Company Law Perspectives

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COMPANY LAW PERSPECTIVES

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Preface

The fourth edition of *Company Law Perspectives* explores key issues in Australian company law and the legal and commercial environment in which companies are regulated. Material from a variety of sources is used. Included are extracts from the *Corporations Act 2001* (Cth), relevant cases, ASIC, legal journals and newspaper articles.

- *Corporations Act 2001* (Cth)—Sections are included in context to illustrate how the company law is structured and expressed in statutory form. Sections are not necessarily reproduced in full.
- Cases—Judgment extracts offer an insight into the reasoning process behind a Court's decision. The extracts are chosen to illustrate the key issues raised in the relevant Chapter. Note that some references and citations are omitted from the extracts.
- ASIC—ASIC monitors corporate behaviour and provides ongoing information and commentary on matters relevant to company law. The ASIC Media and Information Releases indicate how ASIC is carrying out its role as corporate regulator and highlight the application of the law to the business environment.
- Legal journals—These extracts provide an academic perspective on important corporate issues based on research of the relevant area. Citations are omitted.
- Newspapers—Many of the matters unfolding daily in the newspapers relate to areas that are central to the study of company law, including issues concerning directors' duties, members' rights, fundraising, takeovers and insolvency. The reporting of corporate issues in newspapers and other media serves to highlight the connection between company law and everyday commercial behaviour and practice.

Most of the extracted material is not reproduced in its entirety. In some instances, the material has been modified for relevance. Accordingly, the original work should be referred to if any reliance is to be placed on the material contained in the extracts. It also should be noted that the factual content of any material extracted from other sources, particularly the newspaper articles and ASIC Media and Information Releases, may not be current at the time that this book is used. ASIC media releases are point-in-time statements. Issues raised in extracts from these sources may have been resolved. Similarly, court orders may have been successfully appealed and allegations, claims or opinions proven unfounded.

The legislation, case extracts, newspaper articles, ASIC media releases, and journal article extracts, all serve a purpose. They provide essential information about the law and its application and represent different perspectives on the process and nature of corporate regulation.

MICHAEL QUILTER

September 2019

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Thanks to my daughter Laura for her help with this book.

Learning

Study

The ability to understand and succeed in business and company law courses, just like any other learning process, is comprised of skills. The skills needed will vary depending on what is being learnt but will almost always include: clear notes, efficient reading, attentive listening, effective strategy and ordered responses to assessment.

There is no guaranteed formula for success when advising on how to study or do exams. No one particular piece of advice will suit everybody. However, just as in the business world, it is not always what you know, it is how you use it. Technique, motivation, planning, and perspective are all vitally important. For example, it is wise to remember in an examination that the person marking the exam will have a different perspective on the process. You may feel rushed and somewhat unsure in the exam but the marker will look for clarity and order, they will look for the law to be applied to the facts and issues. Your goal should be to hand up a finished exam that as best as possible allows the marker to see what you can do and reward your effort. Set out to impress the marker. Do not limit your goals to merely getting through the exam. Think about what and how you are writing and what it will look like to a marker (for example illegible writing, repetition and irrelevancies are not impressive).

Be realistic (you will not remember everything in the text so be selective), do your best (do not give up, it is certainly not the hardest thing you are ever going to do), go to classes (the lecturer/tutor is, in a way, doing some of the work for you, and it is part of what you paid for anyway), ask questions (of your friends and tutors, it cannot hurt and it almost always helps in how you approach the unit and the exam), write ordered and legible exam answers (you are on show and competing).

You could read 100 books on how to swim yet still drown the first time you jump in the water. The reading and the doing are different things. It is the same with exams; the doing of an exam is not the doing of study. You are in control when you study; you set the pace, and you can be forgiving of yourself. Study is passive whereas exams are active. Accordingly, practice what you will face in exams, get acquainted with questions.

Make use of whatever written material is available, however, it is important to create notes for yourself (that is, do not solely rely on notes or PowerPoint slides that you have copied in class). In lectures, your note-taking serves two main purposes: firstly it helps you focus on the content; secondly it can provide a summary of key points for revision. Most students are linear note-takers (line by line). However, the use of a non-linear style (diagrams, charts etc) is often easier to decipher when the notes are used (usually when revising for an exam). As well as note-taking in lectures, creating your own notes when you are studying also has benefits. For example, if you can write a short paragraph or a few notes on the corporate veil (rather than just copying something from a text), you are already some of the way towards the skill you will actually need in the exam. Make your notes short and use simple language.

