, guidelines and statements of best practise and then finally, business ethics.

The focus of this lecture will be on decision making and the division of power between the Board and shareholders in general meeting. There is a wide variety of companies ranging from small proprietary companies (where directors are often the same people as the shareholders) to large public companies that have a specialised board and many shareholders. Corporations Law must deal with all these companies within one framework – the issue is about the separation of ownership (theoretically, the members and shareholders own the company) and control (the directors who manage the company’s business). The directors are charged with managing the company’s business but more precisely, it is the board of directors: s 198A(1). This is a replaceable rule which means that they are provisions of the Corporations Act which can be replaced. Theoretically, companies can provide something different and not vest the power to manage the company’s business in the directors but they wouldn’t otherwise companies could not operate logistically especially for large companies.

All companies are structured in this way – the directors acting collectively as a board manage the company’s business. The shareholders in general meeting have a number of important powers:

1. Power to remove directors (s 203C and s203D)

There are different rules for proprietary and public companies. In the case of proprietary companies, s 203C is a replaceable rule and it gives the shareholders the right to remove and appoint directors but that power could be given to anyone (contractual provision). If the replaceable rules apply, then the shareholders will have the power to remove directors of proprietary companies but that power can be given to anyone. In relation to public companies, it is a statutory right that shareholders have to remove directors (a general meeting needs to be convened and there are rules about the notice that needs to be given). The statutory right of shareholders to remove directors applies notwithstanding a provision that may appear in the Company’s Constitution (overriding statutory right) – this is supposed to be a check on the power of the board. If the shareholders are not happy with the way the company is being run, they can seek to call a general meeting – need a simple majority (50% or more of shareholders present and voting at that meeting) voting to remove the directors. This is also tied up with takeovers because one of the matters sold in a takeover is the right to appoint a board and that’s another reason why public companies have a rule about shareholders being able to remove directors.

1. Change the Constitution (s 136)

You need a special resolution to change the Company’s constitution. A special resolution is defined in section 9 as a resolution passed by at least 75% of the votes cast by members at a general meeting.

## Constitution and the Replaceable Rules

Internal governance rules of a Company – the way the company will operate, how directors meetings will be held, quorum requirements, etc.

There are two categories of rules:

* Special replaceable rules – these are a set of sample rules that appear in the Corporations Act (s 141) and apply by default. At the time a company is registered (lodge form 201), if you do not do anything else, the internal governance rules for the company will be the replaceable rules.
* Constitution – companies may elect to create a specially drafted constitution and can either replace the replaceable rules completely or the constitution can simply supplement the replaceable rules (where modifying rules that may not be appropriate).

1. History of Corporate Governance Rules

**Prior to July 1998**, all companies were required to have two documents on registration

* Registration form
* Company constitution
  + - Memorandum of Association (incorporating document of Company which set out the name of the company, the type of company, the powers of the company)
    - Articles of Association – set out as a table at the back of the corporations legislation

**Since July 1998**, the framework of replaceable rules was introduced under the Corporations Act. These rules are found scattered throughout the Corporations Act but are listed under s 141. In practise, you need to be familiar with these rules to ensure the needs of those setting up the Company are met and the replaceable rules are appropriate.

Section 134 makes it clear that a Company’s internal rules can be:

* Constitution
* Replaceable rules
* Combination of both

Having a Constitution is often desirable because the replaceable rules are often not appropriate.

*For example*, in a small company, it may be more appropriate to require unanimous decision-making for directors and shareholder meetings (as compared to the replaceable rules which require a majority).

*For example*, the replaceable rules do not allow for partly-paid shares.

A Constitution is mandatory for:

* No liability companies
* Companies limited by guarantee
* Listed Companies (because they do not comply with the ASX Listing Rules)

In large companies, the separation of ownership and control can give rise to problems but in small proprietary companies (e.g. incorporated partnerships), if they bring in a new investor who is not a director, then the issue of separation can become fundamental. The problem of corporate governance and the division of power is more likely to arise in the case of listed public companies but can also be a problem for small proprietary companies when you bring in investors who are not directors.

1. Adoption of Constitution

You adopt a Constitution on registration: s 136(1)(a) but may also adopt a Constitution after the Company has been registered by special resolution: s 136(1)(b)

1. Effect of Constitution and Replaceable Rules: s 140(1)

The Constitution and Replaceable Rules have effect as a statutory contract between:

* the Company and each member;
* the company and each director and company secretary;
* a member and each member

The shareholders and directors are not included and this means that shareholders cannot sue directors for breach of the Company’s constitution. Even though s 140 states that it is a statutory contract, it is a limited contract creating very limited rights.

## Ramifications

The case law has made the position uncertain.

1. *The internal governance rules cannot be enforced by outsiders:* ***Eley v Positive Government Security Life Insurance Co [1875]***

In this case, the articles of association were drafted by Mr Eley (company solicitor) and one of the clauses provided that he was to be the company solicitor for life and could not be dismissed except for misconduct. Mr Eley was also a shareholder in a company and sought to enforce the right that he remain as the company solicitor when his services were not engaged. The court held that even though he was a shareholder the right Mr Eley was seeking to enforce was an outside right and was not given to him in his capacity as a member.

The case of ***Marketing Advisory Services (MAS) v Football Tasmania Ltd [2002]*** confirmed that this restriction applies.

Therefore, if you need to enforce such rights, you need a special contract in addition to the replaceable rules.

1. *Members are bound by the statutory contract is any disputes arising in relation to the affairs of the Company*: ***Hickman v Kent or Romney Marsh [1915]***

If there is a provision in the contract about how disputes should be resolved, then that procedure needs to be followed. In this case, Hickman was a member of the sheep breeders association and commenced a set of court proceedings alleging various irregularities in the affairs of the association. There was a clause in the constitution which provided that disputes were to be resoleved by a mediator – relying on this clause, the association sought to prevent Hickman’s case from proceeding and the association was successful.

1. *Members can sue to enforce rights but their rights are limited to the rights conferred on members in their capacity as members*: ***Hickman Case; Eley Case***

The case law is unclear as to what rights are conferred upon members in their capacity as a member however it seems that these rights are limited to things like the right to vote, right to receive notice of a meeting, right to receive notice in time, etc.

The remedy of oppression is available under s 232 – one of the benefits of members proceeding under this section is that they are not limited by having to prove that their rights in their capacity as members have been affected. They need to prove that a change to the constitution or replaceable rules or not following the rules is not in the best interests of the Company.

1. If the Constitution is breached, the remedy is limited to an injunction or declaration and not damages: ***Webb Distributors v Victoria (1993).***

Section 563A Corporations Act postpones claims owned by a Company to a person in the person’s capacity as a member of the Company until after other creditors have been paid. This provision was the subject of litigation in ***Sons of Gwalia v Margaretic*** – the ruling in this case has been overruled because the government has since changed the law.

***Sons of Gwalia v Margaretic*** – this case concerned a mining company where Mr M had brought shares in the Company and the Company had made misleading statements to the stock exchange. The Company exaggerated how well the Company was doing and Mr M bought shares relying on that information. The traditional position is that if Companies fail (which happend in this case), the order of prioriety is that the creditors get paid first and members (shareholders) are residual claimants.

The court interpreted s 535A in a way that allowed Mr M’s claim to have priority over the claims of creditors. This case caused uproar in the community because the case interfered in the normal order of the priority and resulted in pressure being exerted on the government. As a result, the government passed the Corporations Amendment (Sons of Gwalia) Act 2010 (Cth) has restored the traditional priority rules.

1. *One* *shareholder should be able to recover damages from another shareholder even though damages are not normally the remedy*.
2. *Members are confined to enforcing personal rights*: s 140(1)

The law is unclear as to what are personal rights. There are some arguments that a shareholder should have a broader right to have the Company’s affairs conducted in accordance with the rules (indirectly allowing shareholders to enforce outsider rights): ***Quinn v Axtons and Salmon***

This case involved a managing director who was suing as a shareholder because the articles of the company had provided that the consent of two managing directors was required and that consent had not been obtained. He got an injunction to prevent the Company acting in breach of the articles – the shareholder in this case was able to enforce compliance with the internal governance rules of the company indirectly.

Today, this sort of situation would be covered by the new wording of s 140 which allows directors to enforce rights against the Company when the constitution is not being complied with.

1. *The directors and company secretary can sue to enforce rights under the Constitution:* s 140
2. *Members, as far as procedural irregularities are concerned, cannot complain:* s 1322

Procedural irregularities do not render an action invalid and procedural irregularities are prima facie valid unless the court declares otherwise – if the procedural irregularity causes substantial injustice.

There is uncertainty about what a procedural irregularity is in the case law. Section 1322 provides some examples of procedural irregularities – e.g. defects in quorum, defects of time (insufficient time being given to shareholders at meetings).

## Alteration of the Constitution

Ordinarily, contracts cannot be altered without the consent of all parties. Under section 136, the constitution can be changed with a special resolution – even those who vote against the resolution will be bound by that change.

When changes occur, that can sometimes result in contracts made on previous terms of the Constitution being breached.

***Bailey v NSW Medical Defence Union*** concerned a patient who was making a claim against the estate of Dr Bailey in respect of injuries he had received as a result of medical treatment. Mr Bailey was a member of the NSW Medical Defence Union. Between the time that the alleged medical malpractice occurred and the claim, the articles of association had changed and on that basis, the union terminated its assistance to Dr Bailey’s estate. The issue arose as to whether, because the articles had been changed, a claim could still be made. The court held that in order for a claim to proceed, there had to be a special contract which stood side by side to the main contract which imported the terms of the articles. Whether the separate contract which imports the terms of the original articles, was a matter of construction – the court held that it could not have been the intention of the parties that the insurance cover already purchased upon terms contained within the articles should be diminished by a subsequent alteration to the articles. The amendments were therefore ineffective to vary the terms of the indemnity contract which had previously been entered into by Mr Bailey.

1. Limitations on Power to Alter Constitution (Statutory)

* It is possible to entrench certain provisions and make it harder to change provisions in the Constitution (e.g. additional requirements in addition to special resolution): s 136(3)-(4)
* Section 140(2) prohibits changes to the Constitution that seek to force shareholders to take on additional shares in the Company or that increase their liability in the Company.
* Modifications to the constitution which may be oppressive or unfairly prejudicial: s 232
* Variations to class rights: ss 246B-246G

1. Limitations on Power to Alter Constitution (Common Law)

Modifications that offend the equitable limitation on majority shareholders – if shareholders feel that the Company is being managed in a way that is a fraud on their power, they may bring an action: ***Gambotto Case***

## The Corporate Organs and the Division of Power

There are two organs of a company: the board of directors and the general meeting of members. Each of the organs have particular powers to make particular decisions and the division of power is determined by the Corporations Act, the Company’s Constitution, the general law and the ASX listing rules.

The directors (board of directors – acting collectively) have the general power to manage the company’s business. This is a comprehensive power. For example, the decision to sue the directors who have acted improperly is made by the board.

The basis source of the right to manage the company’s business: s 198A(1)

It is possible for the board to delegate its power to committees (e.g. remuneration committees or audit committees) or delegate its power to a managing director: ss 198C-198D

The director’s decision making powers extend to all things NOT expressly reserved to members by the Corporations Act or the internal governance rules: s 198A (2). The directors, in addition to the power to manage the company’s business have all the other powers of the company except those expressly given to the members. In addition, publicly listed companies must abide by the ASX Listing Rules. Of the two organs, the board has most of the Company’s powers.

Powers of the General Meeting Under the Act

* Appointment/removal of directors: s 203C and s 203D
* Alterations to the constitution: s 136
* Consolidating or subdividing company’s shares: s 254H
* Reducing the company’s issued share capital: ss 256B and 256C
* Altering rights attached to shares: Pt 2F.2
* Altering company’s status: Pt 2B.7
* Elective buy-backs or buy-backs exceeding the 10/12 limit: s 257C
* Certain management decisions where there is a conflict of interests: Pt 2D.2, Ch 2E
* Winding up the company (other than in insolvency)

Powers of the General Meeting – For listed companies under the ASX Listing Rules

* Shareholder approval is required if the company’s main undertaking is to be sold: LR 11.2
* Shareholder approval is required is a significant change to the nature or scale of activities is to be made: LR 11.1

Can the General Meeting Interfere with the Powers of the Board of Directors?

Normally, the GM cannot interfere in the decisions of the directors.

***Automatic Self-Cleansing Filter Syndicate Co v Cunningham [1906]*** – In this case, a Company had a constitution which contained a clause giving the power to manage the company’s business to the board of directors. One of the shareholders was determined that the company sell its company and the directors refused to do so – he called a general meeting (and was a majority shareholders). The shareholders voted to sell the property and the directors refused to follow that direction. The issue was whether the director were bound to follow the directions of the shareholders. The court held that the decision to sell the property was a management decision and the resolution of the shareholders was a nullity and could be ignored by the directors.

The court drew on the organic theory of company law – each organ has special powers and one cannot interfere with the powers of the other.

***John Shaw and Sons v Shaw [1935]*** – In this case, the board had made a decision to sue some of the directors and a shareholder meeting was convened to stop the legal proceeding. The court held that the decision to sue the directors was a management decision and it was therefore up to the board – that power could not be usurped by the general meeting.

While the shareholders do have residual power so if there is a deadlock, it may be possible for the general meeting to decide the matter, if the GM has the power to appoint additional directors, then that should be the method for resolving these issues (ask GM to appoint an additional director if the board is deadlocked). This is the preferred course rather than the shareholders exercising residual power: ***Massey v Wales***; ***Massey v Cooney (2003) 47 ACSR 1***

## The Board

The course will focus on listed public companies – companies with a specialised board. There are two types of directors: non-executive and executive directors.

Executive directors are directors who are also full time employees of the company. People who would be executive directors would be the CEO, CFO, etc and will have deep knowledge of the Company’s operations. Non executive directors (outside directors) are directors who are not full time employees of the Company and are people who sit on the board (e.g. geologist, banker). They bring special skills and a measure of objectivity to board decision making.

### The Role and Function of the Board

In ***AWA v Daniels (1992)***, the court set out the role of the Board. Board meeting are an occasional event and boards have a supervisory role. The executive and management of the business are responsible for the day-to-day operations of the Company.

*“A board’s functions, apart from statutory ones, are said to be usually four-fold:*

* *Sets goals for the corporation*
* *Appoints the corporation’s chief executive (CEO appointed by board and is responsible for day to day running of company)*
* *Oversee the plans of managers for the acquisition and organisation of financial and human resources towards attainment of the corporation’s goals’ and*
* *Review, at reasonable intervals, the corporations’ progress towards attaining its goals.*

*The board of a large public corporation cannot manage the corporation's day to day business. That function must by business necessity be left to the corporation’s executives. If the director of a large public corporation were to be immersed in the details of day to day operations the director would be incapable of taking more abstract, important decisions at board level.”*

This provides insight into why best practise directions are that there be a majority of independent non-executive directors. The rationale is that they can look at situations in an objective way.

### Board Composition

In the wake of the GFC and since, the efficacy and operation of corporate governance mechanisms (including the composition of the board) has become increasingly important for policy makers and legal scholars. There are cycles of boom and bust in Company law – in times of prosperity, the rules are relaxed and there is a hands-off approach from regulators but when the collapses occur, there is often a reaction.

The best practise recommendations discuss board composition. Since the GFC, there is a questioning about whether these mechanisms work because many companies did have a majority of non-executive directors on the board. There is also a question about how independent non-executive directors can really be. Directors hold office, apart from the CEO, usually for a certain period of time and can put themselves up for re-election – hard to maintain independence and challenge the executive in light of re-election prospects.

1. The Legal Rules

* Minimum number of directors (s 201A):
  + Proprietary company: 1
  + Public company: 3 (2 ordinarily resident in Australia)
  + Maximum number? Usually stated in constitution.
* **Who** can be a director? Corporations Act: ss 201A-B, D:
  + Natural person, over 18 years old (201B); signed consent (201C)
  + Not disqualified (201B) – bankrupt or committed criminal offenses
  + Some must ordinarily reside in Australia (at least 2 directors of public company; and at least one director of proprietary company: s 201A(1) and (2)))
  + Who is not the auditor of the company, and hasn’t been the auditor or a member of the audit firm for the last 2 years: s 324CI (does not apply to small proprietary companies)
  + Minimum shareholding? Check constitution.
  + *Implicit Requirements: arising from directors’ duties and minimum* *standards applicable to all directors*

### Best Practise

ASX *Corporate Governance Principles and Recommendations: Principle 2 – Structure the board to add value*

* A majority should be ‘**independent’ non-executive** directors
* The chairperson should be an independent director
* The roles of chairperson and CEO should not be exercised by the same individual
* The board should establish a nomination committee to undertake detail of selection for nomination
* NOTE: “If not, why not” approach – public companies are required to discuss the best practice recommendations in their annual reports and must set out that they have complied with them and if they have not, they must provide an explanation as to why not.

These are not mandatory rules and are soft law.

### Markets

Helping the market work: s 300(10) - Public companies must annually report (in directors’ report) directors’ qualifications, experience, special responsibilities, attendance at meetings. In recent years, the expectations of people on boards have increased. The law has shifted so directors must regularly attend directors meetings – in the past directors who did not attend many meeting could plead ignorance of the company’s affairs if something went wrong.

Note also requirements in s 300(11) for listed companies - reporting of, for example, shares held, rights or options over shares, interests in contracts that confer a benefit on director and all directorships they hold in other listed companies.

The approach is towards disclosure rather than prohibition.

## Committees of Boards

* + Board may delegate any of their powers to a committee of directors; a single director, an employee of the company or any other person: s 198D (Also to a managing director: s 198C)
  + It is ASX best practice to have the following:
    - **Audit committee** - required for top 500 Australian listed companies
    - **Remuneration committee**
    - **Risk management committee** (for large companies)
    - **Nomination committee**

### Appointment of Directors

* Initial appointment specified in application for registration (Form 201): s 117
* Subsequent appointment of directors
  + s 201G(RR): A company may appoint a person as a director by resolution passed in general meeting
  + s 201H(RR): directors may appoint a person as director, subject to:
    - For proprietary company: confirmation within 2 months;
    - For public companies: confirmation at next AGM
    - *Note –* like all directors" powers – must be exercised for benefit of company as a whole
  + s 201E: each appointment will require separate resolution

Note these are replaceable rules and so companies may choose the methods for appointment. All appointments must be notified to ASIC: s 205B Corporations Act

### Special rules for listed companies

* Must be board election every year
* No director (apart from MD) is to hold office for more than 3 years without submitting for re-election
* Directors appointed to casual vacancies must stand for election at next AGM: LR 14.4

### Term of appointment of directors

The Act does not specify the term of appointment of directors however the Constitution will usually specify the term. For proprietary companies, the term may be indefinite.

For Public Companies, there is usually a system for retirement of directors by rotation at AGMs, although usually can offer for re-election. The only person who can be appointed for a longer period is the CEO.

### Types of Directors

There is a distinction between Executive v non-executive directors and affiliated v independent directors. In addition, the Act recognises the following roles:

Managing Director: s 201J - The directors of a company may appoint 1 or more of themselves to the office of managing director of the company

Alternate directors: s 201K (RR) - With the other directors' approval, a director may appoint an alternate to exercise some or all of the director's powers for a specified period. Appointment must be in writing. Alternate directors must be given notice in same way as directors and their exercise of powers is just as effective

1. The Chair

The Chairperson is appointed by the directors (s 248E), gets the casting vote at directors’ meetings (s 248G(2)) and an individual may be elected by directors to chair meetings of the company’s members (s 249U)

The Best Practise Recommendations are that the Chair should not be the same person as the CEO and should be an independent director.

The Chair has procedural control over the meeting but has a important role in practise: ***ASIC v Rich [2003] NSWSC 85.***

### Ceasing to be a director

Directors can resign (s 203A) or retire at the end of their term. They can also be removed or be disqualified (Part 2D.6)

**Re: Public companies**

Section 203D**: removal by vote of general meeting.** Notice of intention to remove director/s must be given to the company at least 2 months before meeting is to be held; copy notice must be given to director/s, and director/s are entitled to put their case by written notice circulated, and speaking to the motion at the meeting

Section 203E:Directors cannot be removed by fellow directors (apart from the CEO)

Note: removing directors can trigger a breach of contract or other rights pursuant to their service contract.

**Re: Proprietary companies:** s 203C (RR) – Directors can be removed by the shareholders

Directors may revoke the appointment of a CEO or Managing Director: s 203F

**Automatic Disqualification**

There are certain matters which automatically disqualify directors: s 206B

* Person becomes disqualified from managing corporations *if they have* ***convictions*** *or become* ***bankrupt*** *or* ***personally insolvent****,* e.g.
  + they are convicted on indictment of an offence that
  + concerns the making, or participation in making, of decisions that affect the whole or a substantial part of the business of the corporation or concerns an act that has the capacity to affect significantly the corporation’s financial standing; **or**
  + they are convicted of an offence that
    - is a contravention of the CA and is punishable by imprisonment for a period greater than 12 months; or involves dishonesty and is punishable by imprisonment for at least 3 months

Period of disqualification: **5 years** from their release from prison if person imprisoned or 5 years from date of conviction if person did not serve term of imprisonment, but note ASIC can apply to court to extend period

**Disqualification by Order of the Court**

* Directors can also be disqualified for contravention of a civil penalty provision (e.g. duties contained in ss 180-183): s 206C. The court makes an order disqualifying them for whatever period the court thinks fit.
* if the person was an officer of 2 or more failed corporations: s 206D;
* if the person repeatedly contravened the CA: s 206E; or
* if the person has been disqualified from managing corporations under the law of a foreign jurisdiction: s 206EAA.

**Section 206C** - Court may disqualify a person from management *if*:

* ASIC applies;
* a declaration is made that a person has contravened a civil penalty provision (s 1317E); and
* the Court is satisfied that the disqualification is justified.
* NOTE: Unlike automatic disqualification under s 206B, no fixed duration of the disqualification for contravention of a civil penalty provision.

Under s 206C(1) **disqualification is for a period that the court considers appropriate**: See, eg, *ASIC v Adler* (2002) 42 ACSR 80 (Santow J) for detailed review of considerations court takes into account when deciding on disqualification under ss 206C and 206E; *ASIC v Rich* (2003) ACSR 682,

In recent cases, very light penalties (including disqualification orders) have been imposed in some recent cases.

ASIC’s Power of disqualification

* See s 206F: ASIC has power to disqualify a person from managing corporations for up to **5 years**
* ASIC must give person a ‘show cause’ notice: s 206F(1)(b)
* ASIC may give notice under s 206F if within the last 7 years person has been an officer of 2 or more companies that were wound up and whose liquidators lodged reports with ASIC under s 533 about the companies’ inability to pay debts

Grounds similar to court’s power of disqualification under s 206D, but ASIC’s power under s 206F has numerous advantages - ASIC has onus to satisfy court that the disqualification is ‘justified’ whereas under s 206F the onus on person served with ‘show cause’ notice to demonstrate why they should not be disqualified

Disqualified directors can apply for **leave** to act as a director of specific companies or companies generally:

* + **from ASIC** (where ASIC has disqualified them under s 206F); or
  + **from the court** under s 206G: see **Re Magna Alloys and Research Pty Ltd (1975)**

Leave may be subject to conditions

ASIC must keep a register of persons who have been disqualified from managing companies (available for public inspection): s 1274AA

Person who acts in breach of disqualification order commits an offence: s 206A (fined $5,500 and/or I years’ jail); may also be personally liable for company’s insolvent trading debts: s 588Z.

One of the statutory provisions that pierce the corporate veil and makes directors liable for the company’s debts – if a director allows a company to trade while insolvent (s 588G) then the director may be personally liable

### How are decisions of the board made?

The Board makes decisions collectively. A resolution of the directors must be passed by a majority of the votes cast by directors entitled to vote on the resolution and the chair has casting vote (248G (RR)).

It is possible, in smaller companies to have a ‘circulating resolution’ (section 248A (RR)). This allows resolution to be passed without an actual meeting if all directors sign resolution

Special rule for one director companies – sign a minute (S 248B (RR))

Minutes of meetings must be kept, as well as resolutions passed without a meeting (s 251A). This can become important in the event of litigation arising later.

**How are meetings called?**

* 248C (RR): by a **director** giving ‘**reasonable notice**’ individually to every other director
* s 248D (RR): by any technology consented to by the directors

**How are meetings managed?**

* s 248E (RR): directors may elect a chair
* s 248F (RR): Unless the directors determine otherwise, the quorum for a directors' meeting is 2 directors and the quorum must be present at all times during the meeting

**Procedural Irregularities:** refer to s 1322

Procedural irregularities are presumed no effect *unless* substantial injustice caused. It is up to the interested person can apply for validation/application.

### Director’s Right to Information

Director has right to inspect the ‘financial records’ of the company at all reasonable times: **statutory right** under s 290

Director has **common law** right to inspect company documents/access to company information more generally. Section 198F confirms the common law right and grants a right of access by directors to company books (other than its financial records) in certain circumstances, introduced by CLERP Act (2004) - CLERP 9

Plus constitution!

### Director’s Remuneration

Formal legal requirements

* Note: ss 202A(1)(RR) (director remuneration to be determined by resolution) and 202B (members may obtain information about directors’ remuneration).
* Companies which are obliged to produce a **directors’ report** under ss 298-300 (ie, large proprietary and public companies) come under additional obligations under s 300, and **listed companies** come under still further obligations: must include a **remuneration report** on the remuneration of ‘key management personnel’ (defined in act)
* Disclosure requirements for remuneration report specified in s 300A
* At company’s AGM, shareholders vote on whether or not to adopt remuneration report under s 250R. This is a no-binding resolution so the directors can ignore it however since 2011, the ‘2 strikes and you’re out’ rule has been introduced (if 25% or more of shareholders vote against adopting a remuneration report over 2 succesive AGM’s, that will trigger a spill of the board – all board members have to resign and new elections take place).

Best practice requirements

* + provide **disclosure** of company’s remuneration policies to help investors to understand the costs and benefits of the policies, and the link between remuneration to directors and key executives, and corporate performance
  + establish a remuneration **committee** – made up of independent directors and an independent chair
  + clearly distinguish the structure of non-executive directors’ remuneration from that of executives.

## General Meeting of Shareholders

The general concerns with meetings are to ensure:

* that sufficient notice is given so that people can decide whether to attend;
* that sufficient information is provided as the basis for decisions; and
* that fair voting procedures exist.

### Shareholder Rights

As "owners", what rights do shareholders have to participate in the running of the company?

Contextual matters

* The rise of "shareholder activism"
* The role of large institutional shareholders (superannuation companies, funds management companies)

Trend in corporate reform of requiring shareholder approval for transactions rather than banning them altogether (flexibility…)

### Meeting

Types: Annual General Meeting (AGM) and Extraordinary General Meeting (EGM)

* Calling a meeting
  + Director (s 249C (RR but see s 249CA)
  + Directors at request of members: s 249D – Members can requisition the directors to hold a meeting. It used to be possible for 100 members to call a meeting but this was revoked by the government last year (2015) because the rule was impinging on the ability of large corporations to make decisions.
  + Members can hold meeting themselves *if* directors don’t comply with request: s 249E
  + Members can hold meeting (without requesting directors) – requisite shareholding of 5% or more of the votes: s 249F

If th members call the meeting themselves, they must pay for it (e.g. hiring venue) but if they requisite the directors to hold the meeting, then the directors pay.

* But note s 249Q and ***NRMA v Parker –*** if meetings are called, they must be called for a proper purpose and for something within the power of the general meeting to deal with. If it is something outside the shareholder’s powers, the holding of the meeting and any resolutions passed will be a nullity.

Notice

* + Period: ss 249H and 249HA
  + Means/to whom: ss 249J and 249K
  + Contents: s 249L (and ss 249O, 249P)
  + Fiduciary duty of directors to inform members, and common law right to receive truly informative notice. Note: s 18 Australian Consumer Law (formerly 52 TPA)
  + **Fraser v NRMA Holdings (1995)**

Conduct of the Meeting

* + Quorum – s 249T (RR) – 2 members
  + Chairperson has wide powers re conduct of meeting

Decision-making

* + Resolutions
  + Ordinary resolution – s 9 – a majority of those present and voting
  + Special resolution- s 9 – passed by 75%
  + A member’s right to vote usually provided for in company’s internal governance rules. S 250E (RR) – gives a member on a show of hands, 1 vote; on a poll, 1 vote for each share held); s 250J (RR) voting by a show of hands unless a poll is demanded. Note: position regarding listed companies: ‘one share/one vote’ principle
  + Proxy rights – s 249Y – same as member subject to constitution
  + Proprietary companies can make resolutions without a meeting: s 249A (single member: s 249B)

# Corporate Contracting

## LAWS4112.PNGCompeting Considerations

## Corporate Capacity and Powers

**Section 124** - Companies have the legal capacity and powers of an individual, and some additional powers that do not apply to humans, including

* issuing shares;
* Issuing debentures; and
* granting a circulating security interest (formerly called a ‘floating charge’) over the company’s property – special type of financing only available to Company. A floating charge is where a company obtains a loan from the bank and the bank will take security over not only, fixed assets (non-circulating security assets including buildings/factory owned by company) but also over less tangible items (e.g. company stock in trade).

Companies did not always have legal capacity and powers of an individual. **In past**, companies had limited capacity, limited in what they could do by their objects clause in constitution. In addition, companies were given further protections under the law – privileged position under law – and were able to escape liability for contracts by pleading *ultra vires* (i.e. contract is beyond company’s power). In addition to the doctrine of *ultra vires*, those who dealt with the company were often fixed with constructive notice because the constitutions were available on the public record (through historical equivalent of ASIC).

**Since 1984***,* even though companies now have same legal capacity as a human being under s 124, they *can* still choose to state their objects in their constitution which identifies and limits the businesses and activities in which the company may engage

### Statements of Objects and Limitations on Powers

***Q:*** *What is the legal effect of objects clauses or limitations on company’s powers?*

**Historically**: doctrine of *ultra vires* and ‘constructive notice’ applied

**Now**, the doctrine of *ultra vires* has been abolished by the combined effect of ss 124 (all companies have the legal capacity and powers of an individual) and 125.

If a company has an objects clause, **s 125(2)** provides that an act **is not invalid** merely because it is contrary to or beyond any of its objects.

Further, if a company’s constitution contains an express limitation or prohibition on the exercise of any of its powers, the exercise of such a power is **not invalid** merely because it is contrary to such an express limitation or prohibition: **s 125(1**).

The doctrine of ‘constructive notice’ is also largely abolished by **s 130**. See also **ss 128** and **129** (to be discussed in detail later in this lecture).