Exam technique

To identify issues in the exam, underline or highlight relevant parts of the question. Keep referring back to the question. Exams are the opportunity for you to show that you know something (content) and that you can use it (application to the facts of the question). Your content must be clear so that it can be easily used (too much information can be hard to sort in the tense atmosphere of an exam). No exam will require you to know or write everything that was covered in the unit; in fact, you will probably include, or have to consider, only a very small selection of the cases, the readings, or the sections, in your answers. So aim to be clear on the essential aspects of each topic to be examined, use these essential aspects to help you break down the question and then deal with the issues as fully as you can in the time allowed.

For example, consider a question requiring a written answer about a member (shareholder) of a profitable company who claimed that their personal rights were being infringed because the board of directors paid themselves high bonuses but never paid a dividend to shareholders. The essential law to apply would include: **ss 232** (oppression) and **233** (orders that can be made by the court) of the *Corporations Act*; reference to cases such as *Wayde v NSW Rugby League Ltd* and *Sanford v Sanford Courier Service Pty Ltd*; and consideration of issues of oppression and the reasonableness of the board's decision. This content (law) would then be applied (used) to discuss the facts of the question. For example, you would discuss what the board did, how it came to its decision, what factors affected its decision, and then comment on whether, in all of the circumstances of the question, the board's decision was one that a reasonable (fair-minded) board could have arrived at. Obviously an answer would require more than merely a series of prompts such as those above but your results will be maximised if you can isolate as many of the issues in a question as possible.

Having clear content will make it easier to see what you are looking for. Whereas knowing the law is an important part of responding to examination questions, the main part of answering problem-style questions is applying the law to the question. Your answer must show that you are dealing with the question not merely writing what you have learnt.

Your answers are the end product of a lot of work, and are often very important in your assessment and, therefore, your career. Make them look important, it will help you structure them and help markers see what you can do. Use underlining, highlighting or capitals to identify the essential elements of your answer.

Keep in mind your purpose—a clear and ordered answer showing the marker that you know some company law and that you can apply it to the questions asked.

Get to the point of the question, do not generalise, do not write what you have learnt if it is not relevant. Remember, it is a question; you are supposed to be answering it, not avoiding answering it.

Do not concentrate too heavily on one part of the exam at the expense of other parts. Your "best" answer is usually answered quite well, quite quickly. Your "worst" answer could usually do with a bit more time.

Exams vary, some allow texts and/or notes to be used, others are "closed book" with no materials taken into the exam. Some require written responses to problem style questions while others include short questions or involve a multiple choice format. If you are aware of the type of exam you are to face, then your study and approach should be structured accordingly. If you want to make the best use of the material studied, you should keep in mind how you are in fact going to use it. For example, multiple choice formats may require a particular approach or technique (although all of the basic study and exam advice, such as focussing on what the question requires and having clear content, still apply). One such study technique could involve drafting your own multiple choice questions. This allows you to familiarise yourself with the format you will face in the exam and to acquire knowledge at the same time. If you feel you are using worthwhile study techniques, that is, techniques that will make a difference to how you approach and perform in the exam, it is more likely that learning will result.

ASIC website and newspaper articles

The most important starting point for learning company law will be the texts, your lectures and your tutorials. However, all students will benefit by looking at the law from a different angle. The internet is a good example. Websites such as the ASIC site (http://www.asic.gov.au) provide general corporate advice as well as current issues. Another good source of corporate issues is newspapers and this is why the newspaper extracts are included in this book. Each extract has been chosen because it has a connection to the relevant area of company law covered in the Chapter. The extracts are quick to read and are indicative of the issues you are studying. When you read the extracts, you should look out for issues that relate to the law covered in the Chapter containing the extract. This way you become alert to corporate issues from a different perspective. Spending the few minutes it takes to read the extracts may help you to recognise issues in the text. The goal is to develop an appreciation of the commercial context of your study, and hopefully by doing so your ability to understand the law will improve.

Chapter Questions

Below is a series of questions. There is one question per Chapter. The purpose of each question is to focus your attention on a core aspect of the Chapter. Obviously, Chapters throw up many possible questions, but the simple aim here is to present only one significant question. The questions represent an overview of the coverage of Company Law Perspectives and provide a framework of sorts for understanding the book's progression.

Chapter 1—Why is the doctrine of precedent important?

Chapter 2—Why are exclusion clauses inserted into some contracts and why it is necessary to construe them strictly against the person seeking to rely on them?

Chapter 3—How wide is the liability for bad advice and how important is the idea of reliance? Illustrate this in relation to the development of the action in tort for negligent misstatement and the position of auditors.

Chapter 4—Why is the doctrine of agency a commercial necessity?

Chapter 5—How does the *Partnership Act* assist in working out when a partnership will exist?

Chapter 6—What is the relationship between the Australian Constitution and the development of Australian company law and what factors do you think drove the nationalisation of company law over the last century?

Chapter 7—Why do you think that public companies are subject to more *Corporations Act* regulation than proprietary companies? Highlight the important characteristics of each to support your conclusions.

Chapter 8—What do you think are the advantages and disadvantages of the corporate veil?

Chapter 9—What role do the replaceable rules play in protecting members rights?

Chapter 10—Why are the assumptions in **s 129** important to persons contracting with the company?

Chapter 11—Explain how companies become liable under: (1) the organic (directing mind and will) principle and (2) the Criminal Code. What do you think are the important differences?

Chapter 12—Why is **s 131** important to pre-contractual negotiations with companies?

Chapter 13—What are the differences between share capital and loan capital? Is one form of financing better than the other?

Chapter 14—What is the main difference between a Prospectus and an Offer Information Statement and why is regulation of fundraising important?

Chapter 15—Explain how companies can reduce their share capital – what are the benefits and what restrictions apply?

Chapter 16—What is a dividend and when can a company distribute a dividend to its members?

Chapter 17—What is the difference between a circulating, and a non-circulating, security interest?

Chapter 18—Compare the ways directors can be disqualified under the *Corporations Act*. How important is the power of disqualification and what do you think is the rationale behind the power of disqualification?

Chapter 19—Explain what it means for a director to owe a fiduciary duty to the company and, using a case from this Chapter as an example, explain how such duty will be breached.

Chapter 20—What is the rationale of the business judgment rule? Does it allow directors too much opportunity to avoid the consequences of poor business decisions? Using a case from this Chapter as an example, explain how the business judgement rule may provide a defence to a breach by a director of the duty of care and diligence in **s 180**.

Chapter 21—What are the civil penalties, and do you think they are adequate to protect the public from director misconduct?

Chapter 22—Why do public companies have more complex reporting requirements than small proprietary companies?

Chapter 23—Who do auditors owe a duty to, and specifically, why is their duty pursuant to **s 311** important?

Chapter 24—What is ASIC's role?

Chapter 25—**Section 232** enables a member to bring proceedings in circumstances where oppression is established. What do you think is the reason the *Corporations Act* protects members from oppression? Using a case from this Chapter as an example, explain the circumstances in which oppression has been found to exist.

Chapter 26—What are the differences between ordinary, and special, resolutions? Why is a quorum necessary?

Chapter 27—How does the application of the 'threshold' percentage in **s 606** further the purposes of the takeover provisions, and in what circumstances will acquisitions beyond the threshold be permitted?

Chapter 28—Do you think insider trading prohibitions are anti-competitive and restrict initiative? Using a case from this Chapter as an example, explain the circumstances in which insider trading has been found to exist.

Chapter 29—When will a company be insolvent, and why is the regulation of insolvency important to company creditors?

Chapter 30—Why are members schemes of arrangement pursuant to **s 411** not commonly used as insolvency restructuring mechanisms?

Chapter 31—What is the effect/impact of administration on the company's creditors; and directors? What do you think is the rationale behind the effect/impact in each case?

Chapter 32—Explain the duties of receivers. How can the imposition of such duties protect the company?

Chapter 33—In what ways does the *Corporations Act* enable a liquidator to target transactions with a view to recouping assets or collecting funds for distribution or payment to creditors? Particularly, in relation to insolvent trading, what must the liquidator show to be able to use **s 588G**?

Chapter 34—Why is the regulation of companies, under the *Corporations Act* and the ACL, important?