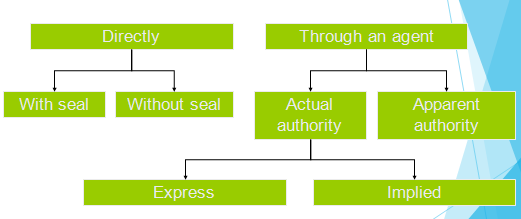
Even though Companies have the capacity of a natural person, companies may choose to include restrictions in their constitution. If the company’s powers are limited, any contract or act that is entered into that is contrary to the Company’s powers will not be invalid. This is an internal constraint only but may have other consequences even though it does not affect the validity of the Company’s contracts.

Contraventions of a company’s constitution may have **other consequences** *even though* they cannot affect the validity of the company’s contracts. Allegations that the company acted contrary to its objects or other restrictions or prohibitions in the company’s constitution:

* may be an element in a legal action against the directors for breach of their duty **–** duty of care and skill or fiduciary duty to act in good faith for a proper purpose (given that the constitution defines and sets limits to what the company’s interests are);
* may also be in breach of their service contract for that director;
* provide grounds for a member to seek an oppression remedy under ss 232-233; or
* allow a member to obtain an order for the winding up of the company on the just and equitable ground: s 461(1)(k)

### How do Companies Contract?

A company has all the powers of a natural person and the doctrines of *ultra vires* and constructive notice have been abolished if a Company does chose to have restrictions in its Constitution. Therefore, a company can no longer escape liability arising from a contract that it has entered.

Companies either contact directly or through an agent. If a Company contracts directly, it can do so with or without a seal or through an agent. If an agent acts on behalf of the Company, determining whether the agent has authority is necessary to determine whether the Company will be bound. There are different types of authority: actual and apparent. Actual authority can be express, implied, apparent or ostensible authority.

#### Contacting Directly

Even though a Company is a separate legal person, it still physically needs someone to act on its behalf. A company contracts directly if the contract is made by one of its ‘organs’ (i.e. the members in general meeting or the board of directors). The board of directors are usually charged with managing the company’s business but are able to delegate all or some of its powers to a governing director, the CEO or a committee of directors who might be charged with a particular task (e.g. exploring investment opportunities for the Company).

Traditionally, a company entered into contracts directly by using its common seal, although these are no longer required. Today, there are three ways for Companies to enter into contracts directly:

* Execute the document without seal, signed as required by s 127(1); or
* Execute the document with the seal and necessary witnesses: s 127(2); or
* Use the procedure set out in the constitution

Section 127(1) discusses the execution of documents by the company itself without a seal. This is permissible where a document is signed by:

* 2 directors of the company; or
* a director and a company secretary of the company; or
* for a proprietary company that has a sole director who is also the sole company secretary – that director

Section 127(2) states that a company with a common seal may execute a document if the seal is fixed to the document and the fixing is witnessed by:

* 2 directors of the company; or
* A director and a company secretary of the company; or
* for a proprietary company that has a sole director who is also the sole company secretary – that director

As well as the procedures set out in section 127 of the Corporations Act and the Company Constitution (if applicable), there also needs to be authority for the Company to enter into the contract. That authority usually comes from the Board because the Board is usually responsible for entering into Contracts on behalf of the company. There will usually be two resolutions:

* Resolution 1 – approves the Company entering into the contract and confers substantive authority on the contract
* Resolution 2 – authorises the execution of the document in a particular way and grants formal authority

##### **Defective Contracts**

What happens if the Company denies that it is bound by a contract due to some lack of authority or defect in procedures?

Section 128 of the Corporations Act states that:

1. *[Persons dealing with companies entitled to make assumptions]* ***A person is entitled to make the assumptions in section 129 in relation to dealings with a company.*** *The company is not entitled to assert in proceedings in relation to the dealings that any of the assumptions are incorrect.*
2. *[Assumptions applicable in certain dealings concerning title] …*
3. *[Effect of fraud by officer or agent]* ***The assumptions may be made*** *even if an* ***officer*** *or agent of the company* ***acts fraudulently****, or* ***forges a document****, in connection with the dealings.*
4. *[Knowledge or suspicion assumption incorrect] A person is not entitled to make an assumption in section 129 if at the time of the dealings they* ***knew*** *or* ***suspected*** *that the assumption was incorrect.*

Knowledge or suspicion will defeat an outsider being able to rely on the assumptions set out in s 129 as per s 128(4).

###### The Assumptions

**Section 129(5) -** Document duly executed **without seal**

*A person may assume that a document has been duly executed by the company if the document appears to have been signed in accordance with subsection 127(1). For the purposes of making the assumption, a person may also assume that anyone who signs the document and states next to their signature that they are the sole director and sole company secretary of the company occupies both offices.*

If an outsider is handed a contract which appears to be signed in accordance with section 127, the outsider can assume that the document has been duly executed.

**Section 129(6)** – Document duly executed **with seal**

*A person may assume that a document has been duly executed by the company if:*

1. *the company's common seal appears to have been fixed to the document in accordance with subsection 127(2); and*
2. *the fixing of the common seal appears to have been witnessed in accordance with that subsection.*

When documents are executed under seal, the stamp is usually preceded by a clause which states that the common seal of [XYZ Pty Ltd] was fixed to this document pursuant to a resolution of the board of directors in the presence of ... The signatures and titles will follow. The assumption that can be made is that they have been duly executed.

For the purposes of making the assumption, a person may also assume that anyone who witnesses the fixing of the common seal and states next to their signature that they are the sole director and sole company secretary of the company occupies both offices.

**It is arguably the case that the assumptions set out in ss 129(5) and (6) only apply to defects in formal authority.**

What can an outsider do about a defect in **substantive** authority?

* The outsider is protected by the **‘indoor management’ rule/rule in *Turquand’s case*** (embodied in s 129(1)): the outsider can assume that the company acts within its constitution and that its powers have been properly and duly performed and outsiders are not bound to inquire whether acts of internal management have been regular. The rationale is that outsiders are not privy to the internal machinery of Company’s and cannot always check whether internal management procedures have been followed.
* A defect in substantive authority will only render the contract unenforceable *if* the exceptions to the indoor management rule apply. Under the common law, if an outsider either knows or is put on inquiry (different to s 128(4)). A person will be put on inquiry if a reasonable person would have asked questions or something has happened to alert the outsider that something might be wrong.

#### Contracting through agents

**Section 126: Agent exercising a company’s power to make contracts**

1. *A company’s power to make, vary, ratify or discharge a contract may be exercised by an individual acting with the company’s express or implied authority and on behalf of the company. The power may be exercised without using a common seal.*
2. *This section does not affect the operation of a law that requires a particular procedure to be complied with in relation to the contract.*

Section 126 makes it clear that a person who is an agent for the company will only be an agent if that person has authority to act on behalf of the Company. A person can only find a Company to a contract if they have authority to contract on the company’s behalf. Authority may be either actual **or** apparent/ostensible.

##### Actual Authority

Actual authority may be express or implied. Express authority can arise from a provision in the Corporations Act (s 198A) or the company’s constitution.

Section 198A - the directors will manage the company’s business.

Express authority can also arise when a company agent (e.g. the board) who has actual authority delegates some of its own actual authority to a governing director or managing director. This could also include giving someone the power of attorney.

*What if a purported agent either has no express actual authority, or has express actual authority that is too narrow for this contract?*

**For example**, if a managing director has been delegated the power to enter into contracts on behalf of the company up to $1M and the MD signs a contract on behalf of the company for $1.5M – this is an example of an agent lacking actual authority.

The company may still be bound by the contract if the outsider can show that the agent has either:

* implied actual authority, **OR**
* apparent authority, **AND**
* the exceptions to the indoor management rule do not apply

###### Implied Actual Authority

**Implied actual authority** can arise by implication from things the principal says and does. For example, appointing someone to a certain position in the company may create such an implication because different positions in a company carry different levels of implied actual authority.

Sections 129(2) and (3) contain assumptions about certain officers in the company and the customary or usual authority associated with their position. Directors and co secretary have ‘customary’/usual authority for their position.

The CEO and other executive officers have the implied actual authority to do *“all things that fall within the usual scope of that office”*: ***Hely Hutchinson v Brayhead* (1968) 1 QB 549**

**Chief Executive Officer (CEO)**:

***Entwells Pty Ltd v National and General Insurance Co Ltd* (1991) 6 WAR 68** - usual authority *“to deal with everyday matters, to supervise the daily running of the company, to supervise the other managers and indeed, generally, be in charge of the business of the co”*

The level of implied actual authority of a CEO is quite extensive. It probably would not extend to selling the company’s business and the court will consider the industry that the CEO is involved in and what the usual or customary powers of a CEO are in that industry and the size and operations of the Company.

Where company has more than 1 director, a **director, acting alone**, has no implied actual authority to bind the company in contracts: **Hely Hutchinson; Northside Developments Pty Ltd v Registrar-General (1990) 170 CLR 146; Brick & Pipe Industries Ltd v Occidental Life Nominees Pty Ltd (1992) 10 ACLC 253.**

**Chair**

The Chair of the Board as 1 member of a body that acts collectively does not usually have the power to bind the company: ***Hely-Hutchinson****.* However, in ***ASIC v Greaves****,* the court set out the responsibilities of a chair and made it clear that a chair has a greater range of responsibilities than ordinary director.

**Secretary**

The position of a Company Secretary has changed from that of mere clerk to ‘chief administrative officer’. The implied actual authority is confined to signing contracts relating to administrative and not management matters: ***Panorama Developments Ltd v Fidelis Furnishing Fabrics Ltd* (1971) 2 QB 711.** In this case, the Company Secretary had hired cars for his private use and the courtheld that the Company was bound.

**Executives below board level**

The implied actual authority of these executives will depend on particular position. In ***AWA Ltd v Daniels* (1992)** Rogers CJ dealt with usual authority of money market and foreign exchange dealers. It will depend on the industry and the size of the company which will determine the extent of the executives’ implied actual authority.

Implied actual authority can also arise from other conduct, e.g. **acquiescence**. If the board knows that someone is purporting to represent the company, and does nothing to stop that, then the board has ‘acquiesced’.

*Example:* If a director has printed business cards and called himself the CEO and the directors do not do anything about it, that is clear acquiescence.

If the person has been doing ‘CEO type’ things, the court has held that they will probably have the implied actual authority of a CEO in a similar company.

***Hely Hutchinson*** - In this case, the chairman (Richards) of the Company was also acting as the de facto MD of the Company. Richardson had given HH a guarantee to cover any losses suffered by him if loans were made by HH to his struggling Company which were not repaid. HH later called on the Company to honor these guarantees and it was held that Richards had acted as though he was MD and other board members and managers of divisions had accepted this assumption of authority. It was held that giving guarantees is within the usual scope of an MD’s authority and even though the Chair only has the authority of a single director, because he had acted as a de facto MD, the guarantee was binding.

***Brick and Pipe***– This case concerned the Goldberg Group of companies which were based in Melbourne. Mr G was the founder of the companies and the group had recently taken over the company Brick and Pipe. BP was required to give OL an indemnity for a $57M loan which had been made to other companies in the Goldberg Group. As it turned out, the indemnity was given without a board resolution (lacked substantive authority) and the people who had signed the indemnity were Mr G and his son-in-law and Mr Furst (both members of the BP board). Mr G and Mr F witnessed the affixing of the company seal to the indemnity agreement. Mr F sigend as secretary and Mr G signed as director of the company. When Mr F signed as secretary, a solicitor for OL queried his capacity because he was not shown to be company secretary in the public records. In addition, the statement was made in front of the company’s financial officer (Mr D) in the presence of Mr G who represented that Mr F had been appointed to the position of company secretary.

The monies were paid and 3 days later, the Goldberg Group of companies collapsed. BP sought to be relieved of liability under the indemnity on the basis that proper procedure had not been followed (Mr F was not the Company Secretary but he was a director – no effect on authority). The case turned on the authority of Mr G and the court ultimately held that Brick and Pipe was found to be liable because even though Mr G was only a director, was the founder of the company and companies in the group were accustomed to act in accordance with his instructions (treated as though he was MD). This was a situation which had been acquiesced by other members of the board.

The argument made by BP was that the transaction had been entered into without a board resolution but evidence showed that transactions had generally been entered into without reference to the board and no attempt had been made to interfere with the assertion of control by Mr G.

###### Apparent/Ostensible Authority

Apparent/ostensible authority can arise even where the principal has not actually authorised, by words or conduct, the agent to act on the principal’s behalf.

***Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd* (1964) 2 QB 480 – T**his case concerned two individuals (P1 and P2) who formed a company for the purpose of developing property. Both held shares in the Company and were both on the board and so was a nominee of each (4 members of board). The quorum for board meetings was 4 but at all material times, P1 (H) was overseas and P2 (C) acted as MD with the approval of the board although he hadn’t been appointed to that position. P2 had engaged a firm of architects on behalf of the Company and the firm brought an action claiming payment for the work that had been done where the company refused to pay its fees. The court held that the company had held out that P2 was its MD and therefore was bound by its actions – P2 had the apparent authority of employing architects which was within the customary authority of an MD.

The representation was that P2 had the authority of the MD and it had been made by the board which had actual authority to manage the affairs of the Company. This was so even though no formal decision was made but because a representation was made since the board failed to prevent P2 from acting as though he was the MD.

**There is an overlap between this and acquiescence. If there is an EXAM QUESTION, where an agent purports to bind a company, you should look to establish whether the agent has authority. It is best to explore whether the agent has express or implied actual authority and in the alternative, apparent or ostensible authority.**

***Crabtree-Vickers Pty Ltd v Australian Direct Mail Advertising & Addressing Co Pty Ltd* (1975) 133 CLR 72 –** This case concerned afamily company (Direct Mail) known whose directors were BM Snr and BM Jnr and their wives, who didn’t take any active role in the Company’s affairs. Peter (son) was employed by the Company but was not a director of the company. BM Jnr had not been formally appointed to the position of MD and did not have actual authority to manage the company’s affairs. Peter had negotiated a contract to buy machinery from Crabtree and there was evidence that BM Jnr had held out Peter as having the appropriate authority to sign the contract or enter into the contract on behalf of the company to the other party. There was an attempt that the company be bound on the basis of apparent/ostensible authority but the court held that the representation was made by someone with apparent not actual authority 🡪 failed on the second element.

***Pacific Carriers Ltd v BNP Paribas* [2004] HCA 35** – In this case, the HC held that the representation needs to be made by someone with actual authority.The case concerned the actions of Ms Dhiri who was the manager of a particular department of the bank. She signed two letters of indemnity (on behalf of the bank) addressed to the charterer of a cargo ship. Under the letters of indemnity, the bank agreed to indemnity the ships charterer in respect of any loss or damage suffered by the charterer as a result of delivering cargo without proper documentation being produced by receiver. When the cargo was delivered without proper documentation being produced, the charterer sued the bank. The bank argued that the bank was not liable because Ms D had no authority to bind the bank. All parties agreed that Ms D lacked express authority to bind the bank because the issuing of indemnities was the function of a different bank department and the bank had internal policies for how letters of indemnity needed to be signed.

The HC held that the argument that the representation had to be made to the charterer by the bank, rather than Ms D herself was correct but too simplistic. The holding out may result from permitting a person to act in a certain manner without taking proper safeguards against misrepresentation. The court held that the circumstances (setting up of organizational structure which presented to outsiders an appearance of authority on the part of Ms D – had office, manager of different department) allowed those dealing with the bank to make certain assumptions about her position. Even though Ms D lacked express authority, ostensible authority arose by virtue of equipping Ms D with a certain title and the bank had also failed to establish proper safeguards to protect itself from unauthorized conduct.

There are three requirements (at common law) to establish apparent/ostensible authority:

* a ‘holding out’ or ‘representation’ which can be words or conduct that agent had authority to enter into contract on behalf of the company;
* the holding out is by someone with **actual authority**; and
* outsider induced by the holding out to enter into contract (i.e. reliance by the outsider)

In the **Paribas case**, where HC took a very broad view of 2nd requirement and therefore this requirement has been relaxed.

**Before *Paribas***: consequence of this requirement that representation/holding out be made by someone with actual authority is that purported ‘agent’ – who lacks actual authority – cannot make a legally recognised representation as to his her own authority.

**In *Paribas***: court held that bank made a representation about the authority of Ms Dhiri to issue indemnities, through equipping her with a certain title (manager of the Documentary Credit Department), status and facilities, and also by failing to establish proper safeguards to protect itself – and outsiders with whom it dealt- from unauthorised conduct.

See Diagram on PP for summary.

###### Indoor Management Rule

Before the doctrine of apparent/ostensible authority, the common law deployed the **indoor management rule/rule in *Turquand’s case***

Underthe indoor management rule, the outsider can assume that acts within its constitution and powers have been properly and duly performed and are not bound to inquire whether acts of internal management have been regular

See LG pg 42 for quote.

Still relevant: will apply where ss 128-129 do not apply, and relevant to interpretation of s 129(1)- statutory embodiment of indoor management rule

***Turquand’s case***– this case involved a deed of settlement company. The directors had borrowed money from the bank on the security of a charge (bond over company’s property) and the company resisted payment on the basis that the directors did not have power to borrow the money – constitution required resolution of the shareholders and no such resolution had been passed. The bank won and at the time the doctrine of constructive notice applied. The court held that the bank had a duty to search company records but unless it was put on notice by the conduct of officers, it could assume that all matters of internal management had been complied with. The record showed that the officers, their powers and special resolutions of the general meeting but no copies of ordinary resolutions had been kept. If the bank had checked, they would have been able to see that the directors could not borrow without shareholder approval but the bank did not have access to the company’s internal records. The bank dealt with the company through the named directors in the authorized way and the loan document was signed under seal – allowed to assume that the board had secured the necessary resolutions.

Outsiders do not have access to the internal machinery of the Company and that’s why the bank was able to enforce its security against the company.

**Exceptions to the Indoor Management Rule**

* actual knowledge exception
* the ‘put on inquiry’ exception (tested objectively):
  + Has the outsider failed to make inquiries that would usually be made by someone in their position, or
  + Would a reasonable person in the outsider’s position have been put on inquiry and investigated?

***Northside Developments v Registrar General***- In this case, ND purported to grant a mortgage to secure a loan made by Barclay’s to companies owned and controlled by Mr Sturgis. The common seal of ND was affixed to the mortgage document and was witnessed by Mr R. Sturgis as director and G. Sturgis as secretary. The board of directors of ND had not authorized the transaction and had not delegated their powers to R. Sturgis even though he was in control of the companies and G. Sturgis was never formally appointed as company secretary.

At the time, the wording of the predecessor of s 128(4) used the same language as the common law (knowledge or put on enquiry).

When the Sturgis companies defaulted in paying the loan, Barclay’s sought to enforce the mortgage which involved selling ND’s land. ND brought legal proceedings seeking compensation on the basis that the mortgage was invalid because it had not been approved or properly executed by ND. The HC found that the mortgage was not binding on ND and held that the put on enquiry exception applied. The bank officers could see that the loan was being made to companies unrelated to ND (loan being made to Sturgis Group) – ND was taking on a large amount of risk for no apparent benefit. The court held that this should have led Barclay’s officers to make satisfy themselves that ND’s entry into the mortgage was properly authorized and that RS and GS had authority to affix and witness the company’s common seal.

***Story v Advance Bank Australia Ltd* (1993) 31 NSWLR 722 –** This was also decided on the predecessor provision which used the term ‘put on enquity’. This case concerned a family company called Fleetwood Star whose only directors and shareholders were Mr and Mrs Story and the company owned the property occupied by the Story’s. In this case, Advance Bank had loaned $1m to Mr Story and as security for the loan, the bank obtained a mortgage over the property owned by Fleetwood Star – the bank was told that the loan was being used partly for business purposes and partly for household expenses. Mr Story’s business was run through Fleetwood Star. The mortgage document was executed under the common seal of Fleetwood Star – the common seal was fixed to the document and witnessed by Mr Story and what appeared to be Mrs Story (forged).

When Mr S defaulted on repaying the loan, the bank brought legal proceedings to enforce the mortgage and sell the house property. It was argued that Fleetwood Star wasn’t bound by the mortgage because the board of directors had not authorized the transactions and the mortgage document had not been properly executed due to forgery. The bank argued that it was entitled to rely on the statutory assumptions but the company argued that the bank could not rely because the put on inquiry exception applied.

The court held that even if the bank had asked what the million dollars was for, Mr S answer would have showed the interest of the company in the loan (because partly for business purposes). The bank was able to enforce the mortgage on the basis that the put on inquiry exception did not apply.

## Assumptions Under Corporations Act: ss 128-129

* Sections 128 and 129 overlap to large extent with common law agency principles and the indoor management rule
* Section 129(1) contains a statutory indoor management rule: company’s constitution and/or RR have been complied with
* Section 129(2) contains an assumption about the authority of certain officers: Implied authority
  + This deals with the situation where the outsider does a search of ASIC records and the records show that the person is a director/company secretary (office bearer), then the outsider can assume that the person has been duly appointed to that office and that the person has the authority to exercise the powers and perform the duties customarily exercised or performed by a director/company secretary of a similar company.
  + Implied actual authority of director/company authority
* **Section 129(3)** contains an assumption about apparent authority
  + A person may assume that anyone who is held out by the company to be an officer or agent of the company has been duly appointed and has authority to exercise the powers and perform the duties customarily exercised or performed by that kind of officer or agent of a similar company.
* Section 129(4) contains an assumption that agents and company officers properly perform their duties to the company
  + Adds to or is part of the indoor management rule
* Sections129(5) and (6) – see earlier slides
  + Proper execution
* Section 129 (7) contains an assumption about authority of company officer who issues a document warranting that the document is genuine or a true copy

These assumptions can be made even in the case of fraud or forgeries. However, the assumptions cannot be made if the person knows or suspects that the assumption is incorrect. Knowledge is obviously the same as the common law test.

### Is ‘suspected’ the same as ‘put on inquiry’?

There are two possible interpretations of the suspicion exception – see [5.375 Textbook].

One approach is that it is tested subjectively so that outsiders are given even more protection than the rule in ***Turquand’s case.*** Even if a reasonable person would have suspected that something was wrong, unless evidence can be adduced that the actual person in question suspected that something was wrong, they will enjoy the benefit of the assumptions. This interpretation (subjective approach) which has been followed in **Oris Funds Management v NAB** and **Sunburst Properties v Agwater**, tends to encourage banks and others dealing with a company to don blinkers when faced with warning signs – may encourage ignorance and condone dereliction of duty where lenders fail to make reasonable inquiries. In failing to make reasonable inquiries, a person dealing with a company may unwittingly assist company officers in breaching their duties and acting without authority to the detriment of the company, its innocent shareholders and creditors. On this view, the test should be objective.

The explanatory memorandum to the 1998 amending legislation which inserted the new test in s 128(4) is not helpful in deciding which interpretation is intended.

**Consider:** Should the courts be more prepared to apply the assumptions to people who are not as commercially aware or sophisticated as banks? Should there be a distinction between different types of outsiders?

# Directors Duties

## Function of Director’s Duties

Director’s Duties are historically derived from analogies with partnerships and trusts. They are a set open-textured standards designed to reduce the agency costs inherent in the separation of ownership and control and are designed to constrain the discretion vested in the directors as to how the company should be operated

Director’s duties are a central regulatory tool in modern corporate law and corporate governance. One of the central corporate governance problems is the agency cost problem – risk that agent will pursue his/her own interests and not the interests of the principal (i.e. company). Director’s duties are designed to address this problem by creating countervailing incentives (i.e. duties represent reason why the directors will not pursue their own interests – they have an obligation not to and there are consequences for breaching the duties).

The bargain between directors (managers) and shareholders (investors) – shareholders give directors autonomy and discretion in how to manage the investment but impose obligations upon directors that require them to manage the investment in the shareholder’s interest.

If the duties are to fulfil the function of addressing the agency-cost issue, there are two criteria that the duties must meet:

1. The duties must strike an appropriate balance between autonomy and control (discretion which directors have and their accountability for how they exercise that discretion). The directors need a sphere of activity/autonomy in which they can take risks (because companies are money generating) and not be held personally liable because the risk did not pay off. The duties try to balance risk and control, risk and return, discretion and accountability.
2. Meaningful enforcement – a duty that cannot be enforced is pointless. How do we enforce director’s duties and who enforces them? Is the enforcement effective to create an incentive for director’s to behave properly?

Enforcement raises a range of issues as to who should be able to enforce the duties and where the money goes if there is recovery. Company law has historically had a problem with enforcement of director’s duties. To some extent in Australia, the enforcement issue has been addressed in part by having a regulator like ASIC with powers to enforce the statutory duties – ASIC takes place of shareholders as enforcer of duty. There are questions about how effective ASIC’s enforcement procedure is. ASIC can only really pursue the most egregious cases and there is a suspicion that ASIC only pursues cases it thinks it can win.

## Types of Duties

Broadly speaking, there are three sets of duties:

1. Fiduciary Duties: loyalty and good faith
2. Duty of Care
3. Statutory Duties (s 180-3 and 184)

Fiduciary duties differ from duties of care because they are concerned with honesty, integrity, good faith, motive and purpose. The duty of care is essentially a negligence standard and is about unacceptable risk taking causing loss. A director who is honest can nevertheless be careless and a director who is very careful can still be dishonest.

For a long time, it was assumed that all duties owed by directors had to be fiduciary duties, including the duty of care (equitable duty of care rather than negligence standards). This had consequences for the rules of causation – equity trends to protect beneficiary so the rules of causation are slanted against the directors. That view is incorrect and has now been correct. The director’s duty of care is equitable in origin but is NOT fiduciary and largely mirrors how the common law standard of negligence would work (subject to some qualifications around application).

The Corporations Act contains duties in ss 180-183 and 184. Section 185 states that the statutory duties are in addition to, and not a replacement of the common law.

* + Section 180 – duty of care
  + Section 181 – something that looks like fiduciary duty of loyalty and good faith

These duties therefore exist in parallel. The common law and statutory rules have largely been interpreted to mean the same thing in terms of the standards and criteria for their application. They do differ in some respects – statutory duties are enforceable by ASIC and many give rise to civil penalties whereas at common law, the duties are enforceable by parties other than ASIC and the remedies tend to be compensatory or restitutionary.

### Why does the Corporations Act contain duties which replicate common law standards?

The duties in the act are the leftover from an earlier attempt to fully criminalise directors duties. When the duties first appeared in legislation, they were couched in terms of criminal offences however this didn’t work because most of the conduct the duties were concerned with was not criminal and given that the standard of proof is higher for criminal over civil wrongs, it proved almost impossible to meet the burden of proof. There is still one remnant of this in s 184 which states that where you can prove intention or dishonesty in breach of tone of the other duties, that can also be a criminal offence.

For non-legal persons, finding out what fiduciary duties require of a director is not simple if it is embedded in the common law. Part of making the corporations act more user friendly, there was an attempt to put everything in one place so company directors and business managers can access their duties by referring to the act rather than seeking legal advice.

## Who Owes the Duties?

Fiduciary duties are owed by fiduciaries. A fiduciary is a person who is expected to act in the interests of another person, and who cannot use their knowledge or position to benefit themselves rather than the person on whose behalf the fiduciary is required to act. A fiduciary position can arise either as a matter of fact (i.e. in the particular circumstances, the relationship fulfils the criteria of a fiduciary relationship) or on the basis of status (i.e. certain roles, positions, occupations, functions attract fiduciary obligations per say). Company directors fall into the latter category and have always been held to be fiduciaries because of the nature of their position. Historically, directors were considered to be quasi trustee since they were in charge of other people’s money and since fiduciary obligations were placed on trustees, they were also imposed on directors.

It remains possible in principle, for a claimant to prove that a person not appointed as a director, nevertheless owes the shareholders or the company a fiduciary duty as a matter of fact. In some cases, shareholders have been able to prove that a director owes that shareholder in particular a fiduciary duty. There is some scope for expanding and contracting the range of people subject to fiduciary duties but for the most part, these duties are owed by directors.

Fiduciaries include directors, senior executive officers and employees

## Who is a Director?

Historically, directors were those who were appointed as directors. It is no longer quite so straightforward and there is an extended definition of Director in section 9 of the Corporations Act. The sections listed in red text do not appear in the legislation and have been added by R.Grantham.

***director*** *of a company or other body means:*

*(a) [de jure] a person who: `*

*(i)  is appointed to the position of a director; or*

*(ii)  is appointed to the position of an alternate director and is acting in that capacity;*

*regardless of the name that is given to their position; and*

*(b)  unless the contrary intention appears, a person who is not validly appointed as a director if:*

*(i)  [de facto] they act in the position of a director; or*

*(ii) [shadow] the directors of the company or body are accustomed to act in accordance with the person's instructions or wishes.*

*Subparagraph (b)(ii) does not apply merely because the directors act on advice given by the person in the proper performance of functions attaching to the person's professional capacity, or the person's business relationship with the directors or the company or body.*

There are three circumstances in which a person will be found to be a director: de jure, de facto and shadow.

A **De Jure director** is one who is appointed as a director – their name appears in ASIC Register as director. To be a de jure director in Australia, the person must be a natural person and a company cannot be the director of another company. This position is different internationally.

A **De Facto director** is one who acts as a director and who everybody else assumes is a director but for some reason, they have not been properly appointed. This may simply be because someone forgot to fill out the paperwork. This is a person who presents themselves as a director, who thinks of himself as a director, who the other members of the board believe is a director and who fulfils all the normal functions of a director but has not been formally appointed.

A **shadow director** is someone who is not a director and generally does not want to be a director but still exercises control from behind the scenes. The directors of the company are accustomed to following this person’s instructions or directions – stand in shadows but exercise control. For the purposes of most of the director’s duties, a shadow director is a director and therefore owes these duties.

This has been tested most often in relation to insolvent trading provisions. The law says that directors who know their company is insolvent must not allow it to trade on and impose losses on creditors. Shadow directors are subject to that duty and if you have allowed the company to trade while insolvent, then you will be personally liable to the creditors who have suffered loss.

A company can be found on the facts to be a shadow director – this becomes important in the context of corporate groups where parent companies run the risk of being found to be the director of its subsidiary. In some ways, this unwinds all the reasons for having a subsidiary in the first place.

If you have the power, you must have the responsible and accountable – hence the extended definition. Most jurisdictions have something similar.

***Buzzle Operations P/L v Apple Computers* [2011] NSWCA 109**

Facts: Buzzle was a reseller of Apple products and had gotten into financial difficulty. It had grown through various mergers and acquisitions and wanted to restructure the business – to do that, it required Apple’s consent to move some of the supply contracts around (from one entity to another). Apple was concerned about the financial viability of the new re-arranged entity and it was fairly hands-on in wanting information and assurances about how things would work and how the numbers stacked one. Apple’s finance director ended up having an office in Buzzle’s headquarters for a while. Buzzle went bust and the liquidators found that Apple was a shadow director of Buzzle and therefore in breach of the duty to avoid insolvent trading.

Issue: Was Apple, in the form of its finance director, a shadow director of Buzzle?

Held: The court held that Apple was not a shadow director because Apple was merely protecting its own commercial interests and there was no suggestion that the board of Buzzle simply did what Apple told it to do. The board of Buzzle remained the genuine decision maker.

***Standard Chartered Bank of Aust Ltd v Antico* (1995) 18 ACSR 1**

Facts: A Company called Pioneer (parent company) owed 43% of the shares in Giant (subsidiary). The bank lent Giant money by way of overdraft and Giant failed to repay and went into liquidation. In the process of trying to recover the money, the bank says to Pioneer that it had 3 of its senior executives on the board of Giant and therefore Pioneer or the three directors are a shadow director of Giant and are therefore also liable.

Held: The court held that Pioneer was a shadow director. The mere fact, on its own, that Pioneer owed 42% of the shares in Giant does not make it a shadow director – this would probably apply to a parent company who owned 100% of the shares. Simply being the major shareholder in a company does not, of itself, make you a shadow director. Banks and financiers provide money to companies, even though in the process of that they may acquire considerable control, it is not uncommon for a bank which was made a major investment to insist on having a representative on the board as part of the financing arrangement – this does not mean that the bank becomes a shadow director. The bank is looking out for its own interests.

The decision as to how Giant was to be funded by Pioneer and the taking of security was never the subject of careful consideration of the Giant board but was accepted by the Giant board as something necessary. The directors of Giant simply accepted the decisions which had affectively been made by Pioneer.

The key question is whether the board of the company in question is the one making decisions or is it the shadow director? As long as the board is functioning as an independent body making its own decision, then the other person will not be a shadow director. However, as soon as there is evidence that the board simply rubber stamps or does what it’s told, then the prospect of becoming a shadow director becomes real. This is important in corporate groups.

Corporate groups are set up for efficiency reasons and to take advantage of limited liability and because you can ring-fence liabilities in the subsidiary so they do not flow through the group to other entities. However, commercially, you want to run the group as a single economic entity – in the context of corporate groups, there is a fine line between having subsidiaries form an efficient part of the overall economic activity but nevertheless allowing them to have a sufficient degree of governance autonomy so the parent company does not become a shadow director. A lot of this has to do with formalities - it is the maintenance of formalities that tell us that the parties are respecting and recognising the parties as separate legal entities. Once the parties treat the group as one big economic entity, there is no reason why the law should recognise them as separate legal entities – the way parties recognize these companies as separate legal entities is by recognising that the boards of the company are the ones who must make the decisions. The reality is that the boards of the subsidiaries will understand the overall plan of the corporate group and comply with that but the formalities are still required (i.e. board of subsidiary must meet and discuss what the parent suggests and determine if it is in the interest of the subsidiary).

There is a distinction between executive and non-executive/independent directors. Executive directors are also employees of the company whereas as non-executive directors are not employed by the company. Corporate governance best practise recommends that, at least for publicly listed companies, a majority of the board should be independent directors (R 2.1).

### Rationale – ASX Recommendation 2.1

An independent director is independent of the corporate senior management, is not invested in the company in the sense of also being an employee and is therefore more likely to exercise oversight of the CEO and other senior executives – no personal investment in the company. They have a reputational consideration to maintain because they want directorships at other places and have to be seen to be effective. They are therefore more likely to act without the conflict of interest we find in executive directors who are more likely to act in their own interest because they can extract greater pre-requisites form the company because they are also employees.

### Do independent directors add value?

Empirical studies have not been able to identify any significant difference between companies with and without independent directors. Another study has suggested that independent director’s destroy value and are a negative. There is no overwhelming evidence that independent directors add value.

Recently, regulators have started to change their view on independent directors. The NZ Financial Market Authority Board states that board effectiveness is not always enhanced by director’s forma independence if it outweighs their independence of mind, and the skills, knowledge, experience and time that a director can contribute. The mere fact that a person is not employed by the company does not necessarily mean they will add value if they do not act independently – that asking the CEO for more information or challenging the CEO. It may not be the case because independent directors do not spend much time involved with the company (no day to day familiarity with company operations) – how much do they know about the company and how much can they add in terms of making good business decisions. The independent directors need executive director support for their position and are often senior executives at other unrelated companies – share a mindset with the executives. Often, it is easier to take the path of least resistance and agree rather than constantly challenging the CEO.

### Officers

The Corporations Act also applies duties to ‘officers’ of the company. Officers include directors and senior management (decision makers about company activities). For some duties, officers are included (e.g. duty of care and duty to act in company’s best interests). However, the duty to avoid insolvent trading applies only to directors and not to officers. When you look at the duties, you must consider whether they apply to directors only or to officers as well.

Officer’ is also defined in s 9. It includes:

* Director or secretary
* Person who makes or participates in making decisions affecting the whole or a substantial part of the business
* Person who has the capacity to affect significantly the corporations financial standing
* Person whose instructions or wishes the directors are accustomed to act upon (other than due to proper performance of professional duties or business relationship).
* Receiver, receiver and manager, administrator, liquidator or similar person.

Case: ***ASIC v Adler* (2002) 41 ACSR 72; 20 ACLC 576 (Santow J)**

### To whom are the Duties Owed?

The duties are owed to the company as a distinct legal entity, and not the shareholders individually:***Percival******v Wright* [1902] 2 Ch 421**

This is a consequence of recognising that the company is a separate legal person so the company is either the principal or beneficiary of the duty. Directors’ duties are owed to **the company as a separate legal entity**: Broadly speaking, this means that directors’ duties can only be enforced by the company and not by individual shareholders.

This gives rise to enforcement problems – how does the company enforce duties owed to it by the directors when the directors are the ones in control of the company and decide which claims the company should pursue.

It would be chaos if the directors were found to owe fiduciary duties and duties of care to individual shareholders and would give rise to a multitude of actions. Conceptually, the duties are owed to the shareholders as a group. The duties benefit the shareholders as a collective and so as a collective right, the right must be enforced collectively – the collective is the company.

In unusual circumstances, a duty will be owed to an individual shareholder – if the member is especially reliant upon the director for information and advice: ***Brunninghausen v Glavanics* (1999) 32 ACSR 294**

## Directors Duty of Care, Skill and Diligence

The duty of a director is to exercise a reasonable standard of care in making decisions and exercising their powers as a director. A director or other officer breaches this duty if he or she is “negligent” and can be held personally liable.

The duty of care arises under:

* The common law and equity
* The employment contract between the director and the company
* S 180(1) CA

The standards at common law and under s 180 are now fundamentally the same. There are differences in terms of the remedial consequences and enforcement.

Section 180(1) of the Corporations Act is enforceable by ASIC and the common law duty is enforceable by the company. Breach of s 180 may give rise to civil penalties whereas breach of the common law duty will give rise to damages.

### The common law and equitable standards

There are 4 broad aspects of the duty:

* Care
* Skill
* Diligence
* Delegation and reliance

**Historically, the** standards required of directors was low and the test was largely subjective - ***Re City Equitable Fire Insurance Company Ltd* (1925) Ch 407** per Romer J. This is the original common law position and the standard articulated was very low and required very little of directors in terms of care, skill and diligence.

The directors need not exhibit a greater degree of skill than may be reasonably be expected of his knowledge and experience – the test was **wholly subjective** and so if the director was an idiot, the standard of care expected was that of an idiot director.

Directors are not bound to give continuous attention to the affairs of the company. This relates to diligence – the directors duties were intermittent and to be performed at periodic board meetings and a director was not bound to attend board meetings.

Any duties that can be adequately delegated to an official can be delegated with the result that the director is no longer responsible. It was possible, even if you were attending board meetings, to delegate everything to the senior executives.

***Re Cardiff Savings Bank (Marquis of Bute’s Case)* [1892] 2 Ch 100 –** The MB was appointed to the board when he was a child and in the course of his life, attended 1 board meeting.He was appointed because figurehead directors were important – people of note accepted board positions simply to lend their name to the company to give it prestige.

The standard set out by Romer J was incredibly low for a number of reasons:

* the courts were trying to balance accountability and risk – weighted in favour of risk taking over accountability.
* if the standard of duties were too high, then you would deter good people from becoming directors
* who the directors are and what skills they bring and how competent they are is a matter for the shareholders – if the shareholders elect an incompetent person, then the shareholders got what they deserved
* due to the variety of sizes and shapes and businesses that the corporate form was used for, it was very hard to articulate what a reasonable director was – it was impossible to articulate a single standard that would encompass everyone (e.g. director of multinational company versus director of small company)
* the courts were wary of engaging in second-guessing the director’s business decision because you run the risk of saying that it turned out badly therefore you must have lacked due care – using hindsight what the directors should have done or known at the time. Courts are not competent to make business decisions.

The standard has since been increased primarily due to public perception. During the 1980’s, there was a period of economic free-for-all, public confidence was being undermined by not holding directors accountable so courts started to impose a higher standard. Insolvency law injected provisions into company law since the 1940’s and insolvent trading rules came as a matter of insolvency law and not of core company law – introduced by insolvency law reformers to protect company creditors the worst excesses of limited liability. The duties directors currently have to avoid company from trading while insolvent endeavour to protect creditors not shareholders.

The courts extrapolated from the duty to avoid insolvent trading and asked what skills and experience was required to discharge the duty to avoid insolvent trading – need to know when company is insolvent. From that, the courts extrapolated a general duty that the directors must understand and monitor the company’s financial position – extrapolated into duty of care. The content of the duty of care emerged as a minimum standard that requires all directors of all companies to know and understand the company’s financial position and to monitor, on an ongoing basis, its performance.

This view was articulated by the court in *Daniels v Anderson* (1995) 13 ACLC 614 (*AWA* case) and this view is reflected in s 180(1) of the Corporations Act. ***AWA*** changed the law and raised standards – there is now a minimum standard for all directors:

* obtain a basic understanding of their company’s business and be familiar with the fundamentals of the company’s business
* keep informed of the activities of the company – a continuing obligation
* monitor the company’s activities (although detailed inspection of day-to-day activities not required) and regularly attend board meetings
* maintain familiarity with the company’s financial status by a regular review of financial statements, ie, monitor the company’s financial position

In the **AWA Case**, the courts articulated the reasonable director, who at a minimum is one who knows and understands the company’s financial position and keeps himself up to date. This case also abandoned the wholly subjective approach and started to move towards an objective director – the standard of care displayed by a director is that of a reasonable director not of this particular person in that role.

***Vrisakis v ASC* (1993) 11 ACSR 162** – Justice Ipp said that the question of whether a director has exercised a reasonable degree of care and diligence can only be answered by balancing the foreseeable risk of harm against the potential benefits that could reasonable have been expected to accrue. This is essentially a balancing act between accountability and risk – directors are expected to take risks but the risks they take must be commensurate with the potential for harm and must be reasonable. The law tries to draw a line between reasonable and unreasonable risks.

### Statutory Duty of Care – s 180

**180 Care and diligence—directors and other officers**

*(1)  A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:*

*(a)  were a director or officer of a corporation in the corporation’s circumstances; and*

*(b)  occupied the office held by, and had the same responsibilities within the corporation as, the director or officer.*

There is now a base objective standard of the reasonable person that is qualified by subjective considerations being the corporation’s circumstances and the responsibilities held by that particular director. We still need a mechanism to balance the risk and return calculation and to allow for the fact that this duty will apply to all directors regardless of the size, type or nature of the business.

“**in the corporation’s circumstances**” – In ***ASIC v Rich [2009] NSWSC 1229***, Austin J said this requires an assessment of:

* The type of company (eg is it listed)
* The size and nature of its business
* The terms of its constitution
* The composition of the board
* The distribution of work and responsibility between executives and board
* Whether or not the company is controlled by a parent company

All of these considerations must be factored in to work out what a reasonable person would do in the discharge of their duties.

“**had the same responsibilities within the corporation**” – the standard in s 180 is objective, but subjective elements are introduced via the consideration of the responsibilities of the director.

***ASIC v Rich* [2009] NSWSC 1229** – ‘responsibilities’ refers to factual arrangements within the company, not just legal duties. This includes:

* Specific tasks delegated to the director
* Way in which work is distributed within the company
* The particular director’s experience and skills

Having regard to the circumstances of the company and the role the particular person has in the company, consider what a reasonable person would have done in the circumstances.

### Statutory Duty of Care: Skill

In the common law formulation, it is the duty of care, skill and diligence however s 180 only discusses care and diligence. The courts have held that ‘skill’ is implicit in s 180 – in order to exercise the degree of care required, you must have certain skills: ***ASIC v Vines* [2003] NSWSC 1116**

The standard of skill expected of a director depends upon whether the person is an executive or non-executive director and whether the person has special qualifications.

Directors with special skills are held to the standard of a person professing to have those skills – ***Gold Ribbon (Accountants) P/L v Sheers* [2006] QCA 335**). If you are on the board and are the partner of a major accounting firm, you are expected to deploy the skills you have as an accountant in discharging your duties as a director – he/she appointed to the board for their commercial acumen. This only works to raise the standard and not to lower it – minimum standard increased by virtue of special skills.

Executive directors’ greater involvement in the business of the company leads to an expectation of greater knowledge, focus and awareness.

#### What is the standard applicable to non-executive directors?

There are two choices:

* Independent directors should be treated as everybody else so that all directors held to same standards
* Independent directors are part time and have limited knowledge and must rely upon executives for their information and therefore should be held to a lower standard

***ASIC v Macdonald (No 11)* (2009) 71 ACSR 368**: ‘The law has not yet established the extent to which the position of a non-executive director shapes the content of the duty of care.’

***NB: Macdonald (No 11)* (2009)** was appealed, but Gzell J what said about limits of permissible delegation by non-executive directors remains good law.

Sections 198D, 189 (dealing with reliance) and 190 (dealing with delegation) are a legislative response to demanding standards imposed by NSWCA in ***AWA* case**.

***ASIC v Macdonald (No 11)* (2009) 71 ACSR 368**

The non-executive directors ought to have asked to see the text of the announcements made and the fact that they did not meant that they did not meet the standard of care.

Concerning the **non-executive directors**, Gzell J found that their failure to discharge their monitoring role amounted to a breach of their duty under s 180(1), stating (at 261) that:

[i]t was part of the function of the directors in monitoring the management of the company to settle the terms of the draft ASX announcement to ensure that it did not assert that the Foundation had sufficient funds to meet all legitimate compensation claims.

Applying an **objective test** under s 180(1), Gzell J concluded (at 261) that their failure to request a copy of the draft ASX announcement dealing with such a significant matter in the life of JHIL, “to familiarise themselves with its terms”, or “to abstain from voting” was inconsistent with the actions of “a reasonable person in their shoes with their responsibilities”

The law is uncertain as to whether executive and non-executive directors are held to the same standards. It is within the scope of the interpretation of the section to introduce a differential standard but the courts are not sure if this is appropriate.

#### Common Specific Board Roles

There may be differential standards based on the particular role or particular function that a particular director may perform in the company – this is something taken into account as part of applying s 181(b) of the Corporations Act.

Chair of the Board:***ASIC v Rich***

The Chair’s role is one of making sure that the board is properly informed and the board functions to do its duty of monitoring. In this case, it was found that the chair did not fulfil that function properly and was therefore liable. The chair of the board was also the chair of the audit committee – it is not clear if Justin Austin was looking at a person who was just a chair or a person who was a chair and a member of the audit committee

Audit Committee – ***ASIC v Healey* [2011] FCA 717**

Being a member of the audit committee does entail additional responsibilities because you are most closely associated with the company’s financial performance and position. The responsibility to understand what is going on, to ask questions and to obtain information will be higher than directors who are not part of the audit sub-committee.

In this case, members of the subcommittee admitted that they had not read the accounts because they were complex and had simply gone off what the CFO told them. Audit committee members must be more diligent and bring more financial acumen than a member of the board who is not part of the audit committee.

General Counsel – ***Shafron v ASIC* (2012) 247 CLR** **465**

In this case, the HC held that the person was liable for breaching the duty of care but the facts are confused. The person who was the GC was also a Company Secretary so it isn’t clear if the HC comments were directed to the role of GC or the role of CS.

## Diligence

Diligence means actively monitoring – reading board papers and attending board meetings. Until the early 1990’s, it was common to find a small business being run by a husband and wife (husband ran business and wife added as director – spread income for tax incomes but the wife was not intended to have any role in the running of the business). When these companies went bust, the wife argued that she was an absentee director, did not know what was going on and could be not liable. This works under the old standard but not under the new standard. You cannot say you did not know because you did not take an interest and did not actively monitor.

The degree of diligence required of a director will vary according to the circumstances of the director’s appointment, but all directors must exercise the amount of diligence that would allow them to be familiar with the operations of the company’s business and keep informed about the financial status of the company.

***Sheahan v Verco* (2001) 19 ACLC 814**

## Duty of Care – By the Back Door

In some recent cases, directors have been held liable for a breach of s180 for allowing their company to contravene the law. Breach of the law is a ‘stepping stone’ to imposing liability of directors. ASIC brought a number of cases for breach of s 180(1) that were based on the directors having allowed the company to breach some other provision of the act or some other law (e.g. disclosure provisions of Corporations Act). This is an unsettled area of law. The liability under the act is one imposed upon the company – should we allow this liability to be extended to the directors personally by this strategy?

***ASIC v Mariner Corp Ltd* [2015] FCA 589** and ***ASIC v Cassimatis (No 8)* [2016] FCA 1023**, the courts have sounded a note of caution. This turns upon whether you can say that the directors have an obligation to prevent the company from breaking the law – it is not clear if directors have that obligation.

**R Langford, ‘Corporate culpability, stepping stones and mariner: Contention surrounding directors' duties where the company breaches the law’ (2016) 34 Company and Securities LJ 75**

## Delegation

Inevitably, directors will want to delegate some tasks to other employees and will need to take advice from people (e.g. other employees or professional external advice). The board does not have a day-to-day operational function for mid-sized companies and merely sets overall policy and strategy and monitors the senior executive – rely upon advice provided to it from within the company. The CFO will present accounts to board and the board will delegate implementation of strategy to employees – the act recognises this.

Delegation of tasks by directors to others – authorised by s 198D

Section 190 relieves directors of responsibility for the actions of delegates in certain circumstances: the director believed on reasonable grounds that:

* The delegate would exercise the power in conformity with the duties imposed on directors of the company; and
* The delegate was reliable and competent

Delegation and reliance are necessary parts of the way companies operate. The legal question is how that interrelates with the director’s duty of care – if a director delegates a task to someone who makes a mistake and causes the company loss, should the director retain responsibility for that loss? Does having delegated to person not ideally suited to task, constitute breach of director’s duty of care? Under the old standard, once delegated, the directors absolved itself of all responsibility. The current position is that the directors must retain some responsibility while allowing delegation and reliance – you can delegate but you must believe on reasonable grounds that the person to whom you are delegating will act properly and is competent.

Director’s can delegate but limitations are imposed – you must delegate to the right person for the right task.

## Reliance

If the director’s call for a report, the directors can rely upon the report and thereby discharge their own duty of care only if the director’s reliance was in good faith and the director made an independent assessment of information and advice received – this may require asking more questions or getting a second opinion. If you have no reason to suspect that the advice is not competent, then if you rely on that advice, you have discharged your own duty of care but you cannot simply rubber stamp. This is an attempt to balance between the fact that directors need to rely on advice and retaining accountability for directors.

Reliance on advice from others – authorised by S 189

The director’s reliance on the information or advice is taken to be reasonable, and thus satisfying the director’s duty of care, if the reliance by the director was:

* in good faith; and
* after making an independent assessment of the information or advice, having regard to the director’s knowledge of the corporation and the complexity of the structure and operations of the corporation

***In Re HIH Insurance ASIC v Adler* [2002] NSWSC 171, [372]**

## Statutory Business Judgement Rule

From the mid 1980’s onwards, the standard of care and skill required by directors was ramped up significantly. The business community felt that the standard had been raised too far and unduly restricted the ability of directors to take appropriate business risks. Parliament responded by introducing a business judgment rule in Section 180(2) – creates safe harbour.

*“The fundamental purpose of the BJR is to protect the authority of directors in the exercise of their duties, not to insulate directors from liability. While it is accepted that directors should be subject to a high level of accountability, a failure to expressly acknowledge that directors should not be liable for decisions made in good faith and with due care may lead to failure by the company and its directors to take advantage of opportunities that involve responsible risk-taking.”* - Explanatory Memorandum

This rule works by saying that if you meet the requirements of s 180(2), you are deemed to have satisfied the duty of care under s 180(1). Section 180(2) sets out criteria which must be met.

**SECTION 180**

**Care and diligence – Civil obligation only**

1. *[Business judgement rule] A director or other officer of a corporation who makes a business judgement is taken to meet the requirements of subsection (1), and their equivalent duties at common law and in equity, in respect of the judgement if they:*
   1. *make the judgement in good faith for a proper purpose; and*
   2. *do not have a material personal interest in the subject matter of the judgement; and*
   3. *inform themselves about the subject matter of the judgement to the extent they reasonably believe to be appropriate; and*
   4. *rationally believe that the judgement is in the best interests of the corporation.*

*The director’s or officer’s belief that the judgement is in the best interests of the corporation is a rational one unless the belief is one that no reasonable person in their position would hold.*

If these criteria are met, then the director has satisfied his/her duty of care. The focus seems to be on good faith, no material interest, acting in best interest of company – these reflect the fiduciary standard despite this section relating to the director’s duty of care. This section (s 180(2)) seeks to establish criteria for a procedurally correct decision – the law is no longer concerned with the substance of the decision once the procedural aspects have been satisfied (if you follow the right procedure in reaching the decision, then it does not matter what the decision was). This follows a trend in Australian corporate law which focuses on procedural aspects as opposed to substance of the decision – the law is not in a position to second guess the substance of the decision (whether decision was in best interests of company, etc). The law is more comfortable in setting out a process to reach a decision and by identifying the criteria by which you should reach that decision, we can guarantee that most concerns will be met (concerned that directors might act improperly – good faith, no personal interest).

The BJR is ultimately derived from the law of the US. There is a **general principle** that courts do not substitute their business judgment for that of directors. This is now also reflected in **s 180(2)**

A director will meet the duty of care if they:

* Make the decision in good faith and for a proper purpose
* Do not have a material personal interest in the decision
* Inform themselves about the subject matter of the judgment
* Rationally believe the decision is in the best interests of the company.

The BJR has not been relied upon successfully very often. The only case where a defendant has successfully relied on it on the BJR, is *ASIC v Mariner* [2015] FCA 589 however the ocurt just applied the obiter comments from ASIC v Rich. In obiter, the court also discussed the rule in *ASIC v Rich* (2009) NSWCA 1229 per Austin J. In discussing the terms and application of the BJR, Justice Austin made a number of points:

* BJR is not about mere mistakes and is about significantly negligent and careless conduct. If a director has made a mistake, you ought not to have to rely on BJR because that ought not to have triggered s 180(1)
* The idea of what constitutes a business judgment should be viewed broadly and should encompass not only the decision itself but also the steps leading up to the decision.
* A business decision requires a positive decision not a failure to act. The BJR will not generally apply where a director fails to adequately monitor a company (fail to inform yourself). This significantly limits the scope of application of the BJR and makes it narrower
* The idea that directors must inform themselves – judge in accordance with importance of decision, the time available for the decision and the state of the company’s business at the time (e.g. big decisions require more informing, decisions made under time pressure may require less informing)
* The reference to ‘rationally believe’ is not a reasonable standard and is slightly lower. A rationale decision is less demanding than a reasonable one
* The BJR only applies to s 180(1) and does not apply to common law duties of care, skill and diligence. It is a defence to the statutory, but not common law duties. This also narrows the scope of the BJR

If the criteria in s 180(2) are met, that is a complete answer to the assertion that the directors have not exercised the duty of care and skill.

# Director’s Fiduciary Duties

The function of the fiduciary duties is to create control over the directors the power that we have given them. Directors are vested with wide power and autonomy to manage the company and then control the exercise of that power and discretion of the directors by imposing upon them duties as to how they exercise those powers and to what end. We are concerned with directors exercising powers for their own benefit as opposed to the benefit of the company – combat agency problem.

Remember that the power to decide what is in the best interests of the company and to manage the company is vested in the directors, not the courts. It is not appropriate for the courts to usurp the director’s decision making authority by substituting their own. There must be a balance between allowing directors to take risks to make money for shareholders but also imposing controls on the risks directors take.

The traditional view is that the duty to act in the best interests of the company, although phrased in positive language, operates negatively to say that you must not act where you have a conflict of interest. The duty to act in the best interest of the company is comprised of the duty to avoid a conflict of interest and the no profit rules (overarching standard). In order to satisfy the duty to act in the best interests of the company, the directors must show that they were not acting subject to a conflict of interest or making a profit for themselves personally – do not need to take positive steps to benefit the company.

In recent years, a different view is emerging in the case law which states that a director who does not have a conflict of interest and is not making a profit, does not automatically satisfy the duty. In some circumstances, the director may have to take positive steps to acquire a benefit for the company or protect the company from a loss.

## Duty of Loyalty

**Common law origin:**

**Re Smith and Fawcett Ltd [1942] Ch 304 (CA)**: the directors of a company must act *‘bona fide in what they consider – not what a court may consider – is in the best interests of the company and not for any collateral purpose’.*

Directors are subject to these duties because they were regarded as being analogous to trustees. Directors are not, in fact trustees in the sense that the company owns the assets and the directors do not hold title to the assets. In a trust context, the beneficiaries are natural persons and when we require the trustee to act in the beneficiary’s interests, we can look to those natural persons and as what their interests are. Where the beneficiary of a duty is a company, it does not have interests in the same way as natural persons - the only interests a company has are the interests ascribed to it and the directors ascribe those interests. Therefore, there is a circular reasoning – the directors must act in the interests of the company but the directors decide what the interests of the company. Therefore, whatever the directors do must be in the interests of the company and there is no control. The courts have tried to combat this by introducing more objectivity into the standard.

The common law standards (***Re Smith v Fawcett***) are basically reflected in s 181.

**SECTION 181**

***Good faith – Civil obligations***

1. *[Good faith – directors and other officers] A director or other officer of a corporation must exercise their powers and discharge their duties:*
   1. *in good faith in the best interests of the corporation; and*
   2. *for a proper purpose.*

Historically, the two limbs (in good faith and proper purpose) were run together. The collateral purpose wording has been reflected in the legislation using the words ‘proper purpose’. The statutory standard has separated the elements into two limbs of one section. The two limbs are regarded as being distinct but closely related.

### Duty to act in best interests of the Company

The court will **not** assume impropriety by directors therefore the onus is always on the claimant (e.g. company, liquidator acting on behalf of company or ASIC)

The duty to act in **good faith** means that the director must act honestly

#### Is the test a subjective or objective one (or a mixture)?

At common law, the test was what the directors and not the court believed to be in the best interests of the company. This was a very subjective standard and in ***Re Smith v Fawcett***, the directors filed affidavits that they honestly believed their actions were in the best interests of the company and the court held that having sworn to that, that was the end of the matter (purely subjective standard).

Purely subjective standards do not impose great restraint and so the law has to deal with situations where objective evidence does not necessarily support the claim. What do you do with a person who is a lunatic but subjectively believes that his/her actions are in the best interest of the company? The court has held that the test is subjective but will consider objective evidence as to the subjective intention of the directors. If you are in a situation where directors claim to have been acting in interests of company but evidence shows that it is highly unlikely that a reasonable director in the same circumstances could have reached that decision, the court will not accept the director’s claims that they were acting honestly and in the best interests of the company. It is not an objective standard but uses objective evidence to measure/determine subjective intent.

#### Is the duty proscriptive or prescriptive?

How do we understand the duty to act in good faith to act in the best interests of the company? Is it a negative duty to say that directors must not act when they have a conflict of interest or positive duty which requires directors to identify what is in the best interests of the company and take steps to pursue that?

In ***Brine v Williams***, the HC (in a non-corporate context) held that the fiduciary duty is proscriptive and does not impose positive obligations. The Court of Appeal in WA in the ***Bell Group cases*** held that in a corporate context, the duty was prescriptive and imposed positive obligations. In the non-corporate context, the duties operate proscriptively but in the corporate context, there is a line of authority developing suggesting that directors have positive duties to identify and take decisions which actively benefit the company.

Ross Graham believes that the duty should be proscriptive because the courts are not competent to make decisions about whether the actions of the directors were in the best interests of the company. They are not competent because the right to decide is vested in the directors (courts do not have right to usurp power) and the court does not have business skills and litigation forum is not appropriate to take into account evidence that directors should take into account in making business decisions.

#### What are the interests of the Company?

The courts have tried to look through the corporate veil to find a group of natural persons whose interests they can identify with those of the company. Notwithstanding the fact that the company is a separate legal entity, the courts have looked to the people behind the company in applying fiduciary duties. The courts have held that the company interests will be identified with the interests of a particular group of people involved in the company to give objective content to the interests of the company which the directors are meant to be pursuing.

Traditionally, the courts have looked to the shareholders. The directors owe duties to the company and not shareholders but when we work out what is meant by ‘acting in the company’s interests’, we assume that the company interests align with the interests of shareholders. The duty in effect becomes a duty to act in the interests of shareholders but doctrinally, is a duty owed to the company.

Which shareholders?

Majority of shareholders at time decision made? All shareholders at time of decision? Broader abstraction including present and future shareholders?

The duty to act **in the best interests of the company** means in the “interests of the company as a whole”. The courts have discussed the concept of the company as a whole and this seems to mean a hypothetical shareholder who has attributes of all shareholders (present and future) but is identifiable with no particular shareholders. This probably means present and future shareholders and definitely does not mean the majority at the time of the decision. Some courts have referred to the ‘company as a going concern’ – look to future as well as immediate interests.