Glossary and Abbreviations

Account of profits—a remedy recouping the gains from a breach of duty
Action—civil proceedings
ACCC—Australian Competition and Consumer Commission
ACN—Australian Company Number, allocated at registration
AGM—annual general meeting
Anor—another
ASIC—Australian Securities and Investments Commission, corporate regulator
Assign—to transfer property or rights
ASX—Australian Securities Exchange Ltd, marketplace for trading of securities
Bidder—company making a takeover bid
Board of directors—all of the directors
Boycott—decision not to buy, sell or otherwise deal with another
Buy-back—means by which a company can reduce capital
Call—a demand to pay amount unpaid on shares
CAMAC—Corporations and Markets Advisory Committee
Cartel—combination or agreement between competitors
Cast—to direct a vote in favour or against a motion at a meeting
CEO—Chief executive officer
CFO—Chief financial officer
Chair of directors—director with responsibility for board and control of meetings
Chose in action—intangible personal property right
CLERP—Corporate Law Economic Reform Program
Collateral—the asset secured by a security interest
Company constitution—internal rules
Common seal—a stamp with the company's name and ACN
Compromised—settled or agreed
Converted—changed to another form
DPP—Director of Public Prosecutions
Damages—monetary compensation
Deed—a formal binding agreement that must be signed and witnessed
De facto director—a person acting as a director though not formally elected
Debenture—acknowledgement of a company debt
Discovery—one party to an action shows documents to the other
Distinguish—reasoning in previous case (precedent) not applicable because of facts
Dividend—share of company profit received by a shareholder
Estoppel—a representation can't be denied if another has relied on it to their detriment
Executive director—a director who is a full-time employee of a company
Expropriation—removing or reducing a person's property or share rights
Extraordinary general meeting—meeting other than AGM dealing with company business
Fiduciary duty—a duty of trust owed to those who rely on that person's decisions

File—lodge with the court
Float—an offer by a new company of shares to the public
Fraud on the minority—majority shareholders improperly use their power
General law—common law and equity
Governing director—non-removable director in pty company with wide powers
Holding (or parent) company—controls subsidiary companies
Indemnity—agreement to cover the loss and damage of another
Indoor management rule—presumption that company's constitution complied with
Injunction—court order preventing or requiring a certain action
Insider trading—using information not generally known to trade in shares
Insolvent trading—incurring debt when it is reasonable to suspect insolvency
IPO—Initial public offering of shares
Leave—permission of the court
Liquidation—winding up a company, finalising its business, distributing assets
Listed company—company whose shares are traded on the ASX
Litigation—process and procedure of legal proceedings
Majority shareholders—that group of shareholders holding voting control
Managing director—appointed by board to manage and control the company
Matter—a case
Merger—a company acquires all shares of another company
Minutes—record of business transacted at company meeting
Mitigate—to limit, not increase loss
Motion—matter for consideration at meeting (also: a court application)
No liability company—members don't pay any calls on shares
Nominee director—appointed to represent the interests of a particular group
Non-executive director—part-time consultant director, not an employee
Novation—replacing or substituting a party, or an obligation, in an agreement
Offer information statement—small-scale fundraising disclosure document
Officer—a person influencing company decision making such as a director
Onus—burden, obligation
Ordinary resolution—decision at meeting requiring a 50% vote of those present
Organic liability—company liability via its directing mind and will
Ostensible authority—creation of agency by the appearance of authority
Partnership—carrying on business in common with a view to profit
Pecuniary—relating to or consisting of money
Penalty unit—has a $ value, updated periodically [s 4AA *Crimes Act 1914* (Cth)]
Perfection—the process of protecting a creditor's security interest rights
Phoenix company—new company arises from old
Power of Attorney—gives a person authority over another's legal or financial affairs
Pre-emption clause—gives existing shareholders priority to new share issues
Preference shares—class of shares with certain benefits such as dividend priority
Pre-registration contract—contract on company's behalf before it is formed
Prima facie—on the face of it, at first appearance