In some situations, the courts have held that the interests of the company are not to be assimilated with the interests of the shareholders and sometimes the interests of the company will reflect the interests of other groups, including creditors. It may also include the interests of the **company’s creditors:** *Walker v Wimborne* (1976) 137 CLR 1 and *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722

* Duty to creditors is to consider, but *not* necessarily give priority to interests of creditors, at least until the company becomes insolvent: see, eg, *Bell Group Ltd (in liq) v Westpac Banking Corp (No 9)* [2008] WASC 239 at [4445] per Owen J

A line of authority developed from the mid 1970’s which said that in certain circumstances, when the directors are considering what is in the company’s interest, they must take into account the interests of the company’s creditors ,either as well as shareholders or in substitution of shareholders. This adjustment of the company’s interests probably only occurs when the company is on the brink of insolvency. Once the company hits insolvency, the shareholders no longer have a stake in the company due to limited liability. Once a company is insolvent, the company is trading on the resources provided by the creditors (therefore creditors have greatest stake in what the company does). It is a curious duty – not a duty owed to creditors directly and creditors have no standing to bring a claim (described as imperfect duty). The only way that duty gets vindicated is through an action brought by a liquidator.

There are a range of other stakeholders in a company:

* Employees
* Customers
* Contractors
* The community/environment

This leads toward a stakeholder/communitarian view of the company and its purposes and in whose interests the company should be run. The argument goes that the company should be run for the benefit of society as a whole and the directors should take into account the interests of all stakeholders in making decisions. On one hand, this makes sense especially if you are talking about large companies who can affect people other than those they contract with (e.g. pollution, uprooting factories and destroying local community for which it was primary employer, environmental effects). The idea of companies being socially responsible and having obligations to society makes sense. In Europe, in particular, the idea of companies having social obligations is taken very seriously – this in part reflects the socio-economic philosophy of European countries. Their brand of capitalism is one which has a greater place for social considerations. In the Anglo-Saxon world (UK, US, NZ, Canada, Australia), there is a different view of capitalism and makes these nations less willing to admit that companies should be run for the benefit of society as a whole.

‘Enlightened Shareholder Value’ – this says that the director’s fundamental duty is to benefit the company (e.g. shareholders) but recognises that in order to generate the most benefit for shareholders, directors must also take into consideration their employees, creditors and communities because this is the best way to make profit (e.g. bad reputation, pollution and fines, etc will reduce profits).

In Australia, s 181 does not elaborate on any of these views but as a matter of common law and interpretation, there is room for directors to take into account non-shareholder interest in certain circumstances.

The downside of social responsibility is that we start to lose control. If we say to the directors that their duty is to make profit for shareholders – that is a relatively concrete yardstick to measure what director’s do and control them (e.g. no reasonable director could have thought this action would benefit shareholders and therefore acted incorrectly). Once directors must balance the interests of shareholders, employees, creditors, customers and community general, it is hard to disagree with the way interests were balanced – the concern is that control is lost over directors because the standard they must meet is fuzzier (more complicated assessment).

#### Nominee Directors

Generally, a nominee director is a major shareholder/stakeholder has appointed this person to the board to represent their particular interests. As part of a financing deal, the company’s main bank may ask to appoint someone to the board to look after the bank’s interests. Are these directors entitled to prefer the interests of their appointer over the interest of the company – no. They are a director of the company and must act in the interests of the company not the interest of the appointer.

It is possible for the company’s constitution to provide for someone to appoint a nominee and to adjust the content of the director’s duties at common law. The constitution may provide that majority shareholder X may appoint 1 person to the board and that person may act in the interests of that shareholder. This will adjust the content of fiduciary duties at common law but will not affect statutory duties.

***Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1991] AC 187 (PC)**

#### Interests of the Company in Corporate Groups

The aim of having a group is to have it as a single economic enterprise. The board of the parent company is in charge and the director’s of the subsidiaries are there to do what they are told however the law states that the directors of the subsidiary must act in the interests of the subsidiaries. Even though a decision may be for the benefit of the group as a whole, if it is not to the benefit of the subsidiary, directors will have breached their duty. The courts have recognised this tension and have tried to accommodate.

***Charterbridge Corp Ltd v Lloyds Bank Ltd* (1970) Ch 62** - In this case, the accommodation was to say that providing a reasonable director could see some benefit to the subsidiary of a decision taken in the interests of the group, this will satisfy the duty. This case advocated for an **objective**test: *would an intelligent, honest person in the position of the directors have reasonably believed that the transaction was for the benefit of the separate entity?*

***Walker v Wimborne* (1976) 137 CLR 1** Mason J – **subjective** test, each company in group separate and distinct, duty of directors of Asiatic to consult its interests alone

**Equiticorp Finance Ltd v Bank of New Zealand (1993) 11 ACLC 952** per Clarke and Cripps JA – possible middle ground? (Note: Kirby P dissent) – in this case, the court held that if the directors prefer the interest of the group or other companies in the group over the company over which they are a director, then they are in breach. However if the company suffers no breach, then there is no claim. This is silly reasoning.

In any event, the matter can now be solved because parliament has seen fit to allow directors of subsidiaries to take into account the interest of the parent company (S 187). This only works between subsidiary and parent – allows directors of subsidiary to take into account interests of parent in making decisions. It does not allow the directors of the subsidiary to take into account the wider group of companies or to take into account the interests of sister subsidiaries.

**SECTION 187**

**Directors of wholly owned subsidiaries**

*A director of a corporation that is a wholly owned subsidiary of a body corporate is taken to act in good faith in the best interests of the subsidiary if:*

* 1. *the constitution of the subsidiary expressly authorises the director to act in the best interests of the holding company; and*
  2. *the director acts in good faith in the best interests of the holding company; and*
  3. *the subsidiary is not insolvent at the time the director acts and does not become insolvent because of the director’s act.*

The equivalent provision in the NZ act allows group and sister subsidiary interests to be taken into account.

### Duty to act for a Proper Purpose

A director of a company must exercise their powers and discharge their duties for a proper purpose. Most cases have concerned the use of directors’ fiduciary power (under 124(1) and s 198A(1)) to issue shares to affect the outcome of a hostile takeover – but the principle is a general one. In this context, directors’ duties have been superseded by specific regulation relating to takeovers, and the question of directors’ duties will **not** arise during the course of the takeover: see Ch 6 CA

The duty to act for a proper purpose is a general duty imposed on directors and will apply to the exercise of any fiduciary power exercised by the director or all exercises of management power by directors (e.g. lending or borrowing money, registering the transfer of shares, buying or selling assets, enter into contracts, etc). The two limbs are separate because the duty to act in the company’s best interests is concerned with the director’s motives and intentions and the reasons they were acting and is largely subjective. Proper purposes are about the scope of the power which the director is purported to exercise and is about whether the directors had the power to do what they tried to do. Since this is about the scope of power, it tends to be objective.

A director who subjectively acted in what he/she thought was in the best interest of the power, may still acted for an improper purpose because the director exceeded scope of power which had been conferred. In a trust context (equitable context), this is referred to as the doctrine of fraud on a power. The idea behind proper purposes is that powers are given to achieve certain ends/outcomes and the holder of the power is limited in what they can do with that power to the purposes for which it was given. If a director is given a power to achieve outcomes A, B and C and the director uses that power to achieve outcome D, then the director has exceeded the scope of the power conferred. This results in the exercise of power being regarded as void in equity.

There is an analogy with the doctrine of ultra vires in administrative law. Equity tends to be concerned with hidden objectives (e.g. director given power to allot shares and does so – proper purposes will ask whether there was a hidden purpose/collateral purpose). Is the power directors are given to allot shares one that can be used to defeat a takeover or is this an impermissible collateral purpose beyond the scope for which power granted?

**Leading case on ‘proper purpose’ is *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 (PC)**

Facts: In this case, Ampol wanted to affect a takeover of RW Miller Holdings Ltd and gave notice of its intention to takeover (already held 30% of the shares). Howard Smith was an ally of RW Miller and the directors of the two companies understood that the only reason Ampol wanted to take over Miller was to gain access to its fleet of oil tankers. The directors (HS and RWM) agreed that this would not be a good thing for RW Miller and hatched a plan to defeat the takeover. The plan was for HS to make a competing takeover bid for Millers and to ensure that the takeover was won by HS. The directors of Miller issued a large parcel of shares to HS which meant that Ampol could never get enough shares to become a majority shareholder and therefore there was no point in pursuing a takeover. Ampol objected and challenged the allotment of shares by the directors of Miller.

Held: The Privy Council held that the allotment of shares was for an improper purpose and therefore the directors were in breach of their duty. The PC accepted the directors of Miller’s assurance that they were acting in the best interests of the company because they believed that the takeover by Ampol was not in the best interests of RW Miller.

The PC also held that this was irrelevant to the question of proper purposes and that question posed a different standard. The way to approach the proper purposes question is through a two stage approach:

* 1. ascertain what the particular power in question is and the legal purposes for which this power may be used (question of law); and
  2. examine the facts of the case and the intentions of the directors and decide what was the actual/ ‘substantial’ purpose for which the directors exercised the power (question of fact)

In this case, the directors of Millers never made a secret of the fact that they were acting to frustrate the takeover by Ampol because they believed that was not in the interests of the company. The reason the directors acted (factual question) was not difficult – directors basically admitted this.

The first question asks what is the proper purpose of the power to allot shares?

Ampol argued that the only proper purpose of the power to allot shares is to raise capital. The PC disagreed and held that there may be other purposes for which you may allot shares. It was not possible to create a list of those purposes but it was possible to identify improper purposes.

Millers and Howard Smith argued that as long as the directors were acting in what they believed to be in the best interests of the company, they must have been acting for a proper purpose because ultimately the only purpose for which directors are given these powers is to benefit the company – if they benefited company, it must have been proper purpose. Unless there is some limitation on the face of the power, the only proper purpose of the power is to benefit the company (Canadian Case Authority). If the company constitution had an express power which allowed directors to allot shares but only with the approval of existing shareholders – that would be a limitation on the face of the power and would prevent the directors from doing some things. In the absence of limitation, the only proper purpose was to benefit company.

The Privy Council held that the power to allot shares had specific purposes and so the Canadian authority did not apply.

Final Decision: The directors have been given power to run the company’s business and the power to allot shares is a power to be used to run the business. The shareholders have been given the ultimate power to decide the control of the company (decide whether to reject or accept takeover because takeover offer is an offer to buy their shares). The PC held that those two spheres of power cannot be allowed to frustrate the other – the directors powers of managing the company cannot be allowed to frustrate the shareholder’s power to determine ultimate control. Therefore, the directors, when given the power to allot shares, could not have been given that power for the purposes of defeating a takeover because whether or not to accept a takeover is a matter for the shareholders.

Many of these cases turn on how the director’s justification is presented (best interests of company).

One of the problems with the proper purposes doctrine turns on the court’s interpretation of the particular power in the context and so it becomes difficult to predict what the court will say the proper purposes of the power are. You cannot conduct yourself on the basis of what is proper or improper because you do not know until it has been decided.

Directors are usually given the power to issue shares. This power may be exercised for a number of proper purposes:

* to raise capital: *Howard Smith v Ampol*
* to provide employees with a financial incentive to work in the interests of the company, through providing them with an employee share plan: *Mills v Mills* (1938) 60 CLR 150
* to enter into a joint venture with another company by issuing shares to that company where this ensures long term stability for the company issuing the shares: *Darvall v Nth Sydney Brick and Tile Co Ltd (1989)* 16 NSWLR 260

Issuing shares for an improper purpose would include issuing shares:

* to dilute the shareholding of a member: *Howard Smith*
* to entrench control of the company in certain shareholders by issuing them more shares
* to enable directors to maintain control of the company; *Mills v Mills*

#### Mixed Purposes

Is a decision by a director which as been made for both a proper and an improper purpose still a breach of the duty to act for a proper purpose?

In order to decide whether there is a breach of duty the court must decide which of the proper or improper purposes was the most important; it must be shown that the **‘substantial’ purpose** was improper: ***Mills v Mills***

More recently, the courts have preferred the **‘but for’ test**, ie, but for the improper purpose, the director would not have exercised the power: see ***Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285**

In this case, a family company (Carlton Hotels) and the outgong patriarch of the family decided that his male offspring were appropriate to take over the business but female offspring were not. He called shares to be allotted to the boys, not the girls, to facilitate this.

#### Summary - Proper Purpose

Directors must always act honestly and if it clear that they are exercising power out of self interest, then they will fail at the first hurdle. Proper purposes only kick in as an independent doctrine where you have a decision which is otherwise in the interests of the company but may not be within the scope of the powers given. If there is a limitation on the face of the power (written into the power), that is an obvious limitation but there may also be implied limitations (inferred from power in context of constitutional arrangements – **Whitehouse Case**). Given that the PC (in **Whitehouse**) did not say the Canadian authority was wrong, there may be cases where there is no limitation on face of power and no implied limitation and therefore the only proper purpose for which the power must be exercised is to benefit the company. At that point, proper purposes and duty to act in best interests of company merge.

## Duty to avoid conflicts of interest

These are duties which apply to trustees and any fiduciary in any context (corporate or not) and therefore is an application of general equitable principles to companies. The overarching duty to act in the best interests of the company means that directors must not act where they are subject to a conflict of interest. The proscriptive requirement that the directors not act for a conflict of interest is manifested in the 3 sub rules below. There are 3 common types of conflict of interest:

* **Sub-Rule 1**: **No Conflict** - Directors must not have a personal interest (or engagement with a third party) which conflicts with their duty to the company **except** with the company’s fully informed consent
  + Duty owed to third party inconsistent to duty owed to company
* **Sub-Rule 2**: **No Profit** - Directors must not misuse their position for their own or a third party’s advantage **except** with the company’s fully informed consent
  + Make personal profit by using position in the company
* **Sub-Rule 2A:** **Corporate Opportunities** - must not misappropriate the company’s “property” for their own or a third party’s benefit
  + Must not use company’s information or property to generate profit for themselves (including not taking business opportunities that would otherwise flow to the company)

### Conflicts – Sub Rule 1

*Directors must not have a personal interest (or engagement with a third party) which conflicts with their duty to the company* **except** *with the company’s fully informed consent*

Typically, this arises where there is a conflict of interest between the director’s interest and company’s interests (e.g. director selling his/her own property to the company). As the owner of the land, the director wants to get the best price for himself but as a director of the company, his duty is to get the best price for the company. The law says that you must not allow a conflict of interest to exist and if one does exist, you must disclose it to the company. If the company knows of the conflict of interest, it can take that into account.

* This rule concerns the relationship between the **company and the director**

At common law, the directors had to disclose to the general meeting and a failure to do so would mean the director was at breach and the transaction between the company and director would be set aside. This has been subject to statutory modification in Australia and there is a sub regime in sections 194-5 which replaces the common law.

**Material personal interest – Director’s duty to disclose**

* + 1. *[Director’s duty to notify other directors of material personal interest when conflict arises] A director of a company who has a material personal interest in a matter that relates to the affairs of the company must give the other directors notice of the interest unless subsection (2) says otherwise.*

Directors must disclose to other directors – it can be a standing disclosure (disclosure register)

Then there is the question of the director’s continuing involvement in the decision to which the conflict relates – different rules for proprietary and public companies.

In a proprietary company, once you have disclosed, you can carry on as part of the decision making process. In public companies, once you have disclosed, it is up to the other directors to decide if you can continue to be involved in the decision making process – the decision is that other directors must discharge having regard to their duties to act in the best interests of the company.

**SECTION 194**

**Voting and completion of transactions – Directors of proprietary companies**

**(*Replaceable rule – See section 135*)**

*If a director of a proprietary company has a material personal interest in a matter that relates to the affairs of the company and:*

* 1. *under section 191 the director discloses the nature and extent of the interest and its relation to the affairs of the company at a meeting of the directors; or*
  2. *the interest is not one that needs to be disclosed under section 191;*

*then:*

* 1. *the director may vote on matters that relate to the interest; and*
  2. *any transactions that relate to the interest may proceed; and*
  3. *the director may retain benefits under the transaction even though the director has the interest; and*
  4. *the company cannot avoid the transaction merely because of the existence of the interest.*

*If disclosure is required under section 191, paragraphs (e) and (f) apply only if the disclosure is made before the transaction is entered into.*

**SECTION 195**

**Restrictions on voting – Directors of public companies only**

1. *[Restrictions on voting and being present] A director of a public company who has a material personal interest in a matter that is being considered at a director’s meeting must not:* 
   1. *be present while the matter is being considered at the meeting; or*
   2. *vote on the matter.*
2. *[Participation with approval of other directors] The director may be present and vote if directors who do not have a material personal interest in the matter have passed a resolution that:*
   1. *identifies the director, the nature and extent of the director’s interest in the matter and its relation to the affairs of the company; and*
   2. *states that those directors are satisfied that the interest should not disqualify the director from voting or being present.*

The modern statutory regime recognises the conflicts of interest occur and seeks to manage the conflict of interest whereas the common law simply sought to prohibit the conflict of interest.

### Conflicts – Sub Rule 2

*Directors must not misuse their position for their own or a third party’s advantage* **except** *with the company’s fully informed consent*

You cannot use your position to make a profit for yourself. The no-profit rule tends to apply where the benefit the director receives comes from a third party. Suppose the company wants to buy land and a third party says to one of the directors that if he/she persuades board to buy land, we will give you a commission or fee. The law says you must not do that because it means you are not acting in the interests of the company and your decision as a director as to whether the company should buy the land is being swayed by your own interest in the transaction.

This is referred to as the ‘**no-profit**’ rule and applies to **director-third party** situations

***Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378 (HL)** – In this case, it was accepted that the directors were acting honestly and were not seeking to make a secret profit. In this case, the company had an opportunity to take up further leases of some cinemas but the company did not have sufficient finances to do so. As a result, the directors personally put money in to take up leases in their own names and eventually sold leases and personally made profit. Although they were acting for the benefit of a company, they made a profit out of their position.

Note: The shareholders in general meeting could ratify the conflict of interest at common law.

#### Corporate Opportunities

Suppose the director is at the golf club and after a round of club with fellow businesspeople overhears a discussion about a business opportunity. It is an opportunity in line with the company’s business – can that director pursue that opportunity personally or must they refer that opportunity to the company? If the opportunity came to that person in their capacity as a director or because of their position as a director, then the law states that that opportunity belongs to the company.

Were you there as a representative of the company or on your day off?

***Cook v Deeks* [1916] 1 AC 554** - This case involved building railways in Canada. Cook, Deeks and Hind had been involved in a company that contracted to build railways for various Canadian railway companies. At some point, Deeks and Hind decided that they did not like Cook anymore and in the process of negotiating contracts, they said that they wanted the contract for themselves and wanted to set up another company to run it (didn’t want existing company to run it). The court held this was clearly an opportunity that should have gone to the company and was usurped by the directors and therefore they breached their duty.

***Queensland Mines v Hudson* (1978) 18 ALR 1**– the company could have taken up mining licenses but did not have finances to do so. The directors did so in a personal capacity and disclosed to the rest of the board what they were proposing and the board consented. Since they had disclosed, it was not a breach of their duty.The board must make an assessment about whether allowing directors to take up the opportunity, even if they cannot, is in the best interests of the company (are they just creating a competitor).

* Does it matter that the company is unable to pursue the profit-maximising activity?
  + No, it can still constitute a breach of duty: Regal Hastings and Cooke Cases
* What effect does the director resigning have?
  + A director cannot resign to avoid director’s obligations and take up opportunity independently
* Can directors pursue opportunities they become aware of in a ‘private’ capacity?
  + In principle, this is permissible but you must ask questions about how the directors came across the opportunity (what capacity)
* Is it open to the director to prove that the transaction is ‘fair’ to the company?
  + No, it is not about whether it is fair to the company and is about proscribing the temptation on the part of directors to act self-interestedly

#### Statutory Duty not to Profit from Position or Information

The conflict of interest rules are now reflected in the Corporations Act: ss 182-3. These rules essentially state the common law position and common law is relevant to understanding substance of the rules.

Directors are **not** allowed to use:

* their position (s 182), or
* information obtained in that position (s 183)

to gain advantage for themselves or someone else, or to cause detriment to company

* No need for directors to actually profit/make a gain
* S 182 and 183 reflect common law

Director’s duties now exist at both common law and under statute. Generally, they are the same but with some notable differences:

* Conflict of interest rules changed fundamentally by statute

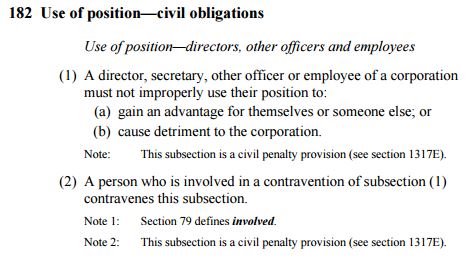
Suppose A holds multiple directorships. What happens when those two companies enter into a transaction together? What does the person who is a director of both companies do? There is clearly a conflict of interest. The directors may seek to recuse themselves from discussions of both problems however the law states that the director’s have a duty to give the company they are a director of the benefit of their views and therefore cannot just not participate. These days, this issue would be handled by the disclosure regime under statute. The disclosure regime in s 191-5 is a facilitative approach rather than a prohibitive approach (about managing inevitability of problems in way which produces satisfactory outcome).

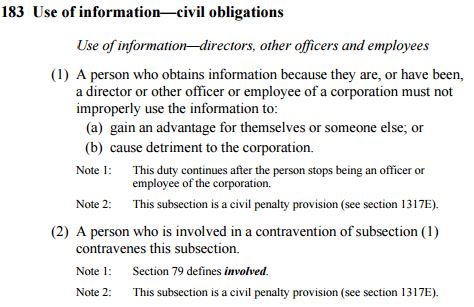
Australia’s director’s duties regime largely reflects the common law.

## Statutory Duty not to Profit from Position or Information

Some of the duties (including those in s 180-181) are a codification of the general law duties. Sections 182-183 are different to the general law.

Section 182 is a statutory version of the fiduciary principle applied in ***Regal Hastings v Gulliver*** that directors are under a duty not to make undisclosed profits from their position causing harm to the company.

This is broader than the general law position and covers employees and company officers. These personnel cannot gain advantage for themselves or someone else (third parties) or cause detriment to the company.

Sections 182 and 183 are quite different to equity and most of the time, what is caught under the general law will be caught by these sections. However, the effect of these sections are much broader covering third parties and causing detriment to others.

***ASIC v Vizard (2005) 154 FCR 57*** – This case concerned the businessman Steve Vizard who was a director of Telstra. He had used confidential information that he obtained as a director of Telstra to trade in shares that Telstra had an interest. It was a convoluted scheme whereby he had instructed his accountant to set up a company that would make the trades and the profit would go into the name of the company but eventually find itself in Vizard’s hands. He didn’t actually profit from the transactions but was held to have breached the duty to be properly using information.

**Commentary**: In the case law, there is no need for directors to actually make a profit or to prove that a loss has been caused to the company – the key to these provisions is the purpose of the director’s actions. If that purpose is seen as improper, then s 183 (in this case) will be breached.

**Decision**: The judge held that Mr V was a director of a public company and owed his position to the fact that people had trust and confidence that he could carry his duties in an appropriate way and he had breached that trust. The court also found that there were three contraventions and were concealed because the transactions were convoluted. The court held that there was dishonesty (no requirement to prove dishonesty) and as a result of the case, civil penalty sanctions were imposed on Mr V and he was banned from being a company director for 10 years and was ordered to pay $390,000 by way of pecuniary penalties. There was no compensation payable because the company had not suffered any detriment.

In many cases that concern breaches of the duties in sections 182 and 183, there will often be breaches of other duties as well.

***ASIC v Adler (2002) 41 ACSR 72*** – There was a $10M payment made by HIH Casualty and General Insurance (HIHC) (a wholly owned subsidiary of HIH Insurance) to Pacific Eagle Equity (PEE), a company controlled by Rodney Adler (director of HIH). The 3 directors involved in the transaction were Adler, Williams (CEO) and Fodera (CFO) – Williams and Fodera were also directors of HIHC.

The money was invested by PEE as follows:

1. $4 m used to purchase HIH shares on stock market in circumstances where market led to believe Adler using his own funds to purchase shares, not HIH funds;
2. $3.86 m used to purchase various technology stocks from Adler Corporation Pty Ltd (Adler Corp), a company of which Adler was the sole director and Adler and his wife the only shareholders; and
3. $ 2.04 m in unsecured loans to entities associated with Adler and/or Adler Corp

Note: $10 m payment made by HIHC to PEE in such a way that would not come to attention of HIH directors, apart from Adler, Williams and Fodera – undocumented transaction. In addition, no collective disclosure of $10 m payment or subsequent investments by PEE made to Board or Investment Committee of HIHC

**Decision:** As a result, the Santow J at first instance found multiple contraventions:

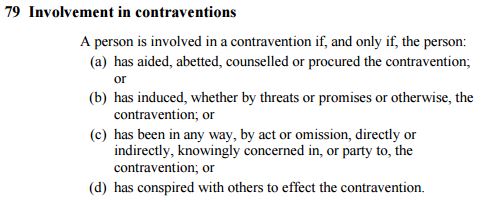
* Adler contravened: s 180(1) (duty of care); s 181(duty of good faith); s 182 (duty not to misuse position); and s 183 (duty not to misuse information)
* Williams contravened: s 180(1); and s 182 (but not s 181).

There is also potential for overlap between ss 182-183 (misuse of information and misuse of position). In ***ASIC v Vizard***, even though only misuse of information was pleaded, the case could have been based on misuse of position. In ***ASIC v Adler***, breaches of both ss 182 and 183 were made.

**See also**: **Grove v Flavel (1986) 11 ACLR 161**

Sections 182 and 183 are civil penalty provisions and therefore attract Part 9.4B and are enforceable by ASIC although the company may also seek compensation under s 1317J(2).

Sections 182(2) and 183(2) apply to anyone who is ‘involved’ in a contravention and are therefore much broader than the equivalent concepts in equity. Section 79 defines ‘involved’, which is also broader than the equity position.



Sections 182-183 developed out of criminal law provisions introduced in Victoria. These do not fit comfortably with common law fiduciary duties. In ***R v Burns***, the High Court held that where a director does an act which he/she knows or ought to know he/she does not have authority to do, that action may be improper.

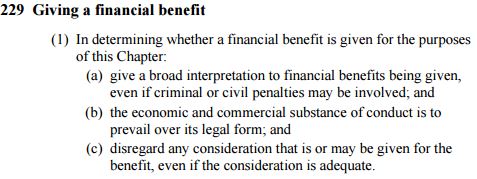
## Financial Benefits to Related Parties

Chapter 2E regulates financial benefits given by a **public company** (or an entity that the public company controls) to its related parties including directors. Chapter 2E specifically applies to public companies only.

Chapter 2E gives the disinterested shareholder a primary rule. Section 208 requires **member** approvalbefore a benefit is given to a related party in accordance with s 217-227. The benefit must be given within a 15 month period after the approval is given.

The purpose of Chapter 2E is set out in s 207 which states that the rules in this chapter are designed to protect the interests of a public company’s members as a whole, by requiring member approval for giving financial benefits to related parties that could endanger their interests.

Section 228 defines ‘related party’ and includes directors (of any entity that controls the public company). Control is defined in s 50AA as having the capacity to determine the outcome of decisions about the entity’s financial and operating policies. If the public company is controlled by an entity that is not a body corporate, each of the persons making up the controlling entity. It also includes spouses of directors but s 228(3) goes further and covers parents and children of directors and entities controlled by any of these people.

Section 229 gives examples of ‘financial benefit’. Financial benefits are not strictly defined and s 229 gives instructions about how the phrase ‘financial benefit’ is to be interpreted. Subsection 3 lists a number of examples of financial benefits including the giving or providing finance or property to a related party, buying/selling/leasing asset, providing or receiving services, issuing securities, taking up or releasing obligations.

Section 217 sets out the procedure for obtaining member approval. Sections 218-223 set out the information that must be given to the shareholders. Disclosure material that one intends to send to the shareholders must first be reviewed by ASIC. This gives ASIC the opportunity to provide members with comments about the disclosure. A majority of the members must approve.

Section 224(1) excludes certain parties from voting on resolutions that seek to give financial benefit (e.g. related party that is to receive the benefit or an associate of such a person cannot vote). Subsection (6) goes on to say that if a party does vote in contravention of subsection (1), then the related party who votes will contravene the subsection whether the proposed resolution is passed or not.

Associate is defined in s 10-17 and includes persons acting in concert with the related party. Anyone who is part of a scheme is an associate.

Section 225 states that a person who votes in contravention of section 224(1) causes the resolution to be passed, then the resolution will be invalid.

Sections 210- 216 sets out the exceptions to the member approval requirement. The most important is found in s 210 and states that member approval is not required if a benefit would have bene given on terms that would be reasonable if the parties are dealing together at arm’s length or the terms are less favourable to the related party. If it is an arm’s length transaction, then member approval may not be required. In ***ASIC v Adler***, Justice Santow discussed what was meant by reasonable and held that it was not reasonable that a purchase of shares in the parent company be paid by its wholly owned subsidiary without any legal documentation or prospect of security – not arm’s length transactions. Other exceptions include if it is reasonable remuneration to a director or company officer under section 211.

Section 209 deals with **consequences** of breach. Subsection (1) states that if a public company breaches section 208 (no member approval and not exception), then the contravention does not affect the validity of the contract or transaction (and the public company is not guilty of an offence) but anyone involved in a contravention (s 79 definition of involved) of s 208 contravenes s 209. Section 209 is also a civil penalty provision. This means that ASIC can pursue a claim under s 1317J(1) and the Company can sue for compensation pursuant to 1317J(2). This section has rarely been used in reported cases but was pleaded in ***ASIC v Adler***where the directors committed multiple breaches and one was under Chapter 2E *–* the $10M payment was considered an interest free unsecured loan and amounted to HIHC giving a financial benefit to PPE, Adler Corporation and Adler (within meaning of s 209) and the court held that PEE, Adler Corporation and Adler were all related parties of HIH.

## Enforcing Duties

The statutory provisions are civil penalty provisions – in most cases, where enforcement occurs, ASIC will bring civil penalty proceedings. Section 184 allows criminal proceedings to be brought when the criminal elements of the offence can be proved (i.e. mental element). Main difference between general law and statutory duties is who enforces the duties. The focus of this topic will be on the enforcement of statutory duties.

There are three ways to enforce director’s duties.

* **General Law**: Enforcement of the general law duties is by ***the* *company***, which may seek a range of civil remedies.
* **Statutory Duties**: Enforcement of the statutory duties is primarily by ***ASIC***, which may seek:
* civil penalties
* criminal penalties

### How are Director’s General Law Duties Enforced?

By ***the board*** – the decision to sue a director/s rests with the board under s 198A. Section 198A grants the directors the power to manage the business of the company. Since the breach is a wrong to the company, it is for the directors to decide whether or not to sue. This can cause problems if the directors are the ones in breach.

This may lead **minority shareholders**, seeking leave, to bring an action in the company’s name (statutory derivative action – Part 2F.1A) or alternately, seek a remedy under the oppression remedy (s 232).