Proceedings—legal action commenced in a court
Profile statement—type of fundraising disclosure document
Promoter—a person involved in starting a company and seeking investors
Provision (of an Act)—a section or part of legislation
Proprietary company—company with limits on size and on public fundraising
Prospectus—the most extensive disclosure document for large fundraising
Public company—no limits on maximum shareholders, invites public investment
Quorum—minimum number necessary for a valid meeting
Quoted—listed on the stock exchange (ASX)
Ratification—shareholder resolution approving director's breach of duty
Realise—sell and convert to money
Rebut—to refute (prove false) by evidence or argument
Receiver—appointed to take control of company property
Registered office—the address of the company for correspondence and notices
Relation-back day—date relevant to working out if a transaction is a voidable transaction
Replaceable rules—parts of the *Corporations Act* dealing with internal management of companies
Securities—documents confirming investment including shares and debentures
Security interest—the right of a creditor over a company asset
Service—delivering legal documents
Shadow director—not formally appointed but influences a director or the board
Share capital—amount received by company in return for the issue of its shares
Short form prospectus—disclosure document referring to material at ASIC
Short selling—selling securities that are not yet owned by the seller
Special resolution—decision at meeting requiring a 75% vote of those present
Stop order—order restraining the issue of shares pursuant to a prospectus
Subsidiary company—a company whose board is controlled by another company
Substantial holding shareholder—has 5% or more of the shares in a public listed company
Takeover—control of a company by acquiring the necessary amount of its shares
Target—the company that is the subject of a takeover
Tip—pass on information about listed securities
Uncommercial transaction—an unreasonable transaction, questionable motive
Unfair preference—preferential payment to a creditor from an insolvent company
Unlimited company—no limit on members' liability on winding up
Unlisted company—public company not listed on the ASX
Vests in—goes to, becomes the property of
Vicarious liability—where a company is liable for the acts of its employees
Voidable transaction—one that may be overturned or reversed by the liquidator
Voluntary administration—mechanism that may result in a company restructure
White knight—a new and higher bidder during a takeover
Winding up—liquidator collects and distributes assets, company is deregistered

Case citation abbreviations

AC—Appeal Cases, England
ACLC—Australian Company Law Cases
ACLR—Australian Company Law Reports
ACSR—Australian Company and Securities Reports
ALJ—Australian Law Journal
ALJR—Australian Law Journal Reports
ALR—Australian Law Reports
All ER—All England Law Reports
App Cas—Appeal Cases, England
ATP—Australian Takeovers Panel
Ch—Chancery, England
CLR—Commonwealth Law Reports
DLR—Dominion Law Reports, Canada
ER—English Reports
FCA—Federal Court of Australia
FCAFC—Federal Court of Australia Full Court
FCR—Federal Court Reports
FLR—Federal Law Reports
HCA—High Court of Australia
KB—Kings Bench, England
NSWCA—New South Wales Court of Appeal
NSWCCA—New South Wales Court of Criminal Appeal
NSWLR—New South Wales Law Reports
NSWSC—New South Wales Supreme Court
QB—Queens Bench, England
QCA—Queensland Court of Appeal
QdR—Queensland Reports
SASC—South Australian Supreme Court
SASR—South Australian State Reports
VSC—Supreme Court of Victoria
VSCA—Supreme Court of Victoria Court of Appeal
WAR—Western Australian Reports
WASCA—Supreme Court of Western Australia Court of Appeal
WLR—Weekly Law Reports, England
WN(NSW)—New South Wales Weekly Notes

Recent cases can be found by searching FirstPoint, the online case law research tool, or the Australian Legal Information Institute website at http://www.austlii.edu.au

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1
The Legal System

[1.10] The majority of this book looks at the regulation of companies, particularly the way in which the law regulates the conduct of directors, the rights of shareholders and the issues surrounding company insolvency. Company law is also, however, part of the wider picture of commercial regulation in which the law of contract and tort impose obligations and provide for remedies where loss or damage occurs.

Companies are predominantly formed to make deals, that is, to enter contracts. As legal individuals, companies must confront similar obligations to humans such as bearing responsibility for both civil and criminal actions. Companies often employ large numbers of people for whose rights and welfare the company is responsible, and of course in the carrying out of its business a company has the propensity to affect any number of external businesses or individuals. Although shareholders and company creditors are the most obvious stakeholders of company performance, we have all become, because of the increasing reach of corporate behaviour, stakeholders in a sense, of corporate conduct. Companies may falter financially and thereby affect corporate reputation and damage share price; however a company's poor management can also lead to defective products or services that have the possibility of causing loss and injury to consumers generally.

Having regard to the larger regulatory framework under which corporate behaviour falls, it is useful to introduce company regulation by highlighting, in summary form, some general areas of the law. The first four chapters of this book achieve this purpose. Following this chapter on the legal system, there is a chapter on each of contract law, tort law and agency. Each of these areas contributes to an understanding of how companies, and business structures generally, develop, interact and perform.