***Liquidator***if company becomes insolvent, then the liquidator can bring misfeasance action in company’s name on behalf of the creditors against director/s. When the company is solvent, the company means the shareholders as a whole however when the company is insolvent or nearing insolvency, the interests of the company will include the interests of the creditors.

ASIC is the primary entity that will bring an action related to breach of the statutory provisions dealing with director’s duties contained in sections 180-183. In terms of regulation, Australia has developed differently as compared to overseas jurisdictions – in the UK, there is no corporate regulator that is similar to ASIC.

### Civil Penalty Provisions

S 1317E: Civil penalty provisions **include**:

* s 180 – duty of care
* s 181 – duty to act in good faith in the best interests of the company and for a proper purpose
* s 182 – duty not to make improper use of position
* s 183 – duty not to make improper use of information
* s 209 – prohibited benefits to related party
* s 588G – duty not to trade while insolvent

But are **not limited** to these provisions and covers things like the market misconduct provisions (e.g. where misleading statements being made to the stock market), the financial assistance provisions, payment of unlawful dividends, etc.

**See** Lipton textbook - Table 13.6.1

Civil penalty provisions are contained in Part 9.4B of the Corporations Act. In the event of breach of a civil penalty provision, **ASIC** (in the first place)may seek a ***declaration of contravention*** from the court: sections 1317E and 1317F and/or **civil penalty orders**:

* a ***pecuniary penalty*** of up to $200,000: section 1317G
* ***disqualification***from managing companies for a period that the court thinks appropriate: section 206C.

Additionally, the court can make a ***compensation order***at the same time as a civil penalty order: section 1317H (includes profits under section 1317H(2)). ASIC can seek compensation or the **Company** can bring proceedings under section 1317J(2) for a compensation order, irrespective of what ASIC does. Instead of both ASIC and Company bringing actions, the two will normally liaise about who is best placed to seek compensation.

1. History and Theory of the Civil Penalty Regime

The Civil Penalty regime was introduced in 1993 but Australia has had a different development from the US and UK. Prior to 1993, there was a criminal penalty regime for breaches of directors’ duties however there were problems with that regime. Criminal law requires a higher standard of proof and the predecessor of ASIC found it was difficult to successfully prosecute and there was an overall sense that the criminal regime was not an efficient way of dealing with corporate misconduct.

The civil penalty regime resulted mainly from the recommendations of the *Cooney* Committee report (1989). Its recommendations were underpinned by ‘strategic regulation theory’/ ‘responsive regulation’ and the ‘pyramid of enforcement’ model. The theory is that responsive regulation provides perspectives on how corporate regulation can be secured most successfully – the theory is that the regulator should speak softly initially (i.e. using sanctions, education, infringement notices) and as the behaviour becomes more serious, use more serious sanctions (criminal sanctions reserved purely for conduct that is criminal). In most situations, ASIC will bring civil proceedings but still retains the power to bring criminal proceedings where there has been criminal conduct.

In ***ASIC v Adler***, criminal proceedings were subsequently brought (after civil penalty proceedings) against the three main directors (Adler, Williams and Fodera) – all of whom served jail time.

The Corporate Law Economic Reform Act 1999 (Cth) (CLERP Act) repealed the original regime and introduced a new Part 9.4B in March 2000 (i.e. the current regime). The CLERP Act also re-wrote the directors’ duties provisions (now found in ss 180-184) The initial drafting of the provisions made it unclear as to when ASIC should institute criminal or civil penalty provisions however now, s 184 deals specifically with when a breach of director’s duties will be a criminal offence. This occurs when mental elements are present – fraud, dishonestly and recklessness.

*“[T]he current regime of corporate regulation is, as the Cooney Committee’s report observed (at 190), characterised by a ‘pyramid of enforcement’. The basic premise is that to deter breaches of the legislation, there should be various levels of enforcement that correspond to the seriousness of the contravention. There are three levels to this pyramid: civil remedies at the base, civil penalties in the middle and criminal sanctions at the top.”*

See ***ASIC v HLP Financial Planning (Aust) Pty Ltd (2007) 164 FCR 487*** at 501 (Finkelstein J) (emphasis added). See also, eg, **ASIC v Morley (2010) 274 ALR 205** at 331 [692] (Spigelman CJ, Beazley and Giles JJA).

### Civil Penalty Orders

Consequent upon ASIC in a successful case, obtaining a declaration of contravention, the civil penalty orders are **pecuniary penalties** of up to $200,000: section 1317G. In ***ASIC v Vizard***, Vizard was ordered to pay pecuniary penalty of $390,000 ($100,000 for each breach). For a pecuniary penalty to be imposed, the contravention must be serious.

In regards to **disqualification orders**, the court must feel that the banning order is justified and will disqualify a director from managing companies for a period that the court thinks appropriate: section 206C.

The civil rules of evidence and procedure apply in civil penalty proceedings: s 1317L. The standard of proof is on the civil standard (on balance of probabilities): s 1332 and not the criminal standard (beyond a reasonable doubt): s 13.2 of the Criminal Code Act 1995 (Cth)

The ***Briginshaw v Briginshaw (1938) 60 CLR 336*** (at 361-366) case made the onus of proof higher than the civil standard and in some cases, the courts have been confused about whether the proceedings are penal or otherwise (due to use of word ‘penalty’) and what rules of evidence and procedure should apply.

1. Criminal Sanctions

If the duties are committed with the additional mental elements of intention or dishonestly, ASIC can liaise with the DPP and prosecute the matter.

* *If* breaches of any of the following duties are committed **intentionally, recklessly or dishonestly**, ASIC/Cth DPP can prosecute and a criminal penalty may be incurred:
  + s 184(1) – duty to act in good faith in the best interests of the company and for a proper purpose
  + s 184(2) – duty not to make improper use of position
  + s 184(3) – duty not to make improper use of information
  + s 588G(3) – duty not to trade while insolvent
* Criminal penalties include:
  + fines of up to $220,000 OR
  + up to 5 years’ jail OR
  + Both: s 1311, Sch 3

Section 180(1) cannot be breached in a criminal way and only civil penalty proceedings can be brought. Section 180(1) is about whether the directors have acted negligently. There are concerns about the short jail terms imposed by the Corporations Act as compared to those imposed in overseas jurisdictions and about the low value of fines.

### ASIC’s Enforcement Record Since 2000

* HIH
* Water Wheel
* One.Tel
* James Hardie
* Centro
* Australian Wheat Board (AWB)
* Storm Financial Services

There is the concern about the low level of penalties under the Corporations Act but also about the court imposing light penalties. Courts imposing ‘light’ penalties:

* ***Gillfillan v ASIC (2012) 92 ACSR 460***; ***Morley v ASIC [No 2] (2011) 83 ACSR 620*** – When James Hardy restructured to deal with its asbestos liabilities, it set up a foundation. The central allegation revolved around a statement made to the stock market about the foundation being fully funded when it was not – the foundation was set up in 2001 and by 2004, the funds were almost depleted. In that case, ASIC brought proceedings against the directors and the company. The case of ***Gillfillan v ASIC*** concerns the appeal by the non-executive directors to the High Court where the penalties imposed upon them were as low as $20,000. ***Morley v ASIC*** concerned the chief financial officer who was also only penalised $20,000.
* ***ASIC v Healey [No 2] (2011) 196 FCR 430*** – this case involved directors approving false accounts. The court only made declarations of contraventions, penalties were imposed on executive and not non-executive directors because the trial judge felt the reputational damage was enough and there was no need to impose further pecuniary penalties or order them to pay compensation.
* ***ASIC v Ingleby (2013) 275 FLR 171*** – This case concerned one of the AWB directors and involved foreign bribery and corruption. The directors breached their duties by allowing money or bribes being paid to the Iraqi government which were disguised as inland transportation costs. A $30,000 penalty was imposed.

Problems with civil penalty proceedings, especially since ***Rich v ASIC (2004) 220 CLR 129****–* Courts’ treatment of civil penalties as *quasi*-criminal offences

**Other problems**:

Is ASIC fully implementing the pyramid model? Is it prepared to escalate to higher levels and bring civil penalty and criminal proceedings in appropriate cases?

**General problems**, including:

* ASIC overburdened and underfunded?
* Size of penalties (criminal and civil) set too low?
* Range of penalties too limited?

### Exoneration of Director’s Duties by Court

Both sections 1318 and 1317S confer judicial discretion to grant relief from liability where the court is satisfied that a person acted ‘honestly’ and, in the circumstances, ‘ought fairly to be excused’ for their contravention.

According to the case law, these provisions ‘do not exonerate’ the applicant by removing the breach or contravention but operate as a ‘dispensing power’ to excuse the applicant: see, eg, ***Deputy Commissioner of Taxation v Dick* (*2007) 226 FLR* *388*** at [78], cited in ***ASIC v Healey [No 2]*** at [86]

The Cases show very difficult to persuade court to grant relief from liability

* ***ASIC v Adler (No 5) (2002) 42 ACSR 80***
* ***ASIC v Macdonald (No 12) [2009] NSWSC 714 at [22]*** – see LG p 67
* ***ASIC v Healey*** [No 2] at [88]
* ***Morley v ASIC*** [No 2] at 37]
* ***Gillfillan v ASIC*** at [302]

If directors are going to rely on these provisions, they must make a positive case as to why they ought to be excused. The onus is on the director to make a case as to why the court should exercise its discretion and relieve them from liability.

### Ratification by General Meeting

So far, there has been ratification in certain contexts:

1. ***Furs and* *Regal***cases
2. Ch 2E

Now, general ratification:

1. GM can authorise or ratify a breach of duty by ordinary resolution PROVIDED full and frank information given – in advance or *ex post facto*
2. Once breach is ratified, a liquidator or the board cannot cause the company to sue the director from breach of duty
3. So, **ratification by general meeting bars company’s cause of action against director**

## ASIC Guest Lecture by Lesley Symons

### What is ASIC?

ASIC is an independent statutory body and is known as Australia’s corporate, markets and financial services regulator. Globally, ASIC has one of the biggest remits of any regulator in the world because ASIC has a broad role and governs security, financial conduct, and market integrity. ASIC has a responsibility in terms of supervising, regulating and taking action in the corporate regulatory space but is also responsible for financial services and financial advisors. ASIC also has responsibility for market integrity, financial services licensing regime (keeping register), in relation to superannuation, insurance, and so on.

It was established under the *ASIC Act 2001* which requires ASIC to:

* 1. maintain, facilitate and improve the performance of the financial system and entities in it;
  2. promote confident and informed participation by investors and consumers in the financial system; and
  3. enforce and give effect to the law

ASIC has 3 strategic priorities:

1. Confident and informed investors and financial consumers
2. Fair, orderly and transparent financial markets
3. Efficient registration and licensing

In relation to corporate misconduct, ASIC has a broad range of powers depending on the nature of the misconduct involved including engaging with stakeholders, issuing notices, providing guidance and education, liaise with government in terms of law reform, advises government in terms of policy, issue infringement notices, take administrative action (e.g. banning action under s 206; use of enforceable undertakings). Enforceable undertakings is an administrative remedy and cannot be punitive (s 93AA ASIC Act) – it is an administrative power and cannot be used for punitive purposes otherwise the action taken is invalid. You cannot fine somebody as part of an enforceable undertaking. ASIC can also issue a number of interlocutory actions including stop orders and freezing orders and ASIC can wind up companies if it believes the company is insolvent. ASIC can also take criminal action in the most extreme cases.

There are a number of director’s duties contained in the Corporations Act:

1. s 180 – due care and diligence
2. s 181 - good faith and proper purposes/best interests of company
3. s 182 and 183 – misuse of position or information
4. s 184 – breach of s 180-183 recklessly or dishonestly (with some element of foreseeable risk or intention)

Criminal sanctions are for a breach of one of the director’s duties provisions (maximum 5 years imprisonment). Criminal sanctions can also be imposed for breach of the insolvent trading provisions if the mental elements can be proved.

***ASIC v Adler*** – The transactions in question were undocumented and were essentially related party loans. ASIC took criminal action against the 3 director defendants which ultimately resulted in a 4.5 year imprisonment sentence for Adler and Williams and a 3 year sentence for Fodera.

In the United States, there have been other cases. In the Madoff case, there was $65B investor money used for a Ponzi scheme (i.e. borrow from A and pay B). As a result, when the case was prosecuted, he was sentenced to 150 years in prison. In the Enron case, the chairman was sentenced to 25 years in prison.

The government is currently in the process of issuing a consultation paper in relation to the sufficiency/inadequacy of corporate wrongdoing in Australia. ASIC has also appointed a taskforce to investigate raising corporate penalties generally to be in line with international standards, using remedies already available but across different areas within the act (e.g. infringement notices that can currently only be used in relation to market offences), bringing in new remedies like deferred prosecution agreements (agree penalty which acts like suspended sentence – if person/company engages in the conduct during the prosecution agreement, the authority can still take the original action it was going to take and activate the suspended sentence).

ASIC has had some recent successes in relation to Insider Trading Cases.

* Oliver Curtis – June 2016 – insider trading re $1.6 million – sentenced to 2 years imprisonment
* Steven Xiao – March 2016 – former MD of China’s Hanlong Mining – insider trading regarding $2.7 million – sentenced to 8 years imprisonment
* Calvin (Bo Shi) Zhu - Feb 2013 – former VP of Hanlong Mining - insider trading re $1.3 million - sentenced to 2 years & 3 months imprisonment

***James Hardie Proceedings***

**Hardie (the James Hardie Proceedings)** – Duty of Care & Diligence (s180)

* *ASIC v MacDonald (No. 11)* (2009) and the series of appeals from that case (*Morley & Ors v ASIC* (2010), *ASIC v Hellicar* [2012] HCA 17, and *Gillfillan v ASIC* (2012))
* Board’s announcement to the market that a *fully-funded* foundation to be established found to be in breach of director duties under s180 because they *ought to have known* it was misleading – *it was plain on the face of the document given their knowledge*
* Directors unsuccessfully tried to argue that they were entitled to rely on management and expert advice

***Centro Case***

*ASIC v Healey & Ors* [**2011**] FCA 717 – Duty of care and diligence (s180)

* The 2007 annual reports of Centro Properties Group (CNP) and the Centro Retail Group (CER), failed to disclose:
  + Approx. $1.5 billion of short-term liabilities (classified as non-current liabilities);
  + Guarantees of short-term liabilities of an associated company of approx. US $1.75 billion, provided after the balance date; and
  + Approx. $500 million of short-term liabilities (again, classified as non-current).
* Failures not detected by management/external auditors.

Classifying liabilities a non-current changes the perception of a company’s balance sheet and allows a company to portray itself as being much financially ‘healthier’ than it may be in reality.

There are limits to the protection from liability that is afforded by delegation and by reliance on the advice of committees and experts. Directors must use their own skills in their position and do what a reasonable director would do in a similar case. The courts expect that directors have the commercial literacy and acumen to understand the financials of any company you may be a director of.

Directors will remain responsible for the delegate’s action unless they can prove certain matters under s190 of the Act. Directors cannot delegate away their “core, irreducible” responsibilities, which include making the declaration of compliance for financial statements (*Centro*) and approving a market announcements (*James Hardie* at 1st instance, not qualified on appeal).

***Storm Case***

The Storm matter was divided into the following cases, all of which commenced in December 2010:

* Unregistered Managed Investment Scheme (UMIS) – CBA, BOQ and Macquarie
* Doyle Proceedings – BOQ, Senrac & Macquarie
* Cassimatis Proceedings – s180(1) - Due Care & Diligence

**Facts:** Storm was a financial advisory firm and a lot of their business was through word of mouth. By the end of 2008, Storm had up to 14,000 clients (mainly in North Queensland). The Storm Model was a stepping up model – essentially Storm targeted elderly clients who had, usually a lot of money in their home and money in superannuation or other assets. These clients had limited income – e.g. part time librarian and on pension.

In the case of Doyle’s, Storm advised the clients to take $450,000 out of their house and $650,000 out of your super and leverage the money and … From Macquarie to obtain a bigger fund to invest in the market. Storm suggested that the clients take out 7% for Storm fees and invest the remaining money in Storm index funds (index funds track markets - increase in proportion with market growth). This is fine as long as the market keeps growing. Storm also ran a stepping idea – in addition to initial leverage, Storm would recommend stepping up (and investing further) regardless of whether the market went up or down. If the market was going up, it was a good time to buy and if the market went down, it was cheap and therefore also a good time to buy. When the market is going up, everything is fine and Storm told investors the scheme would fund itself and the money they were making as the market went up would pay the fees and interest on the margin line and at the end of the day, the investors would have more money.

The GFC caused the market to go down and the investors got margin clause from the likes of Macquarie (owed money on margin) and could not pay because they had no income or reserves. As a result, they had to crystallise their losses – pull out and essentially lost all their money. The losses that resulted were between $1B-$3B.

ASIC investigated the matter and brought 3 actions against a number of different parties:

1. **Unregistered Managed Investment Scheme** – by running this model, Storm was running a UMIS (scheme ought to have been registered with ASIC). The CBA, BOQ and Macquarie through their lending arrangements were a party to the scheme and were knowingly involved in the running of it and equally liable with Storm
2. **Doyle Proceedings** – Proceedings against BOQ, Franchise in Townsville (Senrac) and Macquarie and alleged that there was:
   * Breach of Contract via the 2004 Banking Code (BOQ) and the 1993 Banking Code (Maquarie)
   * Unconscionable conduct – Under ss 12DA etc. of the *ASIC Act 2001* re Ch 7 of the *Corporations Act 2001*
   * Banks as “linked credit providers” under s73 of the (then) TPA 1974 and therefore; jointly liable with Storm
3. **Cassimatis Proceedings** – These proceedings were against the two directors (sole shareholders in company). ASIC alleged that the Cassimatises breached their duty under s180 by:
   * Causing/permitting Storm to be exposed to legal liability/foreseeable risk of harm
   * Arising from the implementation of the Storm Model (which involved commoditised financial advice to investors & failed to take into account their personal circumstances)

ASIC argued that, by conducting the business in the way the way they did and allowing the company to carry on the model that it did, the directors breached their duty by exposing the Storm company to a reasonably foreseeable risk of being prosecuted by regulators, of civil action being taken by investors and by an administrative action being taken by ASIC (revoking licence).

**OUTCOMES – 2010 TO 2017**

* CBA – UMIS - July 2009 – CBA Resolution Scheme with ASIC - $132 million paid to approx. 1,200 CBA/Storm investors
* CBA – UMIS - Dec 2012 – Settled the UMIS case with ASIC & agreed to pay a further $136 million as compensation
* **CBA – Total compensation agreed = $268 million**
* **BOQ** – UMIS – Settled in Sept 2014 – agreed to pay affected investors approx. **$17 million in compensation**

**Doyle Proceedings – Settled May 2013**

* Full amount recovered for the Doyles of $1.1million but no precedent set because the case was settled
* Macquarie and BOQ contributed to the $1.1 million

**The Richards Class Action (funded by Levitts Solicitors)** **– Settled May 2013**

* Macquarie– Same template as Doyle Proceedings
* Settled and agreed to pay $82.5 million **($72.7m to investors)**
* No further compensation via the UMIS action

**Cassimatis Proceedings**

* Aug 2016 – Emmanuel and Julie Cassimatis found to have breached their directors’ duties under s180 of the Corporations Act 2001
* BUT in relation to approx. 3,000 investors, only one event/breach each found by the Federal Court (only found 1 breach, rather than 3000 breaches)
* Feb 2017 – Sentencing submissions made – Decision on penalty reserved
* Max civil penalty is $200,000 per breach for individuals
* ASIC will also seek director disqualification orders and bans on providing financial services however the director’s were only personally liable for $200,000?

ASIC takes enforcement action when appropriate and within the constraints of existing legislation, court practices and procedures, evidential requirements etc. Directors’ duties continue to be an area of focus for ASIC, and this extends to other “gatekeepers” who may be “knowingly concerned” in such breaches. The sufficiency of the Australian regulatory regime regarding white collar crime and penalties is currently under review.

# Minority Protection

Majority rule and decision making is effective because it prevents the minority from holding out the majority for extraneous reasons (e.g. personal reasons). However, the l**aw uses a variety of techniques to protect minorities, including**:

* Supermajority requirements, eg, special resolution for key decisions
* Statutory exclusion of interested parties from voting, eg, s 208(2)
* Taking legal action for a breach of a general law duty owed by a director or other officer: statutory derivative action: Pt 2F.1A
* Seeking to prevent a variation of class rights: Pt 2F.2
* Section 1324 injunction to stop a director, member of other person contravening CA
* Members seeking to enforce a personal right, eg, right to vote, where directors or majority members are attempting to take away this right
* Taking legal action in cases of ‘fraud on the minority’
* Seeking to wind up the company because it is just and equitable to do so, or because the directors are acting in their own interests: s 461
* \*Oppression: s 232

## Statutory Derivative Action: Pt 2F.1A (esp ss 236-237)

Statutory Derivative Actions were introduced as part of the CLERP Act reforms in March 2000. As far as suing is concerned, the right to sue is a decision of the board (part of management powers under section 198A). Since the board is accountable to the majority shareholders, litigation decisions are often constrained by what the majority wants and the problem is that the directors and majority shareholders are the same people or are colluding or aiming to do something at the expense of the minority. The law developed to give minority shareholders some rights and thereby developed the statutory derivate action.

To bring a statutory derivative action, Pt 2F.1A of the Corporations Act requires person seeking to bring a derivative action on behalf of company to obtain **leave** of the court. Even though the statutory derivative action was developed to give minority shareholders rights, the courts have been reluctant to give minority shareholders leave to bring proceedings in the company’s name.

It does effectively abolish the rule in ***Foss v Harbottle****,* i.e. that the company is the proper plaintiff in proceedings which seek to remedy wrongs done to the company.

Section 236(1) states a person can bring proceedings if they are a (former) member, officer or director if they are given leave under section 237. Section 236(2) states that the proceedings must be brought in the company’s name. Section 236(3) states that all the common law is abolished (i.e. ***Foss v Harbottle***) and section 237 concerns permission and how to apply for leave and states that the court must grant leave if it is satisfied of 5 matters:

1. Probable that company won’t bring proceedings
2. Applicant acting in good faith (not acting out of spite or for some collateral purpose)
   * ***Gosey v Graphic World Holdings*** – the aim of the applicant seeking leave was to force the company to pay dividends and so leave was denied.
   * ***Swanson v Pratt*** – the judge made it clear that the applicant will be acting in good faith if the applicant would suffer real injury or detriment as a current shareholder or director and a remedy could be granted that could redress that harm
3. Best interests of company that applicant be granted leave
   * The explanatory bill to the CLERP Act said that there may be good reasons the directors have decided not to sue other directors for breach of duty. Section 237(3) creates a rebuttable presumption that leave is not in the best interests of the company. The wording of section 237(3) replicates the wording of the business judgment rule (defence to duty of care and diligence). The business judgment rule has been interpreted by the court in ***ASIC v Rich*** where it was held that ‘a rational decision’ is one that is made if the director follows a process of reasoning even if that process is unreasonable. If you satisfy section 237(3), you obtain a rebuttable presumption that granting leave is not in the best interests of the company. If directors have made a good faith business judgement not to sue, it is unlikely that the courts will give a shareholder leave.
   * Person defined as third party not being a related party
4. Serious issue to be tried – this does not require the applicant to prove the substantive issues and aims to prevent frivolous and vexatious claims. An applicant is required to show that a proceeding should be commenced.
5. Notice of proceeding given to company or leave of court obtained.

### Ratification by Members

Section 239(1) states that ratification by the general meeting does not prevent an application for leave but the court may take this into account in deciding what order or judgement to make. Ratification is not conclusive but is a factor the courts will take into account – lowers chances of success if ratification has occurred.

Section 242 gives the court wide discretion to make costs orders (‘any orders it considers appropriate’) and states that an order under this section may require indemnification for the costs of the applicant. This was seen as one of the primary benefits of having statutory derivative action however it has been rare for courts to make costs orders against the company for the application. The court usually states that the costs of leave are costs in the proceedings – paid by unsuccessful party. It is virtually unheard of for an indemnity costs order to be made in favour of an applicant for leave in relation to a substantive litigation.

The courts have been stingy about costs, potentially because they dislike derivative actions and see them as an intrusion on majority rule. The courts view applications for leave as a dispute between minority and majority shareholders. The courts are reluctant to make costs order as this gives credence to the minority shareholders view and amounts to determining the issue. There are certain developments which may change the court’s position – e.g. emergence of litigation funding.

See: ***Fiduciary Limited v Morningstar Research***

Section 50 ASIC Act – As a result of an ASIC investigation, if is appears to ASIC to be in the public interest for a person to begin proceedings for things such as breach of directors duties or fraud, ASIC may cause such a proceeding to be commenced in the person’s name. The proceedings brought against the Westpoint Group of Companies are an example of ASIC bringing action under section 50.

## Injunctions

### Who can apply?

ASIC or a person whose interests have been affected by conduct may apply for an injunction under section 1324 (e.g. creditors). The range of persons who may apply for an injunction was considered in ***BHP v Bell Resources*** where the Victorian Supreme Court held that a person who could apply under section 1324 need not show that personal rights of proprietary or similar nature were or may be affected by the conduct or prove special injury arising from the contravention however an applicant had to establish an interest that went beyond the mere interest of members of the public.

Applying this broad interpretation, one would think that shareholders had standing to apply for an injunction to restrain contraventions of the director’s duty provisions. However in ***Mesenburg v Cord Industrial Recruiters (1996) NSWSC*** expressed doubts about whether section 1324 was required to be used this way and held that shareholders did not have standing to apply for a civil penalty order. The court further held that only ASIC could apply for a civil penalty order or apply for an injunction to restrain breach of director’s duties. There are subsequent cases where the courts have adopted a different approach however the more recent Qld authority of ***McKracken v Phoenix Constructions*** agreed with the ***Messenburg*** approach.

### What can an Injunction be sought for?

Section 1324 applies *only* to breaches of the Corporations Act.

It does not apply to breach of director’s duties but does include conduct regarded as criminal offence under the Corporations Act (e.g. company issues disclosure document with misleading and deceptive statements contravenes section 728 Corporations Act (criminal offence) and section 1324 allows the court to order an injunction to restrain issue of document). It also applies to breaches that are not criminal offences (e.g. reducing capital).

## Personal Actions by Shareholders

### What amounts to personal actions?

* Where shareholders can establish a fiduciary relationship (***Glavanics****).* Normally shareholders do not stand in fiduciary relationships with one another.
  + The ***Glavanics Case*** concerned a small proprietary company that operated more like a quasi partnership (same two people were directors and shareholders of company). One had entered into negotiations to sell the business and did not disclose those negotiations to the other shareholder who wanted to be bought ought of the company. The second shareholder discovered later that an offer had been made and the court held that the first shareholder had breached his fiduciary duty to the second shareholder by not disclosing the negotiations about selling business which would have meant he would have been paid more for his share of business. It is an unusual case and confined to its own facts.
* Where shares have been allotted for an improper purpose and which dilute the member’s shareholding in the company (***Residues Treatment***)
* Where company exercises power to alter constitution in a way that harms some shareholders (***Gambotto***)
* Shareholder’s right to enforce rights as a member under the constitution as a contract (s 140 – company constitution amounts to statutory contract)
  + The right to have your votes at the general meeting counted: ***Pender v Lushington***
  + The right to receive proper, informative notice of meetings: ***Kaye v Croydon Tramway Co***
  + The right to have the appointment of a director made in accordance with the constitution: ***Link Agricultural Pty Ltd v Shanahan; Kraus v JG Lloyd Pty Ltd***
* Shareholder personal rights also given by Corporations Act and include:
  + A member who holds at least 5% of the votes may call a general meeting: s 249F
  + A member has the right to inspect the company’s register of members free of charge: s 173
  + A member has the right to inspect the minute books of meetings of the company’s members free of charge: s 251B

## Fraud on the Minority

This is a general law personal action for ‘fraud on the minority’ (aka equitable limitation on the power of the majority). A share is a right of property. In exercising their right to vote, shareholders are not fiduciaries (and therefore generally can’t be sued for ‘abuse’ of the power in general). This absolute protection needs to be qualified because of the potential for abuse of the majority power.

But when is use of power illegitimate? See LG

***Gambotto v WCP Ltd (1995) HCA:*** Industrial Equity Ltd held 99.7% of the shares in the company WCP Ltd. Mr G was the P in this action and was a minority shareholder in WCP. Industrial Equity wanted to make WCP a wholly owned subsidiary and this would result in administrative and taxation services. The financial benefits were benefited to be more than $4M in tax savings and $300,000 savings in accountancy savings and savings by way of not having to maintain separate share register. There was a meeting of WCP at which the shareholders passed a resolution to amend the constitution of WCP by inserting a new provision:

*Any shareholder who held more than 90% of the shares in WCP had the right to compulsorily acquire the shares of other members.*

The price stated was $1.80 per share and at the time, an independent expert had valued the shares at $1.36. A meeting was held to amend the constitution and the resolution was passed unanimously. Mr G did not attend the meeting and Industrial Equity did not vote – the 3 minority shareholders who represented 8300 shares attended the meeting and supported the amendment. Mr G complained that this action amounted to fraud on the minority and he succeeded.

**Held**: The court found that the amendment to the constitution was invalid and amounted to fraud on the minority.

The court established new legal tests depending on the type of amendment:

* **‘Category 1’ amendments** (amendments to allow **expropriation of shares** by the majority, or the expropriation of ‘valuable proprietary rights attaching to the shares’)
* ‘**Category 2’ amendments**: all other amendments to the constitution giving rise to a **conflict of interests**

**CATEGORY 1**

In relation to Category 1, the judges established a two pronged test:

1. A change in the Constitution which results in the expropriation of the shareholder’s shares must be for a proper purpose; and
2. Be fair in all the circumstances (not oppressive)

The court further held that the onus of proving the test lies on those favouring the expropriation.

***When will expropriation be for a ‘proper purpose’***?

* To prevent harm being done to the company
* If you expropriated shares of minority shareholder who was competing with company, that was proper purpose
* If expropriating shares required to comply with regulations (e.g. company conducting business of television status and renewal of television license depending on company’s entire share capital being held by Australian residents).
* *E.g.* ***Gray Eisdell Timms v Combined Auctions***

In the case of ***Gambotto***, even though the commercial interests of the company were furthered and there were financial benefits, the court held this was not a proper purpose. Considering commercial interests of company would not constitute a proper purpose. For this reason, the amendment was invalid.

What does ‘no oppression’ mean (***Gambotto***)?