In a broad sense, law is a set of rules that govern, control or regulate interactions between members of society and between governments and societies (including individual members of society). Australia is a common law country (as distinct from the civil law systems of Europe and Asia); this is that its legal system derived from the English legal system which was transposed to Australia upon colonisation. From around the 13th century, uniformity gradually developed in English law as judges travelled around the country for the purpose of settling legal disputes. Rather than apply local customary law, the judges would apply similar legal principles to each dispute they resolved. In time, this resulted in a legal system that was consistent throughout the country—common law.

The principal sources of law are case (judge-made) law, and statute (parliament-made) law:

Case law

[1.20] This is law as made by judges (the court). Judge-made law has two strands: common law and equity. Equity is an area that arose during the 14th century in England to modify the strictness of the common law (in some cases uniformity had produced injustice). Both areas are based on principles of law arising from the decisions of judges however equity, which has at its essence the idea of fairness, provides certain remedies not available in common law—for example an injunction, an order to stop certain conduct (or to make it happen), is an equitable remedy.

An important concept in the development of the case law and equally in our modern legal system is that of the doctrine of precedent. It is an important foundation of the legal systems of common law countries. Basically, in cases that have similar facts and issues, courts are required to follow the ruling or determination of higher courts in the same jurisdiction (judicial hierarchy). This principle that higher courts decisions will bind lower courts in similar fact situations allows for certainty and a level of predictability in the legal system. However, higher courts are not bound by decisions of courts lower in their judicial hierarchy, and courts within a particular jurisdiction are not bound to follow (apply precedent from) the decisions of courts outside of their legal hierarchy.

When a court decides a matter, that is, when a judgment is delivered, it will often be complex and detailed. Not all of what is delivered as a judgment will form a precedent for lower courts. For the purposes of precedent, two parts of a court's decision will be relevant. Firstly, the reason for the decision as outlined by the court, this is the *ratio decidendi*. It is this part of the decision that will be binding on lower courts. Secondly, during the course of a judgment, the court may raise matters that have significance but that are not necessarily essential to determine the outcome of the case. This is *obiter dicta*, and unlike the ratio, it is not binding but rather persuasive and can still be used by a lower court if the circumstances of the case warrant.

Statute law

[1.30] Laws made by the courts have been an essential factor in regulating the developing economic and social environment in England since the middle ages, and today in Australia this is still the case. The courts are an important part of how the standards for society are set and maintained. However, as societies have become more complex the role of governments has increased; this has been particularly so since the beginning of the last century. This increased governmental presence has meant that the parliament has had a larger role in the development and introduction of laws. This is achieved by the parliament passing legislation (an Act, a statute) which sets out standards and expectations. Accordingly, both case law and statute law govern and regulate Australian society.

A particular benefit of statute law is its relative flexibility. Where legislation is outdated or irrelevant, that legislation can be amended or repealed by parliament

within a reasonably short time. In fact, highly commercial legislation that is market-focused, such as the *Corporations Act 2001* (Cth), is amended fairly often. On the other hand, for a precedent in case law to change, or be overruled, it is necessary for a case to arise in which the facts and issues are similar. This may not happen for several years, and although it is possible for a statute to be passed in order to overcome an unwanted precedent this is rare.

Laws are made by parliament by way of the introduction and then debate of proposals. In Australia, State parliaments (except Queensland) have a lower house (Legislative Assembly) and an upper house (Legislative Council). At federal level, there is also a lower house (House of Representatives) and an upper house (Senate). At the initial stage, a Bill is introduced into the lower house of parliament and "read" (considered) three times (including debate). Thereafter, it passes to the upper house and the same process ensues. Upon approval of both houses, the Bill goes to the Governor-General for approval and thereafter becomes an Act of Parliament. Amendments to statutes already in existence proceed in the same manner.

There are in effect two levels to legislative power in Australia: Federal (Commonwealth) powers and State/Territory powers. Prior to the 20th century, the Australian States were colonies with sovereign power to legislate. However, a strong movement developed in the second half of the 19th century to unify the country with the introduction of a central government. This resulted in the British Parliament passing, in 1900, the *Commonwealth of Australia Constitution Act 1900* (UK). A Commonwealth Parliament and Government were created and the colonies became States. The Australian Constitution created new federal authorities, regulated federal/state relations, created a common market and established a limited bill of rights.