* Fairness comprehended two elements: substantive and procedural fairness
  + Procedural fairness required majority shareholders to make full disclosure about all relevant information about amendment including purpose of amendment and explaining other alternatives and why they have not been pursued, obtaining independent expert’s valuation of the shares to be expropriated, ensuring proper procedures have been followed in relation to the changing of the Company constitution (i.e. special resolution, special notice requirements)
  + Substantive fairness – expropriation of the shares must be fair (price paid for the shares must be fair). An expropriation at less than the market price is unfair. A shareholder’s interest cannot be valued solely by the market value of the shares and other factors including whether the price offered is fair depends on other things including assets, dividends and the nature of the corporation and its likely future
  + Must be ‘fair’, both in **terms** and **process.**

In relation to Category 2 amendments, the court defined a ‘proper purpose’ in a more expansive way and held that amendments could be taken for a broader range of reasons including advancing the overall commercial interests of the company.

Many key policy questions were raised by Gambotto:

* To what extent should the law protect the rights of minority shareholders in the event of a corporate restructure (i.e. making company wholly owned subsidiary of other company) which will offer significant financial advantages
* Should shares be viewed as any other property or a dividend stream which can be forcibly acquired provided the price is fair
* Does the case facilitate greenmail (minority shareholders preventing a restructuring that has commercial benefits to the company unless they are paid a price well above the fair value of the shares)

Due to the above concerns, subsequent cases have held that the Gambotto principles do not apply where shares have been compulsorily acquired in accordance with statutory procedures in the Corporations Act because the statutory requirements provide sufficient protections to minority shareholders. The Corporations Act allows minority shareholders to be expropriated in schemes of arrangement and capital reductions.

## Oppression Remedy

This is the most appropriate remedy of all. Section 232 deals with oppression and states that relief may be granted to a member, or former member, if:

* The conduct of a company’s affairs; or
* An actual or proposed act or omission by or on behalf of a company; or
* A resolution, or a proposed resolution, or members or a class of members of a company

is either

* Contrary to the interests of the company as a whole; or
* Oppressive to, unfairly prejudicial to, or unfairly discriminatory against, a member or members whether in that capacity or in any other capacity.

### Standing

Section 234 (read in conjunction with definition of member in section 231) discusses the standing requirements:

* A member – does not have to be a minority shareholder
* The conduct no longer has to impact on members in their capacity as members
* A person removed from register of members/former member
* A person considered appropriate by ASIC

**NOTE:** In practice, most oppression actions are brought by members (shareholders) of proprietary companies.In the case of public companies, if you do not like the way a company is being run, you can simply sell your shares however there are restrictions on the transferability of shares for proprietary companies.

### What kind of Conduct?

**What counts as ‘oppressive, unfairly prejudicial or unfairly discriminatory conduct’ under s 232?**

There is not a single test however the HC has articulated the test below.

* ***Wayde v NSW Rugby League Ltd (1985) 180 CLR 459*** – most common test: Was the decision made by the directors a decision that no board of directors acting reasonably would have made?
* ***Scottish Co-operative Wholesale Society Ltd v Meyer [1959] AC 324*** (diversion of business opportunities) – conduct must be harsh, wrongful and burdensome.

***Wayde v NSW Rugby League Ltd (1985) 180 CLR 459 –*** This case involved NSW Rugby League Ltd and its members are a number of clubs. The league’s constitution states that it has the objective of promoting the best interest of rugby league and the constitution authorizes the board of directors to decide which clubs can participate in the competition. The board decided there were too many clubs in the constitution and decided that the Western Suburbs Club should not participate.

**Issue:** The issue was whether the actions of the directors breach s 232 and oppress or unfairly discriminate against a member.

**Held**: The court held that the actions of the directors did discriminate against the Western Suburbs Club however the court decided that the directors did not breach s 232. The actions of the directors may have caused discrimination but they were not unfair. The director’s obligations under the constitution involved prompting the best interests of the game and this involved solving the difficulty presented by a competition which occupied too long a period of the year. The solution they reached involved reducing the number of clubs playing in the competition and the court held this was a reasonable decision in the circumstances.

Mere dissatisfaction with management/being ‘locked-in’ (restrictions on transferability of shares) not sufficient to establish oppressive conduct.

***Re G Jeffrey (Mens Store) Pty Ltd (1984) SC Vic*** – The brother of MD sought a winding up order or order for purchase of his shares on the basis that there was oppressive conduct however Crockett J held that there was no oppression, nothing unfair, no discrimination, and that the company had been run in a conservative manner in the past and that did not amount to unfair prejudice

***Thomas v HW Thomas Ltd (1884) 2 ACLC 610*** – This case involved a family company with 11 employees. Alan Thomas was the MD and Malcolm Thomas was not employed by the company. The financial management of the company had been conservative – did not borrow capital and although it distributed only small dividends, it had built up substantial property holdings. Malcolm Thomas had moved a motion at a general meeting of the company that some of the property holds be sold and the proceeds of sale be invested in income earning investments that would increase dividends to members. His motion was unsuccessful and he then brought an oppression action.

**Held**: The court held that the he had not been oppressed by the actions of directors in adopting a conservative dividend policy. The court noted that other members were content with the way the company was being run and that it was not unreasonable for Malcolm to comply with the expectations of majority holders. The court also held that it is not necessary for complainant to point to actual irregularity or prove that directors acted dishonestly or with intention of oppressing the member – It is a question of impact or effect of the actions of the directors or majority members.

It can also be by act or ‘course of conduct’. Often there will be a combination of factors that will lead the court to find that there has been oppression.

Most oppression actions have concerned ‘quasi-partnership’ companies (small proprietary companies). These companies often have the same people as employees, directors and shareholders of the company and it is important that there is relief available in appropriate cases where there is a restriction on transferability of shares.

The cases of ***Re Spargos Mining NL (1990) 8 ACLC 1218***; ***Jenkins v Enterprise Gold Mines NL (1992) 10 ACLC 136 WA SC*** concerned public companies. The cases concerned:

* Multiple breaches of directors’ duties
* Subordination of interests of company to interests of corporate group (even though companies operate as a group, directors owe their primary duty to the company not the group)
* Directors acting contrary to interests of shareholders as a whole

### Examples of Conduct that may be raised in an Oppression Case

* Improper diversion of business (***Scottish Co-operative***) – shareholders diverted business away from company
* Payment of excessive remuneration to controller or associates of the controller: ***Sanford Courier Service Pty Ltd* (1987)**
* Unfairly restricting dividends (or diverting profits to executive remuneration, meaning low returns for shareholders). Note that just because directors adopt a conservative policy regarding dividends, where other members agree to this policy, this fact is not enough: see ***Thomas* case Cf *Shamsallah Holdings Pty Ltd* (2001)** (involved payment of low dividends which was held to be oppressive).
* Improper exclusion from management (***Hogg v Dymock (1993)11 ACSR 610***)

This case involved a small proprietary company established to operate a historic prison as a tourist attraction. The P held a 50% share in the company and was an executive director and the D was a husband/wife who held 50% of the shares and were also directors. A disagreement arose between the P and the D leading to the two D voting to dismiss the P and appoint themselves as the managing directors. The P alleged she had been oppressed by the two directors. The court held that the company had been established on the basis that the P and D’s would be partners in the company and share equally in the day to day conduct of the business and management of it at the level of directors. There was a common expectation of continuing involvement by the P so that her dismissal by the other directors was oppressive.

* Denial of access to information or withholding information about the company’s affairs (***Re Back 2 Bay 6 Pty Ltd***)
* Oppressive conduct of board meetings (***John J Starr (Real Estate) Pty Ltd* (1991) 9 ACLC 1372**)
  + This case involved a company that conducted the franchising of real estate agents and a dictatorial managing director (Star) who refused to provide the board with proper budgets, brought forward matters which concerned interests of franchisees without proper notice and restricted speaking time available to directors at board meetings where significant matters needed to be discussed and made major decisions without reference to the board. The court held that the way director’s meetings were being conducted was oppressive.
* Acting for benefit of related companies rather than shareholders (***Re Spargos Mining NL***)

### Remedies for Oppression

The court has wide discretion to make any orders as it thinks appropriate: s 233 (a)-(j). The list in section 233 is non-exhaustive and includes things like:

* Modification of company’s constitution – ***Re Spargos Mining NL***
* An order regulating the company’s affairs – ***John J Starr* case**
* The oppressed members shares to be purchased by the company or other members at a price which the court determines to be fair
* Appointment of a receiver – ***Jenkins v Enterprise Gold Mines***

*So, remedial advantages of oppression over some other remedies, e.g. personal action under s 140, fraud on minority in altering constitution or ratifying breach of duty.*

## Winding Up

This is quite a drastic remedy because it means the business of the company will come to an end. Normally, companies are wound up because they are insolvent or unable to pay its debts. Section 461 deals with winding up and sets out grounds other than insolvency on which a court can order a winding up and those grounds include:

* S 461(1)(e): **directors acting in their own interests**
* S 461(f) and (g): where there is **oppressive, unfairly prejudicial or unfairly discriminatory conduct**
* S 461(1)(k): it is **just and equitable to do so**

The wording of this provision mirrors the language of the oppression remedy under s 232.

**NOTE**: Shareholders have standing to sue under s 462(2) and other remedies are available under section 467(4).

### 

This applies where directors acting in their own interests and not in the company’s interests in running the company. Typically, this is used in corporate group situations (see ***Re Cumberland Holdings (1976) NSWSC***) and it is not necessary that all directors act this way. The two limbs under section 461(1)(e) are given a broad interpretation (i.e. being unfair and being unjust to a significant section of other members).

***The just and equitable ground*** – s 461(1)(k)

It is a question of fact whether this ground has been made out however there are a number of categories that the cases have identified as being just and equitable:

* Fraud, misconduct, oppression, conduct leading to justifiable lack of confidence (small proprietary companies – important that people feel they can work together)
* Deadlock
* ‘Failure of the substratum’ (otherwise known as ‘company action outside the intention and common understanding of the members’ when they became members) – company no longer pursues objects for which it was formed: ***Re Tivoli Freeholds Ltd* [1972] VR 445**

**Facts:** This case involved a company established to conduct an entertainment business. It did this by acquiring theatre properties and conducting entertainment. The company had almost 100 members but came under the control of a majority shareholder who, through the control of the board of directors, had the company sell a number of the theatre properties and lend the money to the controlling member. The controlling money then used the funds to engage in corporate raiding (i.e. buying shares of other companies whose shares were selling at below asset value and either selling assets of companies or restructuring companies and then later selling their shares for a profit). This marked a movement away from the original purpose for which the company had been set up to corporate raiding. A minority shareholder, who with supporters, represented 42% of the company’s share capital applied to have the company wound up.

**Held:** The court granted the order to wind up the company on the basis that it would be just and equitable to do so because the company was engaging in business that was entirely outside the general intention and common understanding of the members when they became members (i.e. that company would continue in entertainment business).

* ‘Quasi-partnership’ companies – breakdown in mutual trust: ***Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360 HL**

**Facts:** In this case, there were two partners in a partnership which imported and sold carpets. They moved away from the partnership structure and created a company and became equal shareholders in the company and the company’s two directors. One of the director’s sons later became a director and a shareholder. The company’s business was successful and all profits were distributed to the directors by way of remuneration and the profits were not used to pay dividends. There was a major disagreement between the 3 directors/shareholders and 1 director and his son voted at a meeting of the members to remove the other person as director. The director and his son had legal power to do so because the power to remove directors can be given to anyone (not just shareholders) and it was given to the directors in this case.

**Held:** The court found that the company was established on the understanding that the original members would be in a personal relationship involving mutual trust and confidence and would both participate in the management of the company. The action of dismissing one of the director’s and excluding him from management of the company was held to be oppressive.

* Expands scope for winding up remedy in context of a ‘quasi-partnership’ company
* Members may have rights, obligations or expectations not embodied in company’s constitutional documents which court may protect

## Recent Developments

### Rise of shareholder activism

While in the past decade or so, we have seen a dramatic rise of shareholder activism across Europe and the US where activist hedge funds, globally, hold over $130B in assets, this trend is also becoming common in Australia.

Shareholder activists are focused on using the positions they acquire in companies as a basis for effecting change in that company. Most often, these activists target companies with perceived board weaknesses and/or appear to be underperforming. There have been some recent examples of shareholder activism in Australia:

* **Harvey Norman** – the Australian Shareholders Association urged shareholders to vote against a remuneration company in 2016. Recall that remuneration reports are voted on at the general meeting in the case of public companies – non binding vote by shareholders to adopt/reject report. If you have 2 successive meetings where 25% or more of the shareholders vote against adopting the report, that can lead to a spill of the board (i.e. board members having to reign and new board elections held). The ASA was unsuccessful and the remuneration report was passed.
* **AGL** – The activists in this case were Get Up and the Asset Owners Disclosure Project (two activists acting together) and the shareholder groups moved a special resolution to amend AGL’s constitution to impose certain obligations on the company in pursuit of climate change limitation goals. The resolution was not passed but the chairman made a statement committing AGL to objectives broadly consistent with the resolution.
* **Intrepid Mines** – the activist was Quantum Pacific who requisitioned a number of shareholder meetings and sought to oust the existing Intrepid Mines Board and return the company’s case balance including a settlement ($88.7M) received to the shareholders and 3 quantum nominees were appointed to the board and a share buy back was implemented.

### Use of proxy advisors

There are also concerns about the lack of regulation of proxy advisory firms – concerns about influence and intentions of proxy advisory firms (advise shareholders who are using proxy votes as to how to vote). They follow relatively turbulent AGM seasons both in 2016 and 2017 for an unprecedented number of major corporations who vote faced significant protest votes on resolutions relating to remuneration. There is a view that there is time for a code of conduct (because shareholders do not owe fiduciary duties) to be developed by the industry, potentially in conjunction with ASIC, to improve transparency, accountability and disclosure of conflicts while ensuring proxy advisors remain independent and free from greater pressures during these periods.

# Shares and Capital Transactions

The company’s capital are the resources the company uses to do its business. Without capital (money), there is no business and therefore no company. Corporate capital and the rules surrounding it are of the utmost importance to the company and corporate law. Many of these rules are very technical and are almost entirely statutory based. This is a benefit since the legislation has simplified the rules around corporate capital and what a company can do with it. The legislation has changed the rules over the last 20 years in a way that represents a difference regulatory approach from command and control style regulation.

## Shares

Issuing shares is one of the main, if not the main source, of funding for a company. The company sells rights in itself and against itself, claims on its assets and revenue, to investors in consideration for the monies that investors provide to the company to run its business. A person becomes a shareholder or a member (interchangeable terms) by acquiring ownership of a share and company law only takes notice of the acquisition of ***legal*** ***title*** (not beneficial ownership). A person becomes legal title holder of a share when that person’s name is entered into the company’s share register – the share register only records legal entitlements not beneficial entitlements. This simplifies the process of managing share registries however this has become an issue in terms of global fraud and corruption. Beneficial ownership of a share and therefore claims against the company/access to the company’s wealth can largely be hidden from sight and this has facilitated the use of the corporate form for bribery and corruption.

### Share or Loan?

A company’s total capital will be comprised of shares (aka equity – investor funds) and monies raised by way of debt (borrowed from creditors) and retained earnings and assets owned by the company. There is a question about whether how you mix and match the types of capital, balance between debt, earnings and retained earnings, makes a difference to the overall value of the company.

The Modigliani-Miller theorem states that the relative balance or mix of debt, equity and other aspects of the company’s capital structure does not affect its long term value. The benefits of one cancel out the negatives of the other. From a financial perspective, the view is that the value of the company is not affected by the way you mix and match capital. However, to make this theorem, a number of assumptions were made. Shares and debt are treated differently as far as legal characterisation is concerned and they have different legal consequences. If a person owns a share, that gives the person in and against the company (open ended) and typically entail control rights (right to vote) but the same cannot be said of debt. If you borrow money from the bank, the bank does not normally get a say in the company’s decision making process. Debt and equity shares are treated differently for tax purposes. If a company pays dividends to its shareholders on their shares, that is not a tax deductible expenditure however interest paid on loans that the company takes out is tax deductible. These real world differences mean that the mix of debt and equity could affect the long term value of the company depending on the relative cost of debt and equity (how much it costs the company to entice investors to invest in the company or borrow money). If a company has a lot of debt, it will be paying out a lot of interest out of its cash flow and revenue streams – greater stress on cash flow. If a company has a lot of equity, it is not paying out interest and does not have to pay dividends unless it is able to however the more shares a company has, the lower the value of the shares – may affect price earnings ratio. If its shares are very low and there is not able to get a good return on shares, the company may struggle to attract investors.

At the moment, debt is very cheap – interest rates at historic lows. Therefore it has been cheaper to take on debt (cheaper interest rates) in comparison to equity. These are commercial decisions which the company makes about how it will structure itself and fund its activities. For a particular company, there may be an optimal mix of debt and equity.

### What is a Share

A share is an intangible item of personal property and is not necessarily the share certification – it is a chose in action. Shares constitute rights in and against the company, enforceable through law. Americans refer to shares as ‘stock’ – there is no practical difference between these terms. In some cases, stock is used to refer to an individual’s share portfolio but for most purposes, shares and stock mean the same thing.

A share, typically comprises 3 rights:

* a right to vote,
* a right to receive a dividend if declared and
* a right to participate in surplus assets on a winding up of the company

A share is the bundle of those three rights however the shareholder does not own the company’s assets. The company owns the company’s assets and this is a consequence of corporate personality. The shareholders do not own the company and shares represent claims in and against the company. Shares are not thought of as ownership in the company except in a broad economic sense that shareholders are the ultimate beneficiaries of the company’s activities. The company is a separate legal person and not owned. Typically, shares contain those 3 rights but the parties (people who create companies) are able to craft particular shares containing particular packages of rights in any way they like – these rights attaching to a share will be set out in the company’s constitution.

A standard share may have the above 3 rights but a particular share that a company creates may have completely different rights (i.e. non voting right, confer super voting rights so that share counts for 10 votes, right to dividend is preferential so that a person holding this class of shares has a better right to dividends than an ordinary shareholder – preference shares).

The stock exchange listing rules impose several limitations for listed companies. In order to facilitate the ready transfer of shares and marketability of shares, the stock exchange prohibits non-regular shares.

**Bonus shares** are another form of share – rights attaching are whatever the company decides. It is called a bonus share because the company will take resources it has, turn them into shares and give them as a bonus to shareholders.

**Redeemable shares** are shares whereby either the shareholder or the company has a right to have the shares redeemed (bought back) at some time in the future. This essentially limits the term of the investment.

A company might also issue **options** – right in the holder to buy shares in the future at a particular price. When you buy an option, you are essentially betting on the share price going in a particular direction. Generally if you bought options to buy shares in 3 months for $1, you are betting that the share price will go up because in 3 months, if the share price is $5, you can still buy them for $1.

In the past, companies have sought to control director’s self interest is by paying director’s with share options – encourage directors, because of their own self interest, to maximise the company’s profits to raise the share value so that their options are worth more. Directors did so but through manipulations of income, company’s returns to artificially boost the share price.

There are references in the literature to ‘paid up capital’, ‘uncalled capital’, ‘par value’ and ‘nominal value’. Paid up capital and uncalled capital refer to the fact that when a company sells its shares to a shareholder, it may not ask the shareholder to pay the full price at that point in time. Suppose a company is selling a parcel of shares for $1000 – the Company may not need the full amount and therefore might ask the shareholders to pay $500 immediately and then owe the company $500. This is permissible under s 254A of the Corporations Act. The company can then make a call on those shares at a later point in time when it needs the money or, if the company goes into liquidation, the liquidator may demand the additional $500.

Par value and nominal value mean largely the same thing. It used to be the case that when a company created and issued shares, it had to fix a dollar value on those shares – fixed amount of those shares (par or nominal value). The idea behind this was that this was the minimum amount the company could sell the share for – the company could sell the share for more if the market price allowed (i.e. sell $1 share for $1.50 but not for 90c). This guaranteed that if a company had, in its capital structure, 1 million $1 shares, it could be guaranteed that the company had received at least $1M. It was a way of guaranteeing that the company received the value which it appeared to have in its accounts. If a company sold a par value share ($1) for $1.50, there were rules which stated that the company had to treat the extra 50c as a share premium and that had to be accounted for in a separate share premium account and had to be used for certain purposes. Since 1998, Australia has abolished par value – the value of the shares is whatever the market price is.

### Issuing Shares

There are two ways that an individual may become an owner of a share:

1. the company issues the shares to the shareholder – the investor is buying shares directly from the company (“**initial public offering**”) or
2. one shareholder sells their shares to another person who then becomes a shareholder (secondary trade) and the money is paid between the shareholders and the company is not involved in the transaction except for registering the share transfer in its register.

Most of what happens on the stock exchange is secondary trading. Stock exchanges are also used for initial public offerings where the company floats its shares on the stock market and sells them to investors.

The difference between issue and allotment of shares – issue concerns a situation where the company enters into a binding agreement with a shareholder to buy and sell shares whereas allotment refers to where the company appropriates a parcel of shares to be transferred to the shareholder.

The process by which an investor acquires shares from a company is usually that an investor will make an application for shares to the company (constitutes an offer) and the company accepts the offer. This position is different in relation to publicly listed companies and is statutorily regulated.

## Class Rights and Variation of Class Rights

A company may choose to have more than one class of shares: e.g. ordinary shares and preference shares. Since the rights attaching to the shares are different, there are separate classes of shares. This gives rise to issues as to fairness between those two classes and the way the company is run and how to manage/regulate changes in the rights of shares relative to other shares.

Sections 246B-246G are a series of rules designed to ensure that the right to vary class rights is not used as a means of oppression, unfairly or to shaft one class relative to another class. Section 246B states that if a company wishes to change the rights attaching to a particular class of shares, it must follow one of two procedure:

1. If the Company Constitution contains a process for the variation of class rights, then the variation must follow the rules set out in the constitution
2. If the constitution does not contain a variation of class rights process, then the process must be:
   1. Special resolution (75%) passed by company (i.e. all shareholders); and
   2. Resolution passed by 75% of the holders of the class whose rights are being varied

A disgruntled shareholder whose rights have bene varied has a right to apply to court to have a variation set aside under these provisions.

At common law, a variation was limited to the variation of legal rights (e.g. if share previously had right to vote and the variation was to turn the shares into non-voting shares) but if the effect was merely economical or commercial (e.g. made right to vote worth less), that would not constitute a variation of the legal rights at common law. The Corporations Act has a wider concept of variation and s 246C sets out a range of actions that are deemed to be variation (dividing shares and creating different classes, issuing new shares with different rights to existing shares).

## Capital Maintenance Doctrine

One consequence of the combination of separate legal personality and limited liability is that creditors of the company may look only to the company for the satisfaction of their claims and cannot pursue shareholders if the company has insufficient resources to meet their debts. The pool of assets represented by the company’s capital is the only source of recourse which creditors have. This poses risks for creditors – if that capital is somehow altered or changed and disappears, then creditors are left wearing the entire risk and do not get paid. It is important for the law and for creditors, to understand the circumstances in which the company’s capital can be expended, changed or can disappear. Implicit in the arrangement whereby shareholders get everything that is left over but all of the fixed claims are met first (shareholders as residual claimants on company’s assets) – how do we make sure creditors do not get paid before other claimants? Part of the solution is through capital maintenance – the principle of capital maintenance states that shareholders cannot withdraw their investment until all other claimants have been paid (i.e. when the company is wound up).

Capital maintenance seeks to lock shareholder’s investment in to make sure it is always available for creditors. It is to ensure that there is no return of capital to shareholders until all other claimants have been paid. This does not mean that shareholders can never leave – shareholders can sell their shares to another person. What we are trying to lock in is the investment, not that particular individual and making sure that investment is not returned to shareholders until all other claimants are paid. The effect of the doctrine of capital maintenance is to regulate, control and constrain transactions which have the effect or are designed to return capital to shareholders (i.e. reducing company’s capital).

There are 4 main types of transactions which engage the principal capital maintenance and involve a reduction or return of capital to shareholders:

* Dividends
* Reductions of Capital
* Self-Acquisition and buy-backs
* Financial assistance

### History

The best statement of the common law principle of capital maintenance is found in the court’s judgement in ***Trevor v Whitworth [1887] 12 App Case 409 (HL)***.

**Facts:** The case involved a company (James Scofield and Company Ltd) and a deceased shareholder. The executor of the deceased shareholder, as part of winding up the estate, wanted to sell the shares that the deceased held in the company back to the company. The company’s constitution included a provision which said that the company could purchase its own shares. The company agreed to purchase its own shares however before the purchase could be finalised, the company went into liquidation. The liquidator became uncertain and sought to take the matter to court for a ruling.

**Held:** The House of Lords held that the company could not buy its own shares notwithstanding a power to buy its own shares was allowed by the constitution. It would be unfair to creditors to allow a company to return capital to shareholders prior to all claims being met through a winding up.

**Commentary:** The Court discusses capital maintenance and a proposed return of capital to shareholders (by company buying own shares) as being ultra vires (i.e. illegal). Even if a company has a provision in its constitution which allows for the repurchase or reduction of capital, it is still not possible for a company to buy its own shares as a matter of common law because it is illegal to do so.

The return of capital which the doctrine of capital maintenance is concerned with is one that involves a return of capital to shareholders. It is not a rule which states that the company cannot rule its capital in the course of trading – if in the course of trading, the company suffers a misfortune and uses capital to fund its activities and make good shortfalls, then that is part of the risk that everybody must accept. It is only where the return is a return of capital to shareholders, in their capacity as shareholders, that the rule is engaged. You may have a situation where a person has a relationship with a company in more than one capacity (i.e. shareholders + trade creditor – it does not infringe the capital maintenance rule for the company to use its capital to pay X as a creditor and the rule is only infringed if capital is returned to X as a shareholder).

The fact that a company’s capital can be lost in the course of trading and is therefore unavailable for the payment of creditor claims means the capital maintenance doctrine never worked in the way presented – it does not sit there as a guarantee fund which is always there. If a company has a run of bad luck and loses money over the last 4 years, the company does have to use profits in the 5th year to make good capital losses in the previous 4 years. Capital does not have to be made good. A company can, lose most of its legal capital and there may be no capital left as a result of trading history. The capital maintenance rule does not, in reality, offer creditors a guarantee.

This position was altered by the introduction of statutory changes. The common law capital maintenance doctrine has been significantly altered by statute. Section 259A of the Corporations Act still embodies the basic capital maintenance principal: you must not retain capital to shareholders other than through the winding up process. There are now a number of exceptions that allow return of capital to shareholders in a range of circumstances and you could say that the exceptions have eaten the rule away. Those exceptions concern dividends, reductions of capital, buy-backs and financial assistance.

The change has occurred for a number of reasons:

* Recognition that it is not good, as a matter of policy and for the performance of companies as vehicles for the creation of wealth, to lock up chunks of wealth so that they cannot be used efficiently. There are legitimate situations where companies end up with excess capital – the capital maintenance rule states that the capital must remain locked up in the company and cannot be returned to shareholders. However, from an efficiency perspective, it would make more sense to give the spare capital back to shareholders so they can invest it profitably elsewhere. There is a strong view that the rules around company capital and maintenance must be more flexible and must encourage efficient investment and facilitate the company as a vehicle for wealth creation. Therefore, we must recognise and allow situations where returning capital to shareholders is proper and appropriate. There are still concerns about the risks imposed on creditors but those risks can be addressed.
* Capital maintenance doctrine did not work as a guarantee in a practical sense. Assets or capital lost through the trading process did not have to made up in subsequent years and a company’s assets could be ground down by poor trading. Capital maintenance therefore did not function in the way envisaged and this gave rise to a view that if the principal did not work, why bother keeping it.
* The capital maintenance rule was a simple prohibition – you must not return capital to shareholders and if you do, that is illegal. This is described as command and control regulation and involves issuing a command which is backed by a sanction. Increasingly, regulatory theorists and legislatures have recognised that command and control regulation has significant limits. As soon as you draw a clear line and say you must not do this, people find a way around it and then the legislature has to tweak the rule to cover the work-arounds. It is a very blunt type of regulatory instrument and encourages people to find a way around the rule. We have shifted to responsive regulation or a proceduralised approach to regulation – creating structures, processes and procedures which address the concerns but also guide those being regulated to produce the regulatory goals desired. In the context of capital transactions, the underlying concern is that we do not want creditors to bear too much of the risk. There is an incentive for the company to shift more of the risk to the creditors and it is unfair if the creditors are only allowed to claim against the company but the company has given assets back to the shareholders. Responsive regulation aims to address the concern and still allow companies to manage capital in ways that suit them. The answer is to establish a process or criteria (mechanism by which to return capital) which adequately deals with the concern about creditors.

Responsive regulation has two implications: whereas the capital transactions and capital maintenance rule used to generate vast amounts of case law, it does not anymore. When the answer was simply ‘no’, people tried to find ways around the rule – whether you had adequately got around the rule was a matter to be decided in court. Secondly, a majority of Corporations law starts to look like administrative law by focusing on procedural fairness.

The four capital transactions, prior to statutory modifications were very complex and had produced vast amounts of case law. By comparison, the statutory rules are simple and straightforward.

### Dividends

A dividend is a payment to shareholders in proportion to the shares held by that individual. It represents a return on the investment and is equivalent to interest on a loan. Common law has always regulated dividends because of the risk that capital may be returned to shareholders through the dividend process. The Corporations Act continues to regulate dividends but in a different way. At common law, dividends could be paid only from profits and not from capital. What was a profit was to be determined by the application of accounting principles.

Part of the impetus for the simplification of the law was the GFC. Under the accounting rules and dividend only from profits rule, following the GFC, large parts of the corporate sector had huge prior losses and had to write down the value of assets. This meant that under the old rules, they were taking currently as profits and using them to make good previous trading losses. This meant that for the current year and years going forward, they had no profits as determined by accounting rules and therefore could not pay dividends. This was regarded as stifling the economy and led to the amendment of s 254T to abandon the common law approach. The new approach allows dividends to be paid if the company has an excess of assets over liabilities, it is fair and reasonable to shareholders to do so and payment of the dividends does not materially prejudice the ability of the company to pay creditors. In essence, this was supposed to be a simple solvency test for the payment of dividends. This rule protects creditors because if the company is solvent, it can meet all its creditors claims and it avoids the distinctions previously made by the common law.

Unfortunately, s 254T was not drafted in the best way. Paragraph (a) is a solvency standard and there are still accounting standards to determine what are assets and what are liabilities. What is the point of requiring that the payment of dividends be fair and reasonable – this does not address the concern about the effect on creditors. Paragraph (c) is restating the solvency standard. Therefore, paragraphs (b) and (c) seem to be completely redundant. The matter is further complicated by subsection (2) which may suggest that before a company can declare a dividend, it must have its accounts audited to determine whether it has assets over liabilities and this procedure needs to be followed each time it wishes to pay a dividend. This seems unnecessary and a hark back to the common law rule.

The process for declaring and paying a dividend is largely regulated by section 254U which states that it is up to the directors to decide when dividends are payable. Shareholders do not have a right to a dividend unless that right is built into its shares – it is generally up to the discretion of the board to decide whether a company can and should pay a dividend. The board, first, declares that a dividend will be paid and then the dividend is paid on the date specified for the payment. At the date specified for payment of the dividend, a debt is created in favour of the shareholders for the payment of the dividend and the shareholders can enforce that debt.

### Reductions of Capital

It was recognised that company’s need some capacity to return capital or adjust capital structures. Legislative changes were introduced and under strict court supervision, a company could apply to a court for an order to reduce its capital. This was a slow and cumbersome process and has been since modified. Nowadays, this is largely an internal process and does not require court supervision.

Section 256A allows for capital reduction and allows for it by ensuring that the reduction does not jeopardise the company’s solvency, there is fairness as between shareholders and requires appropriate disclosure. The core rule in section 256A is that a capital reduction may occur if it follows the process and criteria set out in section 256B, which contains three cumulative criteria. The reduction in capital must be:

* Fair and reasonable to the shareholders as a whole AND
* Not materially prejudice the company’s ability to pay its creditors AND
* Be approved by shareholders (under procedures s 256C)

The idea of fair and reasonable to shareholders is taken to refer to the company’s business and the hypothetical shareholder (not just a particular group of shareholders). This is designed to ensure minority and majority are treated fairly because there is a risk that a capital reduction may favour a group of shareholders by allowing them to withdraw money but forcing other shareholders to remain locked in. The second requirement aims to protect creditors and the final requirement aims to provide some oversight over the board. The board will decide to initiate the process and to reduce capital. The shareholders here, stand in as a proxy for a regulator because we can assume that shareholders will not approve if they are unhappy.

This process deals with the various concerns identified – no court supervision and no ASIC supervision. Disgruntled and dissenting shareholders are also given a right to ask for a court review (s 1324(1A)).

There are two alternative processes for shareholder approval under s 256C depending on how the reduction is done: either equal or selective. If it is **equal**, it means that each shareholder’s holding is reduced by the same proportion and shareholder approval is by way of an ordinary resolution (bare majority). A **selective reduction** means that shareholders are not treated the same (reducing capital of some shareholders but not others or reducing capital of some shareholders more than others), and in this instance, a special resolution of the board is required.

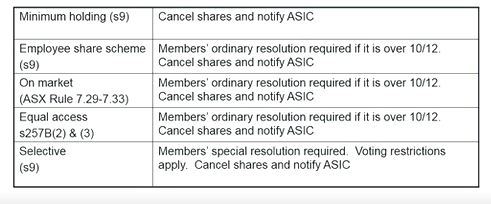
If you do not comply with the process (process is somehow defective), then section 256D provides that the reduction of capital is not invalidated. Instead, the directors and those involved in the failure to comply with the process will have committed a civil penalty offense. Section 588G (insolvent trading provision) states that a reduction of capital is deemed to be the incurring of a debt for the purposes of the insolvent trading liability. If the board decides that the transaction (reduction of capital) will not materially prejudice the interests of the creditors but it does – then they are in the frame for insolvent trading liability. If proven, this requires the directors to contribute personally the assets to the company to make good the loss to the creditors.

### Self Acquisition/Buy-Backs

At common law, a company cannot buy back its own shares or own its own shares however, there is an exception created by the Corporations Act. There are circumstances where a company can buy back its own shares and the width of the exceptions and ease with which they can be complied with is such that the core prohibition has been eaten away by the exception.

Buy-backs are allowed to permit flexibility for the company to manage its capital needs. One way of effecting a reduction of capital is by allowing the company to buy-back its shares and then cancelling the shares (form of reducing company). In Australia, shares which a company buys back through this process are cancelled however in other jurisdictions, companies can owe its own shares (treasury stock).

This is useful for capital restructuring and is often used by publicly listed companies as a market signal of profitability (i.e. we are so flushed with cash that we can buy back shares). It also enhances the value of the existing shares and can be used by companies with a high cash holding to use up that cash. It can also be used as a takeover defence mechanism. In Australia, you cannot directly defend against takeovers however a careful board may use the buy-back mechanism to tidy up small holdings in the market so that a bidder cannot buy up small parcels.

Section 257B contains a table which sets out the procedural requirements for certain types of buy backs. The phrase ‘10/12’ is a shorthand for saying that a company may buy 10% of its own share capital within a 12 month period. If a company buys less than 10% of its shares, it generally does not need any further approvals – the board has, within its discretion, the ability to buy up to 10% of the company’s shares within a 12 month period without any further approval. If a company buys back more than 10% of its shares within a 12 month period, then additional approvals are required (see table).

A **minimum holding** is a less than marketable parcel, that is a small holding. Stock exchanges generally denote a minimum parcel to trade and if shareholders hold less than the minimum parcel, companies can cancel those shares.

A company may buy its own shares in order to fund an **employee share scheme** and in this case, the shares are transferred either to the employees or an entity which holds the shares on behalf of the employees.

**On market** means that a company goes to the stock exchange and buys its own shares on the stock exchange. ASX Rule 7.29-7.33 state that a company cannot pay more than 5% of the monthly average price for its shares.

**Equal access** means that the same proportion of shares are being bought back from all the shareholders. Member approval is required only if you go above the 10% over 12 month limit. If a **selective** buy-back is being implemented, then a special resolution of the members is required – to ensure fairness between all shareholders.

### Financial Assistance

For a number of reasons, a company may wish to assist someone to buy its shares (e.g. issue shares to someone who cannot afford and company may assist in that purchase). If a company does that, as a matter of common law, this was thought to fall within the capital maintenance rule. If a company gives a shareholder money to buy the shares, the company is effectively reducing the price paid for the shares and is then returning capital to that shareholder. At common law, there was an absolute prohibition on this conduct and as a result, a body of case law developed as people devised schemes to provide financial assistance.

Law reform bodies considered why the prohibition occurred and whether legitimate reasons existed for financial assistance.

Consider, for example the fact that banks lend you money and take security over the house you are buying (similar to PMSI). You use assets you are going to buy to fund you to buy the assets. Similar concepts can apply to small companies:

Suppose Jo wants to sell his business. If it wasn’t a company, the purchaser of the business could use the business and business assets as security to raise a loan and purchase the company. However, since the transaction concerns a company, it constitutes financial assistance and isn’t permissible.

The law reform body held that this difference does not make economic sense and we should allow, subject to protections, the purchaser of shares to use the company’s assets as a means of funding the buying of the shares in the first place. This largely applies to small companies but the reforms have not been limited to small companies. Publicly listed companies have been constrained from providing financial assistance by stock exchange listing rules and disclosure requirements.

Financial assistance is now governed by ss 260A-D of the Corporations Act. Section 260A permits a company to provide financially assistance if the conditions in s 260A(1)(a)-(c) are met:

* Does not materially prejudice the interests of shareholders OR creditors
* Assistance is approved by shareholders
* Assistance falls under exceptions listed in section 260C

If the Company decides that it is in the interests of the company or shareholders, it can still provide financial assistance even though it may affect its ability to pay the creditors (due to use of word ‘or’ in the legislation). If the financial assistance is approved by shareholders, the assistance can be provided even if it results in harm to creditors. It is assumed that making these alternatives was a drafting error because shareholder approval does not make up for harm to creditors.

Financial assistance is not defined in the Corporations Act. Previous versions of the legislation suggested that things like lending money to a person to buy shares and guaranteeing a loan obtained from a third person to enable a person to buy company shares is financial assistance. The case law suggests that financial assistance may be both direct and indirect.

***Darvall v North Sydney Brick & Tile Co Ltd (No2)* (1989) 16 NSWLR 260** – the Company D made a takeover bid for NSBT and the directors of NSBT did not want the takeover to proceed because it was not in the company’s interests. D wanted access to a piece of undeveloped land that NSBT owned. The directors of NSBT decided to sell the land to one of its subsidiaries (NorWest) who enters into a JV arrangement with Chase to develop the land. Chase then makes a loan to the MD of MSBT (Mr L). Mr L uses the proceeds of the loan to mount his own takeover bid for NSBT, thus excluding D. Has NSBT provided financial assistance to Mr L to buy its shares? The court held that the series of interconnected transactions between the parties constituted financial assistance whereby funds generated by the sale of the land by NSBT ultimately found their way into Mr L’s hands to assist him to purchase shares (underlying design of series of transactions).

***Belmont Finance Corp v Williams Furniture Ltd (No2)* [1980] 1 All ER 393** – The Company knew that someone wanted to buy its shares and agreed to buy assets from that person. That person then has cash and uses the cash to buy shares in the company. The court held that this amounted to financial assistance. The purchasing by the company of assets that a person is selling is not financial assistance perse however, in this case, the court held it was financial assistance because it was done with the intention or design of putting the person in funds to buy shares.

The cases also establish that there must be assistance and what the company does must allow the person to buy shares. But for the company’s actions, the person would not have been able to buy the shares. It is also the case that financial assistance must be financial – however financial does not have a technical meaning.

#### No Material Prejudice

In order to provide financial assistance should not materially prejudice the interests of shareholders or creditors. As the law has developed and since 1998, this means that there must be some net loss or reduction in the company’s wealth, value, assets. Prior to 1998, there were two views: (1) there must be some detriment to the company and (2) even if there is no detriment to the company, financial assistance is prohibited. The company must give up or lose something or somehow the company’s assets must be reduced. Financial assistance may be treated differently depending on how it is does – quantitative and qualitative aspect.

Some types of financial assistance, the mechanism may be considered objectionable per say and therefore it does not matter how much money is involved or how substantial the assistance is, it will be prohibited. Where a company simply gives a shareholder money to buy shares, even if the amount of money is small, this will still constitute material prejudice to the company and therefore financial assistance.

In contrast, ***Talg Glen v Optus***, where a company provides prospective purchasers with reply paid envelopes so they could put their share transfer forms in the envelopes and send them to the company to be registered. The court held, that in one sense, this amounted to financial assistance (reducing cost of becoming shareholder) but will be unlikely to constitute material prejudice to company even if amount spent in providing envelopes is significant.

There is material prejudice if the company’s resources are reduced, the company is impoverished or there is some reduction. If there is material prejudice, then you cannot provide financial assistance.

#### Shareholder Approval

This is provide for in s 260B which states that if you exclude the votes of the person acquiring the shares, by special resolution but if you include those votes, then it is an ordinary resolution of all shareholders. Section 260B(4) provides that a company must disclose to the meeting of shareholder all material information about the proposed financial assistance.

Material = *‘whether it was necessary to fully and fairly inform a shareholder who scans it quickly as an ordinary person in business would do’*

Section 260B(4) also provides that the board must include in the information which goes to shareholders, the board’s reasons for wanting to provide the financial assistance.

Section 260B(5) requires that the company must give notice of the meeting to be held to approve the financial assistance to ASIC before it sends that notice to shareholders. This is designed to give ASIC an opportunity to intervene or say the information provided is not adequate.

Section 260C contains a number of exceptions.

If a company can provide financial assistance provided:

* It does not either materially prejudice the company (use up company’s resources) OR
* Obtain shareholder approval OR
* Fall under exemption

#### Consequences of Breach

The transaction will stand however the directors involves in the failure of the process, commit civil penalty and become personally liable. The provision of financial assistance is a deemed incurring of a debt so the insolvent trading provisions kick in. The directors therefore have a double incentive to get it right.

* See s 260D – contravention of s 260A does not affect the validity of the transaction/s concerned.
* However, an injunction and/or damages may be available under s1324.
* Section 260D(1)(b): contravention does not mean the company is guilty of an offence, but it will be an offence by a ‘person involved’ in the contravention if the involvement is dishonest: s 260D(3).
* Section 260A also a ‘civil penalty provision’, so consequences of breaching a civil penalty provision apply: see Pt 9.4B
* Contravention may also bring into play the insolvent trading provisions: see s 588G

# Public Issues, Debt and Charges

This lecture will deal with the second part of corporate finance.

## Public Issues

Public Issues – rules and regulations around company’s offering/selling shares to the public.

A company issues shares for several reasons: to establish who its members/shareholders are (those shareholders have various governance and investment roles) and to raise funds to carry on its business. Shares are a proportionate claim on the company’s assets and income streams and as a means of facilitating the investment shareholders make in the company, the company confers governance rights on shareholders (e.g. right to vote – have a say in what happens to investment). In Australia and in most other countries, the rights of companies to sell shares to the public are limited and restrict that right to public companies. In Australia, one of the consequences of setting up a proprietary company is that while you may sell shares to individuals, you cannot advertise sales for share to the world.

Many public companies that wish to sell their shares to the public do so through the stock exchange. Many companies wishing to raise finance from the public will become listed as this is the most efficient way of getting an offer out to the public. The eligibility to sell shares to the public generally is being a public company – you do not have to be listed but being listed facilitates the sale of shares in a practical sense.

One of the key rational for the emergence of a company was the aggregation of capital. As projects and benches became larger and needed larger amounts of capital, it became harder for single individuals to fund projects on their own – the company was created and the share plus the concept of limited liability enabled small investors to pool their funds in an effective and risk controlled way. Due to the way shares are structured and the principle of limited liability, the shareholder knows exactly how much risk they are undertaking – downside risk is limited to price paid for shares but upside risk is unlimited. Shareholders do not need to be aware of the other investors because the company model is distinct from a partnership where partners are jointly and severally liable for the entire debts of the business.

The downside is that investors are exposed to certain risks in terms of knowing what it is they are buying – how does a shareholder or prospective shareholder find out the merits of the investment, particularly where the share is being offered for the first time. For example, when purchasing a car, there are ways to verify what the salesperson is telling you. A shareholder’s investment is based on what the company is telling you about future prospects – the problem is an asymmetry of information between buyer and seller. The seller knows a lot more than the buyer does and the buyer has no independent means of verifying what the seller is telling them. This risk has been recognised ever since companies were created and in fact, early Corporations legislation focused on company’s disclosure obligations – provide shareholders with information to determine if they want to invest or not. It has been a theme of company law to use disclosure as a regulatory instrument to deal with the problem of informational asymmetry. It is a cheap regulatory tool to implement and does not interfere with market forces (restores assumed premises of market transactions – i.e. that both parties are adequately informed).

However, this is not the only strategy and at various times in history, there has also been merits regulation (regulate quality of product) which is more intrusive and focused on the sale of goods. We may also directly regulate key terms – e.g. price (cap on certain aspects of price) however this is not usually seen in corporate law and is usually seen in consumer law. Corporate Law tends to stick to disclosure as the mechanism and it works reasonably well.

In Australia, the regulatory scheme for public issues is contained within the Corporations Act however this is not the case in many other jurisdictions which contain similar legislation in Securities Law. Securities law is about the protection of market integrity and not about regulating companies (regulating particular market for particular product – shares in a company). The way companies are governed and managed affects value of shares but there are good reasons for treating securities as a separate issue. Securities law concerns market integrity, market fairness and preventing market manipulation and does not concern the management of companies. The general regulatory scheme in Australia (and in many jurisdictions) is one that contains a broad and inclusive rule with many exceptions. The broad rule is that if you are going to sell shares to the public, you must disclose certain information to the public first: ss 706-707. Section 706 deals with initial public offerings, namely where the company is selling shares to the public. This is the primary focus of the regulation in the corporations Act as it gives rise to the most serious issues. Section 707 deals with the regulation of secondary trading where one person sells shares they currently own to another person, usually by the mechanism of the stock market. Secondary trading is less regulated because the market forces around secondary trading are much stronger. The view is that the market will imbed all the information relevant to the price of the share and so there are other ways to validate the price other than what the company is saying where secondary trading is concerned.

The basic rule for an initial public offering is that the offer must be accompanied by disclosure (s 706 and following) and is reinforced by s 727 which contains a prohibition on the offering of shares without adequate disclosure as mandated. Section 717 sets out a table that provides an overview of the process and section 718 requires that the disclosure be registered with ASIC. Section 709 sets out 4 types of disclosure: prospectus, short form prospectus, profile statement and offer information statement. Section 705 contains a table that sets out the details of the types of disclosure.

### Prospectus

The basic requirements of a prospectus are set out in section 710-713. A prospectus can be used for any type of offer to the public and is the most versatile and most onerous document. The prospectus is a large and complicated document which includes statement of what is being offered as well as documentary evidence that supports the claims being made about it (e.g. reports from accountants, lawyers). Prosectus’ are extremely expensive to produce and it is estimated that the cost of an initial public offering by way of prospectus is about 7% of the total monies that are sought to be raised. If you are issuing shares worth $100M to the public, it will cost the company around $7M in terms of the regulatory requirements. The $7M includes a cost for an underwriter that guarantees the uptake of the shares (job is to buy shares that are not issued to members of the public). In addition, the cost of preparing a prospectus is estimated at being around 1/3 of the 7%.

### Short form Prospectus

A short form prospectus is authorised by section 712 and differs from a prospectus only in that the short form incorporates by reference, documents that the company has already filed with ASIC. Rather than including all the information to disclosure, the short form allows reference to documents already filed.

Section 715A states that a prospectus must be ‘clear, concise and effective’, if a prospective does not fit that criteria, there is no breach of the Corporations Act rules however ASIC may issue a stop order (pursuant to s 739) and request that the prospectus be rewritten. This is possible given that the prospectus must be provided to ASIC before being issued to the public. ASIC, also provides in its regulatory guide (RG 228) that a document will be clear, concise and effective if it highlights key information, provides balanced disclosure (Good and bad news), flows logically, conveys clear messages and limits repetition. Section 715A was introduced because historically, prospectus’ were dense documents that were difficult for amateur investors to follow. The section aims to force companies to communicate important information to investors.

The content of a prospectus is discussed at ss 710-711. Section 710(1) sets out a general requirement that a prospectus must contain all the information that investors and their professional advisors would reasonably require to make an informed assessment of matters set out in s 710. There is a table in section 710 which includes:

* What are the rights and liabilities of the shares being offered?
* What has been the performance of the company over the last period?

In this part of the Corporations Act, companies are referred to as ‘issuers’ or ‘public issuers’. Section 711 also includes a list of specific matters which must be disclosed. There is no requirement in sections 710 or 711 for the Company to make forecasts about its future performance but as an investor, this is potentially the most important thing to learn about. This is because this information can be confusing and is necessarily speculative. The tendency for companies to overestimate their likely success in the future is too great. From a company’s perspective, there is a risk that if you are too bullish about the company’s future performance and it turns out differently, you may be found to have included misleading or incorrect information in the prospectus. Such a finding imposes personal liability upon the directors.

### Profile Statement

A profile statement is considered in section 714 and may be authorised by ASIC but this must be in addition to a prospectus. The idea is that companies will prepare a relatively short profile statement to prospective investors but under section 721, the company must available for prospective investors, free of charge, a full prospectus. For this reason, profile statements are not widely used.

### Offer Information Statement

The Offer Information Statement was introduced for small public issues (less than $10M): s 709(14). There was a recognition that the costs of producing a full prospectus are prohibitive where there is a small public issue. Section 715 sets out the contents of an offer information statement.

Once you have prepared these disclosure documents and issued them to the public, they remain valid for 13 months. This is because the document takes a long time to produce but company’s need to time their offerings to maximise their value (e.g. if Company just had a poor quarter, you do not want to make a prospectus OR if company in same industry has just made public offer).

### Exemptions

The regulatory strategy was to have a broad and inclusive rule (anything that looks like an offer of shares to the public) and some exceptions. The broad rule makes it hard to find loopholes and work around the rule and the exemptions cover those situations where it is not appropriate to require a prospectus.

#### Small Scale Offerings

These offerings are discussed in s 708(1)-(7). If you have a small scale offering, you do not need a prospectus. A small scale offering is where a company is making an offer of shares that is both small in value and to a small group of people. A small scale offer involves a personal offer and a personal offer is one directed at people you already have a connection with or professional relationship with. A small scale offer is therefore a personal offer which is made to particular people (i.e. no more than 20 investors) and does not seek to raise more than $2M in any 12 month period.

#### Sophisticated Investors

Sophisticated Investors are considered in s 708(8) and 708(1). The concept behind this exemption is that sophisticated investors have the resources, ability and interest to look after themselves and make their own inquiries. A sophisticated investor can be one of the following:

* Where the offer of shares is in a parcel which is large (i.e. more than $500k)
* Wealthy investors – defined as someone whose income is more than $250k/year or they have net assets worth more than $2.5M
* Professional investors

If an offer is made to a ‘sophisticated investor’, then the disclosure requirements are waived.

#### Existing Shareholders

This is considered in s 708(13) and will include bonus shares. The rationale behind this exemption is that existing shareholders have already bought into the company and therefore should know what they are getting. If the shareholders are not happy with the way the company is going, presumably they will not buy more shares.

#### Rights Issuers

This is contemplated in s 708AA. A rights issue means that shares are being offered to existing shareholders in the same proportion of their current holdings. The existing shareholder exemption is principally for bonus shares but rights issues are new shares being sold to existing shareholders. This was later exempted in 2007 because it was felt that by not exempting it, the regime unduly penalised smaller companies. Even a small company wanting to issue new shares to its existing shareholders would have otherwise had to issue a prospectus to shareholders.

### Liability

There is a basic requirement that if you are issuing shares to the public, you must engage in disclosure this is backed up by sanctions for non-compliance (i.e. failure to make disclosure when you are required to OR where the disclosure is misleading or deceptive). Section 727 prohibits the offer of shares to the public without the required disclosure and breach of this section is a criminal offensive, punishable by a fine of 200 penalty units or a 5 years imprisonment or both. A Penalty Unit is defined in s 4AA of the Crimes Act as being $180 (i.e. maximum fine of $36K). These penalties are imposed on the director’s and not the company itself.

There is also liability under section 728 for misleading or deceptive statements in the disclosure document. If you are lucky, ASIC will pick up on such content and issue a stop order however if the document is issued to the public, that will constitute a criminal offence and the same penalties that apply to non-disclosure apply to misleading or deceptive disclosure.

In many cases, non-disclosure arises because a company thought it fell under one of the exemption but ASIC took a different view and the courts upheld that view. The only differences between non-disclosure and negligent disclosure for the purposes of liability is that in sections 731 and 733, there are some defences in relation to negligent, deceptive or misleading disclosure. Section 731 states that a defence may arise if you had an honest and reasonable belief that what you said was true and had made all reasonable inquiries. Section 733 gives directors a partial defence in relation to information provided to them by others.

The result of non-disclosure or misleading disclosure (particularly the latter), is that investors who bought shares may have suffered loss. Section 729 deals with the availability of claims for compensation by investors who bought on the basis of the misleading information. Section 729(1) makes this claim available against the company, the directors, the underwriters of the issue and against any person who made a statement in the disclosure document which was misleading (including all professional advisors). The difficulty with an investor seeking compensation as a result of a misleading disclosure, it is a prerequisite of that claim that the shareholder be able to establish a causal link between the misleading information and his/her decision to buy shares. This is often difficult because there will be a range of other factors the shareholder relied upon in making the investment decision.

## Debt Finance

Companies funding will be a finance of the money received for shares, retained earnings and debt (money that it has borrowed). The debt may have certain advantages over other aspects of finance (i.e. interest on loans is tax deductible) and borrowing money may be cheaper than raising money from the public by selling shares since interest rates are so low. You can also raise money from creditors through debt without having to surrender control rights. On the other hand, if the company has large amounts of debt and is therefore making large interest payments, that might put the company cashflow under strain.

Companies can borrow through the same mechanisms that individuals can however there are some differences in terminology:

Companies issue **debentures** as the vehicle for borrowing money and may borrow money from a single source (i.e. bank) or they may issue debentures to the public in the same way they issue shares. At common law, a debenture meant a document that was usually executed as a deed that acknowledged the existence of the debt and recorded any securities over that debt – it was not a means of raising finance itself and was instead a document of record (recorded existence of debt and terms). The Corporations Act historically had an even broader meaning - any chose in action or bill of exchange. This led to some confusion in the marketplace because people tend to associate debentures with secured debt. As a result, section 283BH prescribes the way you can describe a debenture.

* + - **Mortgage Debenture** – loan secured by mortgage over real property
    - **Debenture** – debt secured over personal property
    - **Unsecure Debenture** – everything else

Debentures do not describe a particular kind of debt or security. ‘Debentures’ is a catch all phrase for a document which records debt and its terms.

Debentures are first and foremost a contractual arrangement between company and lender. The rights and duties of the parties are determined by that contract. If the Debenture arrangement also includes security for the loan, we look to those bodies of law which regulate securities over real property (i.e. common law and Land Title Act) and personal property (i.e. PPSA).

Debenture arrangements might also include a trust or trustee – if the debenture involves a large group of small investors pooling their funds, the Corporations Act under s 283AA requires that a trustee be appointed to manage the arrangement.

Prior to 2009, company securities (i.e. situation where company has given security for a debt) was regulated by a separate company charges registration system found in the Corporations Act. It was a separate regime driven by the fact that companies could offer a peculiar form of charge or security that individuals could not and the Corporations Act provided for a separate registration system. In 2009, the implementation of the PPSA replaced this system and therefore company charges are the same as charges any other person can give. This means that charges over the land are regulated by the Torrens System and charges over personal property are regulated by the PPSA.

### Why does Secured Debt exist?

All other things being equal, the riskier a loan is, the higher the interest rate you will pay. The interest rate includes not only a component that rents the money but it also has a component that insures the lender in the case of default (early repayment). Security makes repayment more likely. If you have a mortgage over the house and the borrower does not repay you, you can still recover by having recourse to the asset and selling it. If you are providing an assurance of payment by provision of security, you do not need to charge as much as interest (no prepayment component). The interest payable on an unsecured loan will always be higher than the interest payable on a secured loan. For that reason, borrowers want to provide security because they want to pay less and lenders are happy to take security because it reduces their monitoring costs. If you are a lender and the loan is unsecured, you need to ensure the borrower does not dissipate its assets. Secured debt is a means of reducing interest rates and a means of reducing the cost of capital – money is more freely available, cheaper and can be put to work more effectively.

In this context, security is a form of right right, usually in a piece of property of some kind, that enables the holder of that right to have recourse to that asset to satisfy the debt. It is typically a proprietary right (e.g. mortgage – lender has property right in land that enables them to sell land and recover what they are owed). It is a contingent and defeasible property interest because it exists only to facilitate payment and in many contexts, the only reason we are interested in the existence of the property right in the form of security is because of how it affects the insolvency regime. In insolvency, unsecured creditors usually get paid nothing or very little (e.g. 5c on $1) – at the back of the que. If you have a property right in an asset owned by the debtor, you can stand outside the insolvency regime and do not have to participate as a creditor. Instead, you can sell the asset and recover the debt owed to you. Property rights are the only rights that survive the onset of insolvency and therefore are particularly important in secured lending.

### Non-Circulating Security Interest and Charges

The PPSA provides for securities that are both fixed and circulating. Security that is fixed is over a particular asset:

If B takes a charge over A’s car in return for a loan to A to buy the car, that is over a particular asset. The affect is that A cannot sell the car without first satisfying the security interest. The existence of the security restricts A’s ability to deal with the assets.

Fixed security interests are most suited to large and static assets which you do not deal with very often (e.g. land, plant). A fixed charge is not suitable for stock or raw materials:

If you are in the business of making brass widgets, a fixed charge is suitable over the factory and machine which makes the widgets. You cannot give a fixed charge over the stock of brass which you use to create widgets because you need those widgets to trade. You would need a release from the charge holder each type you wanted to sell the brass.

Fixed charges are not suitable for circulating assets (i.e. assets you need to buy and sell on a regular basis as part of trade).

The PPSA recognises a form of security over circulating assets – this charge does not attach immediately to any particular asset. Instead, it hovers over that asset and becomes latent. It allows the debtor to trade those assets in the course of their business and the charge only fixes onto particular assets when there is some event which causes it to do so (events normally specified in charge – e.g. act of insolvency). In respect of circulating security interests, prior to 2009, these were referred to as floating charges and floating charges could only be granted by companies. Post 2009, anybody (individual or company) can grant a circulating security charge. The common law did not allow floating charges to be granted by an individual because floating charges could be given over all your assets – concern that individuals would deprive themselves of the necessaries of life.

One other problem of a circulating security interest is that they are incredibly encompassing. Since they notionally attach at the point of crystallisation, ahead of all other claims, it means that the holder of a circulating security interest or floating charge always gets in first. The only creditors they are behind are those who already have a fixed charge over particular assets. Typically, banks would, in the document of debenture say the following:

‘*Fixed charge over land, building and plant. Floating charge over everything else’*.

This left people who were owed wages or superannuation entitlements in an unfavourable position. It also left the ATO at the back of the que – companies are accounting for GST and payroll tax. Since circulating security interests are so encompassing, the law has intervened to postpone the priority of these types of charges. In sections 433 (receivership) and 561 (liquidation), the priority of the holder of a circulating security interest is postponed behind a list of preferential creditors. Preferential creditors include employees and the ATO.

### Registration of Charges

Under land title registration systems and the PPSA, the priority of a claim is determined by the date of registration and not the date of creation. If you wish to have your priority of payment fixed, you must register your charge. The Corporations Act intervenes in the order of priorities in a number of ways as part of the insolvency process, it vests in liquidators and receivers, powers to change the order of priority. It may do that by allowing the liquidator to invalidate transactions that occurred immediately prior to the period of insolvency.

E.g. Granting company to charge over large indebtedness before company went insolvent. This means that the lending company becomes a secured creditor and gets paid – this was clearly done because those involved could see insolvency arising. This undermines the integrity of the insolvency regime and therefore the Corporations Act allows the liquidator to allege that a company performed an act to defeat the insolvency system and therefore invalidate the transaction.

**FINAL EXAMINATION**

* 2 hours – 10 mins reading time
* Open book
* 60%
* 2 compulsory problem questions – same style and nature of tutorial questions

**What we Look For?**

* Answer the question – Important!
* Quality not quantity
* Do not worry about case citations
* Do not worry about copying out statutory provisions
* **FOCUS ON**: Effect of statutory provision and how it relates to problem and addresses the question

# Liquidation, Receivership & Voluntary Administration

External administration is essentially where somebody from the outside is appointed to take over from the directors. There are three types of external administration: liquidation, receivership and voluntary administration, and each serves a different purpose. External administration occurs when a company becomes insolvent. All external administrators are ‘officers’ and will therefore owe the duties that directors and other officers owe under the Corporations Act (ss 180-183). These statutory duties are in addition to their general law duties.