The Constitution gives both exclusive and concurrent powers to the Commonwealth Parliament to make laws for the good governance of the country. This means that both the Commonwealth and the State Parliaments introduce legislation (make statute law). There is relatively little exclusive law making power in the Constitution. Examples are in s 52 (Commonwealth Government matters); s 90 (customs and excise); s 114 (military); s 115 (money) and s 122 (governing the Territories). Most of the law-making powers of the Commonwealth Parliament are concurrent with the States. The most important section in the Constitution in this regard is s 51. What s 51 does is to set out areas in which the Commonwealth Parliament can make laws; however, because the powers are concurrent, the States may also legislate in the area. The way in which the Constitution avoids duplication is to set out in s 109 that where a State law is inconsistent with a Commonwealth law, the Commonwealth law will prevail (override) and the State law will, to the extent of the inconsistency, be invalid.

Following is a selection of the powers in s 51:

The Parliament shall, subject to this Constitution, have power to make laws for the peace, order and good government of the Commonwealth with respect to:

- trade and commerce with other countries, and among the States (s 51(i));
- taxation; but so as not to discriminate between States or parts of States (s 51(ii));

- postal, telegraphic, telephonic and other like services (s 51(v));
- the naval and military defence of the Commonwealth and of the several States, and the control of the forces to execute and maintain the laws of the Commonwealth (s 51(vi));
- census and statistics (s 51(xi));
- currency, coinage and legal tender (s 51(xii));
- banking, other than State banking; also State banking extending beyond the limits of the State concerned, the incorporation of banks, and the issue of paper money (s 51(xiii));
- bankruptcy and insolvency (s 51(xvii));
- copyrights, patents of inventions and designs, and trade marks (s 51(xviii));
- foreign corporations, and trading or financial corporations formed within the limits of the Commonwealth (s 51(xx));
- immigration and emigration (s 51(xxvii));
- influx of criminals (s 51(xxviii));
- external affairs (s 51(xxix)).

The Constitution provides for three separate branches of government: the legislature (parliament) which makes the law; the judiciary which interprets and enforces the law and the executive which administers the law. This is referred to as the separation of powers doctrine, and whereas all functions of each branch are not always completely distinct the commitment to the doctrine protects the independence of the legal system.

The Constitution has not undergone significant change since its introduction. Amendment is possible by way of a referendum pursuant to s 128 which sets out a number of conditions including the need for a majority of the electors in a majority of the States voting to approve the proposed law, as well as a majority of all the electors (States and Territories) voting to approve the proposed law.

The courts use a mix of different approaches to the interpretation of statutes—the "literal approach" focuses on the precise meaning of the words used; the "purpose approach" considers the intention of the drafters of the statute; the "golden rule" uses a moderate approach to avoid inconsistency or extreme outcomes; and lastly a court will consider extrinsic material (relevant matters outside of the statute).

Hierarchy of Australian courts

[1.40] Legal disputes in Australia will be litigated in either the Federal or State court system. Both systems are hierarchal having different levels of courts with differing

jurisdictional capacities. That is, a court's ability to hear and determine a matter will depend on how wide, geographically, its jurisdiction spreads (the NSW District Court will only determine disputes arising in NSW); how high its monetary threshold is; and whether there is any restriction on the type of matters it hears. Subject to procedural matters, appeals may be available from decisions of lower courts to higher courts. Appeals are generally confined to matters concerning whether an error in applying the law has occurred in the original judgment.

Most States have three levels of courts. The lowest level is the Magistrates Court (in NSW the Local Court); next is the District Court (in Victoria the County Court); and the highest State and Territory court is the Supreme Court (including the Supreme Court of Appeal). In Tasmania, the Northern Territory and the Australian Capital Territory there is no middle level.

There are four principal federal courts:

- The High Court of Australia is the highest court and the final court of appeal in Australia. It hears matters involving disputes about the interpretation of the Constitution, as well as final appeals in civil and criminal matters from all courts in Australia;
- The Federal Court of Australia hears matters on a range of different subject matter including bankruptcy, corporations, industrial relations, native title, taxation and trade practices laws, and hears appeals from decisions (except family law decisions) of the Federal Circuit Court;
- The Family Court of Australia is a specialist court dealing with family disputes; and
- The Federal Circuit Court of Australia hears disputes in matters in relation to family, administrative, bankruptcy, industrial relations, migration and trade practices matters.