The primary aim of insolvency law is to provide a fair and orderly process for dealing with the financial affairs of insolvent companies and individuals. Insolvency should provide mechanisms which enable the debtor and creditor to participate with the least possible delay and expense. There are additional aims that insolvency law strives to achieve (see textbook [22.10]).

## Liquidation

Insolvent companies are usually put into liquidation however companies can be put into liquidation for other reasons (e.g. remedy for oppression). Liquidation is a drastic remedy and is most suitable when a company is insolvent because the company will be de-registered and the company’s business will cease. The liquidator’s role is essentially to bring proceedings on behalf of the company in order to increase the assets available for distribution to creditors. The liquidator’s primary function is to act for the benefit of creditors, in particular unsecured creditors (since receiver’s act for the benefit of secured creditors). The liquidator aims to turn assets into cash and distribute the money to the creditors and then later to the shareholders (depending on what is left over).

Liquidation involves a ‘liquidator’ selling off company’s assets and distributing the proceeds among creditors and members (if any surplus remains). It is unusual for there to be a surplus and often there will be insufficient monies to pay the unsecured creditors. Ultimately the company will be deregistered and the company’s business will come to an end.

### Routes to Insolvent Liquidation

Insolvent companies can be placed in liquidation in two ways, either:

**Compulsory liquidation or ‘winding up in insolvency’**: Under Pt 5.4, creditors or other eligible applicants may force the company into liquidation by obtaining a court order

**Creditors’ voluntary winding up**: ss 495-496 – does not require a court order and may arise, for example, if creditors of a company under administration vote to wind up the company.

### Aims of Liquidation of Insolvent Companies

The general objectives of liquidation of insolvent companies is to ensure that:

* Creditors, especially unsecured creditors share equally and fairly in the distribution of an insolvent company’s insufficient assets. Prior to the current insolvency regime, if you were an unsecured creditor, you needed to sue the company and get to court first to obtain the money owed to you. The money recovered by the first unsecured creditor was at the expense of other unsecured creditors who did not recover at all. Now, it is usually the liquidator who will sue on behalf to the unsecured creditors however in some special circumstances, creditors may with the permission of the liquidator or the court, bring separate proceedings against the company. Where there are insufficient monies, each unsecured creditor shares equally and prorata in whatever money is available.
* Hopelessly insolvent companies cease trading for the good of the wider business community and in particular people who are dealing with them (i.e. employees and creditors). Often it is very difficult to acknowledge that the company is insolvent, especially in relation to small companies – people put heart and soul into company.
* There is an investigation into an insolvent company’s affairs prior to the commencement of the winding up to try to determine the reasons for the insolvency: see Lipton et al at [22.120]

It is also possible for solvent companies to be wound up:

* **Members’ voluntary winding up**: ss 497-500; or
* Court may order a winding up on grounds other than insolvency. There may be a **compulsory liquidation on grounds other than insolvency**, for example, to end oppression of members (ss 232-233) or because it is just and equitable to do so (s 461(1)(k))

### Types of Liquidation/Winding Up

There are four types of liquidation:

* Voluntary liquidation by members
* Voluntary liquidation by creditors
* Compulsory liquidation on grounds other than insolvency
* Compulsory liquidation on grounds of insolvency

There are two types of voluntary winding up:

* Members’ voluntary winding up
* Creditors’ voluntary winding up

A members’ voluntary winding up commences when the members pass a special resolution and is only possible for solvent companies. A creditors’ voluntary winding up is similar to a members’ voluntary winding up, **except** that the company is **insolvent**. Usually, a creditors’ voluntary winding up occurs in the context of the company having gone into administration and a decision being made to wind up the company.

There are two types of court ordered winding up:

* **On grounds of insolvency**: governed by Pt 5.4 CA, ss 459A- 459T which adopts the phrase ‘winding up in insolvency’ to emphasise the distinction between the compulsory liquidation of solvent and insolvent companies
* On **grounds other than insolvency**

#### Court Ordered Winding up on Grounds other than Insolvency

The application may be made by the company, a creditor, a member or ASIC and upon the following grounds:

* The company has suspended business for a whole year
* The directors have conducted the company in their own interests rather than in the interests of the members as a whole
* The affairs of the company have been conducted in a manner oppressive or unfairly prejudicial to or unfairly discriminatory against a member or members
* The court is of the opinion that it is just and equitable that the company be wound up: s 461

#### Court ordered Winding up on Grounds of Insolvency

An application is made to the court for the company to be wound up: s 459A. Section 459P(1) lists who may apply to the court for a winding up in insolvency. The eligible applicants include:

* Creditors (usually unsecured creditors) – these are the most common applicants and includes prospective and contingent creditors. A prospective creditor is a creditor to whom a debt is due but not immediately payable. A contingent creditor is a person to whom a debt is owed, payment of which is only due on the occurrence of some future event (e.g. guarantor)
* The Company
* A Director
* a liquidator or provisional liquidator
* ASIC
* Other Prescribed Agencies (APRA)

Certain applicants require leave of the court under s 459P(2) and they are contingent or prospective creditors, a contributory (shareholder that is a holder of partly paid shares – calls can be made on shares for whatever balance is owing on the shares) directors and ASIC. Leave of the court is required by these parties to prevent mischievous and harmful winding up companies that are brought to harass and pressure the debtor company. To ensure that an application contains up to date information about the company’s insolvency, the winding up application must be determined within 6 months: s 459R.

There are several stages to obtaining a compulsory winding up order: see Lipton et al at [25.55]. An application must be determined within 6 months. It is possible that between the filing of the application and the making of the order the court may appoint a **provisional liquidator** to protect the company’s assets: s 472(2).

At the hearing of the application, the court must be satisfied that the company is insolvent before it will make an order to wind up the company in insolvency. In these situations, proof of insolvency is a difficult evidentiary matter.

##### How does a creditor prove that a company is insolvent?

There is a definition of a solvent company in the Corporations Act (s 95A). A company is solvent if it is able to pay its debts as and when they are payable. This definition is not helpful because if applied literally, many companies would be insolvent a lot of the time. It is about the commercial viability of the company and considers the cash flow situation of the company but a short term liquidity is not necessarily proof of insolvency. The law sets up a number of presumptions under s 459C(2) in proof of insolvency.

The most common is that company is presumed to be insolvent if it has failed to comply with a statutory demand for at least $2000 (currently the ‘statutory minimum’) that creditor served on the company: s 459C(2)(a).

The creditor will serve the company with a statutory demand in relation to a debt for at least $2000 but there are strict procedural requirements around the service and content of the notice. At the end of the relevant period (i.e. 21 days), if the debt remains outstanding, the company is presumed to be insolvent. This is a significant presumption that the law sets up. It is possible for a company to apply to set the demand aside on two grounds:

* + - 1. it contains a major defect or
      2. there is a genuine dispute about the existence or amount of the debt.

Under s 459S, it restricts a company, without leave of the court, from opposing an application for a winding up on insolvency that is based on a failure to comply with the statutory demand. The purpose is to penalise companies that do not give early notice of any issues they have with the statutory demand. The company is expected to put its claim that the demand is defective or that the debt is being disputed at the time of contesting the statutory demand.

A company is insolvent when it is unable to pay its debts as and when they become due and payable: s 95A Corporations Act. It is a ‘commercial’ or ‘cash flow’ test rather than a ‘balance sheet’ test which assesses whether assets exceed liabilities. The mere fact that assets exceed liabilities does not necessarily establish solvency, but it is relevant to consider the extent of assets, the available credit and the ability of the company to call in debts (future events)*:* ***Leslie v Howship Holdings Pty Ltd* (1997)**.

A cash flow test is used because the law is concerned with liquidity, although the case law does suggest that a temporary lack of liquidity does not necessarily mean company is insolvent, but also the position of the company in its trading situation. Essentially, the cash flow test asks whether the company is viable: ***Re New World Alliance Pty Ltd (rec and magr apptd)* (1994)**

See***Austin Australia Pty Ltd v De Martin Gasparini Pty Ltd* [2007]** for ‘the usual indicia of insolvency’: Lipton et al at p 874. The usual indicia of insolvency include:

* Whether there have been unsatisfied judgments against the company
* History of dishonoured cheques
* Suppliers insisting on cash on delivery terms
* The issue of post-dated or rounded sum cheques
* Special arrangements with creditors
* Inability to produce timely audited accounts
* Unpaid bills (group tax, payroll tax, worker’s compensation premiums, superannuation contributions)
* Demands from bankers to reduce their overdraft
* Other evidence of deteriorating relations with bankers
* Receipt of letters of demand
* Statutory demands and court processes for debt

In the final analysis, evidence of a company’s insolvency is largely a question of fact to be determined as a matter of commercial reality in light of all the circumstances: ***Southern Cross Interiors Pty Ltd v Deputy Commissioner of Taxation* [2001]**.

### What is the Effect of the Appointment of A Liquidator?

The appointment of a liquidator does not affect the rights of secured creditor: s 471C. For example, a secured creditor’s right to appoint a receiver are unaffected from the appointment of a liquidator. There are certain security interests that may be challenged. Secured creditors with ‘circulating security interests’ may have their claims postponed by, for example, employee claims under s 561.

Other creditors (i.e. unsecured creditors) cannot generally take action if a liquidator is appointed. The liquidator acts on behalf of the unsecured creditors.

The company cannot carry on business except for the purposes of the winding up and the company is managed by the liquidator, not the directors.

### What are the Liquidator’s Functions?

* To take possession of the company’s assets: s 478(1)
* To realise (sell) the company’s assets
* To work out what debts are payable by the company and what valid claims exist against the company – the liquidator will advertise and require that secured creditors lodge proof of debts and seek outstanding judgments for breach of contract
* To distribute the proceeds of the realised assets among the creditors and others with legitimate claims against the company
* If there are any surplus funds, these funds will be distributed amongst the members
* To bring about deregistration of the company

If in the course of his/her dealings with the company, the liquidator discovers breach of director’s duties or dishonesty by employees, they are obliged to report these matters to ASIC. Liquidators can sack employees who they have found guilty of fraud or dishonest behaviour.

### What are a Liquidator’s Duties?

Under the Act the liquidator must:

* Conduct an impartial investigation of the company’s affairs
* Collect the company’s assets
* Keep proper books during the winding up
* Lodge the required notices and reports with ASIC (including notice of appointment as liquidator, report whether any breaches of Corporations Act and statements on financial position in the winding up at 6 monthly intervals)

The liquidator also owes fiduciary duties to the company. The liquidator is also an ‘officer’ of the company under the Corporations Act and therefore owes the company statutory duties.

### What are the Liquidator’s Powers?

* The liquidator has the power to sell the company’s property or dispose of it in some other way.
* The liquidator has the power to carry on the company’s business, but only to the extent necessary for the beneficial disposal or winding up of that business: s 477(1)(a)
* The liquidator has the power to make a compromise or arrangement with creditors or others with claims against the company, or with debtors of the company but the approval of the court or the creditors is needed for a compromise of a debt owed to the company worth more than $20,000
* Power to defend or bring legal proceedings in the company’s name including bringing any statutory actions which will increase the pool of assets/money available for distribution
* Power to make calls on contributories, e.g. a call on owners of partly paid shares to pay up whatever is owing on their shares
* Power to obtain information about the company

### What funds are available to the Liquidator?

The funds available to the liquidator include assets owned by the company at the time the court makes the winding up order (or the members pass the special resolution to wind up the company), except for:

* Assets over which a secured creditor has a valid security interest – the rights of a secured creditor are unaffected by the appointment of a liquidator however there are certain security interests that will be invalid if they are not perfected (e.g. not registered on PPSA)
* Assets that the company holds on trust (usually at the time the business is established). If property is placed in a trust at a later date, it may be viewed as a voidable transaction and set aside by the liquidator.

The funds available also include assets that come into the company’s ownership after the winding up order is made, such as:

* Compensation recovered by the liquidator from a director who has breached a duty owed to the company, for example the duty in s 588G
* Funds received from contributories, such as owners of partly paid shares, after the liquidator has made a call on them
* Funds that the liquidator has ‘clawed back’ via court proceedings under the ‘voidable transactions’ provisions
* Funds recovered from the holders of void security interests

### Proceedings for Insolvent Trading: s 588G

The duty to prevent insolvent trading is owed by ‘directors’ only and not officers (definition of directors in s 9 – includes shadow directors and de facto directors). There are four steps to consider in assessing whether the duty has been breached:

1. Does s 588G(1) apply – does the duty apply?
2. If so, have the directors contravened s 588G(2)?
3. Are any of the defences in s 588H available?
4. What remedies are available?
   * s 588G is not only a civil penalty provision but also a statutory lifting of the corporate veil and so directors will be personally liable for the company’s debts if the duty is breached

#### Does the Duty Apply?

Section 588G(1) applies if

* Person is a ‘director’ of the company;
* Debt is ‘incurred’ – normally the incurring of a debt is the ordering of goods or services (entering into unavoidable obligation to pay sum of money in the future but will also cover contingent liabilities (e.g. guarantee) (***Hawkens v Bank of China***). Section 588G(1A)) sets out certain transactions that are deemed to be debts.
* company ‘insolvent’ at time debt incurred or becomes insolvent by incurring the debt. You are seeking evidence or indicia or insolvency. Since insolvency can be a difficult evidentiary matter, the legislation sets up presumptions of insolvency relevant to s 588G in ss 588E(3) (insolvent at any time during the previous 12 months) and 588E(4) (failure to keep proper financial records)). The presumptions are rebuttable and so if the director can raise eviendece to the contrary, then the presumptions will not apply. The indicia are not relevant to an application to a court for the winding up upon insolvency.
* Reasonable grounds for ‘**suspecting**’ insolvency. It is more than mere speculation and a person must have a positive feeling of actual apprehension that there is insolvency: ***Queensland Bacon Pty Ltd v Rees* (1996) 115 CLR 266.** See also ***Credit Corporation Australia Pty Ltd v Atkins* (1999) 17 ACLC 756**

#### Has the Duty been Contravened?

By failing to prevent the company from incurring the debt, the person **contravenes** the section if:

* The **director was aware** at the time the debt was incurred that there were **reasonable grounds for suspecting** that the company was insolvent, or
* **A reasonable person** in a similar position in a company in the company’s circumstances **would have been aware** that there were **grounds for suspecting** that the company was insolvent: see ***Metropolitan Fire Systems Pty Ltd v Miller* (1997) 23 ACSR 699**; ***Commonwealth Bank of Australia v Friedrich* (1991) 9 ACLC 946**. In both cases, the court held that the conduct of the director is judged against that of a reasonable director of ordinary competence who has the ability to have a basic understanding of the company’s financial status. This test is informed by the law that has developed in relation to the duty of care (Daniels v Anderson – all directors need to be aware of a company’s financial position and activities and it is an ongoing obligation to stay informed). Even where a director is not involved in the company’s business but a director in their position would have been so aware, such a director will be found to have breached this duty.

#### Are any Defences Available?

There are 4 defences available under s 588H:

1. Reasonable grounds to ‘**expect’** solvency: s 588H(2).

There was some confusion about the use of the word ‘suspect’ in the contravention section and the use of ‘expect’ in the defences section and questions arose about whether the use of the differing terminology was deliberate. The court in ***Metropolitan Fire Systems v Miller*** held that to suspect something requires a lower threshold of knowledge or awareness than to expect it. The standard of proof to make out the defence is higher than to establish a contravention. The expectation must be differentiated from mere hope to satisfy the defence and implies a measure of confidence that the company is solvent. The court further held that the directors must have reasonable grounds for regarding that it is likely that the company was able to pay its debts as and when they fell due – point to grounds that support their belief that they expected solvency

1. Reasonable reliance on information provided by others: s 588H(3).

This defence and the following one need to be read together for interpretation purposes. Subsection (4) gives a defence to directors who have not participated in management due to illness for some other good ground. The words ‘some other good ground’ and ‘reasonable reliance on information by others’ have been interpret narrowly by the courts.

1. Non-participation in management because of illness or some other good ground: s 588H(4).

***Deputy Commissioner of Taxation v Clark* (2005) 21 ACLC 1063** - This case involved a proprietary company with two directors (Mr and Mrs Clark). The company was set up as a vehicle to run a family carpentry business and the evidence was that MRs Clark had never been a company director before and had no business experience. Most of her time was taken up as a housewife and from time to time, signed company documents that her husband requested she signed. Mrs Clark left the management of the company to her husband and did not believe she needed to be involved. She sought to rely on the defence set out in s 588H(4) and the court did not accept the defence was enlivened. The court held that it was a core irreducible duty for directors to be involved in the management of the company and every director is expected to participate in management.

1. Reasonable steps to prevent the company incurring debt: s 588H(5).

In assessing that defence, the court will look at what action the directors took to appoint an administrator pursuant to s 588H(6). The fact that a director appoints an administrator is not conclusive evidence that the director took reasonable steps to prevent the incurring of a debt but it has become an important step the courts will consider. Since the consequences of breaching the duty to prevent insolvent trading is so serious, many directors appoint administrators when worried about the solvency of the company.

#### Consequences of Breach

The Director may be ordered to pay compensation. If the company is being wound up, the liquidator may sue director for compensation: s 588M. it is possible for individual creditors to sue with either written consent of liquidator: s 588R or permission of the court: s 588T but often the liquidator will bring the action.

Section 588G is a *civil penalty* provision so the director is liable to civil penalties under Pt 9.4B and may result in civil penalty provisions being brought by ASIC. It can be a criminal offence pursuant to section 588G(3) if the incurring of the debt is dishonest (additional mental element).

The legislation also considers groups of companies and makes the parent company liable for insolvent trading debt of its subsidiary if the parent company has allowed the subsidiary to incur debts whilst insolvent: ss 588V-X. This mirrors the position whereby individual directors are liable for the insolvent trading debts of their company.

### What is a Voidable Transaction?

A **voidable transaction** is a certain kind of transaction entered into by the company in the period leading up to its winding up, which the liquidator is able to reverse and recover any funds paid by the company to another person. There are 7 types of voidable transactions. The legislation uses the phrase ‘relation back day’ which is defined in section 9 of the Corporations Act and the definition depends on how the liquidation came about (i.e. by court order or resolution of creditors).

**Type 1** – Insolvent transaction within 6 months before relation back day (s 588FE(2))

**Type 2** – Insolvent transaction and uncommercial transaction within 2 years before relation back day (s 588FE(3))

**Type 3** – Insolvent transaction with related entity within 4 years before relation back day (s 588FE(4)). Related entity is defined as a director or any relative of a director.

**Type 4** – Insolvent transaction where it can be proved that the purpose of entering the transaction was to interfere with winding-up within 10 years before relation back day (s 588FE(5))

**Type 5** – Unfair loan any time on or before winding up (s 588FE(6)). There is no time period.

**Type 6** - Unreasonable director-related transaction entered into during 4 years ending on relation-back day, or after that day but on or before winding up: s 588FE(6). You do not need to prove that the company was insolvent at the time. In some situations, it may be better for the liquidator to argue that a transaction is an unreasonable director-related one rather than a transaction with a related person which must be an insolvent transaction with a related entity.

**Type 7** - Unfair preference or uncommercial transaction or unfair loan or unreasonable director-related transaction entered into between relation-back day and the winding up where the company was in Voluntary Administration and not entered into on behalf of the company by the administrator: s 588FE (2A)-(2B)

The first 4 types of voidable transactions involve an ‘insolvent transaction’. Type 5 deals exclusively with ‘unfair loans.’ Type 6 involves an ‘unreasonable director-related transaction’. Type 7 involves voidable transactions that were entered into by the company during Voluntary Administration or a deed of company arrangement.

Six types of voidable transactions involve the concept of ‘relation-back day’.

The **relation-back day** is either the day on which an application for a liquidation order was filed or the day on which the liquidation is deemed to have begun, depending on the circumstances: s 9

An **insolvent transaction** is either an ‘unfair preference’ or an ‘uncommercial transaction’ either entered into when the company was insolvent or which caused or contributed to the company’s insolvency: s 588FC

An ‘**unfair preference’** is a transaction between a company and an unsecured creditor which results in the creditor receiving more from the company than they would have received if they had to prove for the debt in a winding up: s 588FA.This would cover a situation where the company owes 20 creditors and a particular creditor is paid (e.g. may be pressing company for payment). They receive payment of their debt at the expense of the other creditors who remain unpaid. The rationale for the current regime is to provide an orderly and fair way of dealing with creditors claims so that they all share equally and proportionately in the insufficient funds.

An ‘**uncommercial transaction’** is one that a reasonable person in the company’s circumstances would not have entered into: s 588FB

An ‘**unfair loan’** is a loan which has an extortionate interest rate or charges attached to it: s 588FD. If the current interest rate is 6% but the loan is made to a director or a company at 20%, then that will be an extortionate interest rate.

An ‘**Unreasonable director-related transaction**’ is a transaction made by a company in favour of a director or certain relatives of a director that involves

* + a payment made by the company
  + a disposition of company property
  + the issue of shares or other securities; or
  + the incurring by the company of an obligation to make such a payment, disposition or issue

and that a reasonable person in the company’s circumstances would not have entered into, having regard to:

1. the benefits (if any) and detriment to the company;
2. the benefits other parties gain; and
3. (iii) any other relevant matter: s 588FDA

If there is a benefit to the individual where, for example, a payment is made to a director or relative, but there is no benefit to the company, it will probably be an unreasonable director related transaction.

#### Any Exceptions?

A party to a Type 1, 2, 3 or 4 voidable transaction will NOT have to repay the liquidator if:

* they became a party to the transaction in good faith **AND**
* they had no reasonable ground for suspecting that the company was or would become insolvent **AND**
* the provided valuable consideration under the transaction or changed their position in reliance on the transaction: s 588FG(2)

### What is a Void Security Interest?

A **void security interest** is:

* a floating charge or any other circulating security interest granted by the company during the six months ending on the relation-back day (or between the relation-back day and the start of winding up), except where the company was solvent immediately after the charge was created, or the company benefited from the charge: s 588FJ **OR**
* A security interest that is not perfected – e.g. a security interest that has not been registered on the personal property securities register: PPS Act, ss 267,267A **OR**
* a security interest created within the last six months in favour of an officer of the company: s 588FP (e.g. loan director makes to the company)

Being void means that the secured creditor would lose the priority they would otherwise have as a secured creditor and would then rank equally with the other unsecured creditors.

### Liquidator’s Functions

* Collect and realise assets
* Work out what debts are payable by company, and what is owed to the company
* Distribute proceeds of realised assets among creditors
* If any surplus, distribute among members

### How are Funds Distributed?

The order in which funds are distributed by the liquidator is set out in s 556 as follows:

1. Secured creditors
2. Liquidation expenses (including liquidator’s remuneration)
3. Unpaid wages, unpaid superannuation contributions, and other employee entitlements
4. Unsecured creditors
5. Members (if there is a surplus)

If there are not enough funds to pay all employee claims, the liquidator must pay these claims before paying a secured creditor with a circulating security interest: s 561. This is because under s 434, certain debts are treated as preferential debts that have priority to the claims of a **secured creditor holding a circulating security interest**. In other words, where a secured creditor holds a circulating security interest, their entitlement to payment will be deferred to certain preferential debts. Most importantly, these debts include employee claims under s 561 which are paid in the following order:

1. Employees’ wages: s 556 (1)(e)
2. Employees’ leave entitlements: s 556(1) (g)
3. Retrenchment pay: s 556(1)(h)

If there is not enough to pay all their entitlements, employees will receive a pro rata (proportionate claim). Employees also have a right to claim against a statutory fund (GEERS Scheme – General Employees Entitlements Redundancy Scheme).

The law does identify certain employees as excluded employees including directors, spouses and relatives of directors. Even though they have priority, their claims are limited. Amounts paid in respect of wages cannot exceed $2000: s 556(1A); leave limited to $1500: s 556(1B); and retrenchment limited under s 556(1C).

### Deregistration

Deregistration brings the company’s existence to an end. The three types of deregistration are:

* deregistration following winding up
* voluntary deregistration
* deregistration initiated by ASIC

In certain circumstances, the registration of a company can be reinstated: s 601AH

## Receivership

Receivership is dealt with under Part 5.2 (Sections 416-434) and involves the appointment of an independent, experienced insolvency practitioner as a receiver. A receiver must be on the list of registered liquidators: s 418a

A receiver is usually appointed by a secured creditor (e.g. a debenture holder when the company has breached one or more of its obligations under the loan agreement) to:

* Take possession of the secured property
* Sell it and
* Repay the secured debt owed by the company out of the proceeds of sale

Receivers are most commonly appointed by a secured creditor who, under the security instrument, will have a right in the event of default (i.e. failure to pay, appointment of administrator) to appoint a receiver. However, a receiver may also be appointed by the court (under s 1323(1)(h) in course of ASIC investigation or under s 233 as a remedy for oppression). Receivers are appointed to enforce a secured creditor’s security, as a remedy in an oppression action or during an ASIC investigation.

Broadly, where appointed under a security interest (e.g. charge) the receiver’s function is to collect the secured property, sell it and distribute the proceeds to the secured creditor. The sources of the receiver’s powers are set out in both the loan agreement or debenture (or court order) under which receiver was appointed and s 420 Corporations Act. Under s 420, the receiver has broad range of power including the power to:

* carry on the company’s business/businesses
* convert the company’s property into money
* borrow on security
* execute documents
* bring and defend legal proceedings in company’s name
* hire and fire employees
* appoint agents

### General Receivership

Where the receiver is appointed to take control of all, or nearly all, of the company’s business and assets, this is a general receivership. Contract with a situation where a receiver is appointed in respect of particular property. Where a receiver is appointed in a general receivership, the receiver will:

* take over the control of the company’s bank accounts and insurance arrangements
* work out what property the company owns and have it valued
* review all uncompleted contracts
* arrange the continued supply of essential goods and services
* fire any employees who are not required during the receivership
* review the company’s system of internal control and ordering
* sell assets where necessary

### Receiver’s Duty

Since the main power of the receiver is to sell the secured property, the receiver is under a duty of care when selling company assets: s 420A. In regard to the sale of company property, the general law imposes a duty on receiver to act in good faith. The case law suggests that the duty of care involves obtaining the market value of the property however a receiver does not have to wait until market conditions are good and must simply obtain market value at the time: ***Pendlebury v Colonial Mutual Life Assurance Society Ltd***

Under the laws of contract, tort and fiduciary principles the receiver owes duties to the secured creditor who appointed them

The receiver also owes fiduciary duties to the company.

The receiver is also an ‘agent’ of the company which means that the company can sue the receiver if he/she does the wrong thing.

A Receiver is also an ‘officer’ of the company under s 9 and so if the receiver breaches the duties imposed upon directors, for example, proceedings can be brought against them.

### Receiver’s Liabilities

A receiver may be liable for:

* breach of duty
* invalid appointment
* some contracts created before the receivership
* contracts created during the receivership

A receiver will usually insist upon getting an indemnity from the secured creditor who appoints them to cover them for these sorts of liabilities.

## Voluntary Administration

Voluntary administration is governed by Part 5.3A of the Corporations Act. This is a mechanism under which a company is put into a temporary safety zone from creditors’ claims while a decision is made by its creditors whether the company should:

* Execute a deed of company arrangement (DOCA) - plan of action to enable the Company to either trade out of its difficulties or identify profitable parts of business (selling off business) to continue on with profitable part of business or selling that part of the business. The latter option means that creditors would receive more than if the company was immediately wound up.
* Be wound up – this is an option if the company’s financial status is hopeless and the decision is made to wind up/liquidate the company
* Be returned to the control of its board of directors

An administrator will be a professional with experience in the insolvency area. Often an administrator will be appointed by directors who may be worried about the solvency of the company. The directors of an insolvent company have an incentive to appoint an administrator under the VA provisions because doing this provides some protection for them against liability: see s 588H(5) and (6). The administrator’s role is to determine the financial health of the company, along with the creditors.

The goal of the Voluntary Administration provisions is to maximise the chance of the company, or as much as possible of its business, continuing in existence; or if that is not possible, provide a mechanism for creditors and members to get a better return than from an immediate winding up: s 435A

The two phases of voluntary administration are:

* the ***administration phase*** – when company is under administration
* the ***deed phase*** (assuming option 1 above has been chosen) – when the company is subject to a DOCA

The administration phase begins with the appointment of the administrator. An administrator can be appointed by the board or a liquidator or provisional liquidator or a secured creditor entitled to enforce over all or substantially all of the property. The administrator must be an independent person who is a registered liquidator: ss 448B, 448C. The administrator’s task is to investigate the financial affairs and decide on a course of action that is in the best interests of the creditors. The administrator effectively takes over control of the company’s business from the directors.

During the administration phase the company’s property goes into a “safety zone” (moratorium):

* There are restrictions on winding up
* Owners and lessors of property cannot recovery their property
* Legal proceedings against the company are restricted
* Enforcement processes are restricted
* Officers cannot act without administrator’s agreement
* Members cannot transfer shares without court permission

Creditors are prevented from taking action against the company during the administration, except:

* Secured creditor with a substantial charge: s 441A, or
  + Security over all or nearly all of the company’s property – have 13 day decision period to decide whether you will take steps to enforce your security (appoint receiver). If the 13 day period elapses, the creditor is prohibited from enforcing its security without permission from the court or administrator.
  + Often the administrator will attempt to get this type of creditor to work with him/her because if a substantial creditor choses to enforce its security, the administrator does not have many assets to work with. The chances of the administration being successful and the company surviving are limited.
* Charge over perishable property: s 441C

The administrator must arrange a meeting of creditors within 8 business days of appointment to form a consultative committee (representatives of creditors) or to replace the administrator if desired: section 436E. A second meeting must be called within 20 business days to decide the fate of the company and either

* End the administration and hand the company back to the directors or
* Enter into a deed of company arrangement or
* Wind up the company

You need a majority in number and value (more than ½ creditors and majority of creditors whose debts collectively amount to more than ½ of the company’s debts) voting in favour of the resolution at the second meeting. The administrator makes a recommendation, with reasons, to the creditors.

The deed phase of Voluntary Administration commences if the 2nd meeting of creditors decides to proceed with the execution of a deed of company arrangement. A majority of creditors in terms of both number and value must vote to adopt the deed. The deed contains the arrangements made between the company and its creditors at the second meeting, including, for example

* debt compromise – prepared to take only some of the money owing to them
* repayment schedule
* debt converted into equity
* creditors to supervise management

Once adopted, the deed binds all unsecured creditors so far as concerns claims on or before the day specified in the deed. Secured creditors who voted against adoption of the deed are not barred from enforcing their security.

See LG p 103