The legal profession comprises those who hear and decide the outcome of litigation (the legal processes and procedures of the courts) including judges, magistrates and other court officials such as registrars. There are also those who represent and advise both within the processes of litigation and generally. This part of the legal profession is referred to broadly as lawyers or legal practitioners and comprise: solicitors, who advise and act for clients in a very wide range of matters, including the giving of commercial advice, and barristers, who specialise in the law of evidence and courtroom procedure and are "briefed" (instructed) by solicitors to advise, or most often to appear in court to argue a client's case.

Litigation at any level of the court hierarchy can be an expensive and uncertain process. Partly for this reason, both federal and state systems have developed processes of alternative dispute resolution involving mediation, conciliation and relatively informal dispute resolution forums, such as tribunals (an example is the NSW Civil and Administrative Tribunal).

Summary—The Legal System

Law comprises rules that regulate societies

Australia is a common law country with its legal origins in England

Case law is judge-made

Higher courts' decisions will bind lower courts—this is the doctrine of precedent

Where a party to litigation is dissatisfied with the outcome, they can appeal

The High Court is the highest Australian court and final appeal court

Statute law (legislation) is parliament-made

In Australia, both the Commonwealth and the State parliaments legislate

Section 51 of the Australian Constitution sets out concurrent powers

2
Contract

[2.10] Contract law provides a framework to help resolve disputes and enforce rights and obligations. It is largely a product of the common law—it has been developed by the courts rather than by parliament passing laws. Note though that with the impact of consumer law since the mid-20th century legislation has increasingly augmented the common law position. Important in this regard is the *Competition and Consumer Act 2010* (Cth) which includes the *Australian Consumer Law* (see Ch 34).

A contract is a legally binding agreement and is able to be enforced by a party to it. Only those parties to a contract will acquire rights and incur liabilities pursuant to it. This concept is referred to as privity of contract. Enforcement of a contract will depend on the establishment of a number of matters. Firstly, that there is a contract actually in place; this involves identifying the essentials of a valid contract, that is, an offer and acceptance, the existence of an intention to be bound by the contract, and consideration or value passing between the parties. Secondly, enforcing a contract will depend on identifying the terms of the contract and then establishing a breach, or finding that entry to the contract did not involve genuine consent, that is, finding a vitiating element. Thirdly, it is not enough simply to find a breach of a term or that a vitiating element existed at formation; there must be a connection between the breach and the damage sustained. This involves the issue of causation. Once these three elements have been established it is still necessary to decide what remedy is relevant, that is, can the party who suffered the loss sue for that loss only or can the contracted also be terminated, thereby ending the obligations thereunder.

Essentials of a valid contract

Offer and acceptance

[2.20] For a contract to exist there must be a "meeting of the minds", a concluded agreement between the parties, and this involves the acceptance of an offer. An offer can be written (including SMS, email and websites) and/or oral. A party making an offer can withdraw it before acceptance, and if a party to whom an offer is made (offeree) rejects an offer or makes a counter-offer the law treats the original offer as withdrawn and the offeror does not need to resurrect it.

Contracts can be bilateral or unilateral. Bilateral contracts are most common and involve an exchange of promises between the parties. Unilateral contracts involve only one party's promise, for example the offering of a reward for lost goods. However, acceptance of an offer must always be in direct relation to that offer. In *R v Clarke* (1927) 40 CLR 227, the Western Australian Government offered a reward for information that may lead to the arrest and conviction of persons alleged to have murdered two

policemen. Clarke was arrested, as an associate, in connection with the investigation, although not accused of the crimes. In return for a pardon, he supplied information that led to the arrests. He claimed the reward but was denied by the court on the ground that the information supplied was not in relation to, or an acceptance of, the reward offer, but for the purposes of a pardon.

Broadly contracts can be distinguished by the circumstances of their formation. In situations such as advertisements, catalogues and shop displays, what may seem like an offer by the seller is regarded in law as an "invitation to treat", in effect an indication that the seller is willing to consider offers to purchase the goods at the advertised price (ie, the buyer makes the offer). It is only when the seller accepts payment that a contract is formed, not when the buyer offers the purchase price. There are several commercial reasons behind this principle based on the seller's right to not enter a contract if to do so would force a sale at an outdated price, or extinguish display stock, or if the seller simply chooses not to sell.

Generally, silence will not constitute acceptance. However, where a buyer/customer engages in some form of conduct as a direct result of the offer (without necessarily directly accepting in writing or verbally), this conduct can amount to acceptance. In *Carlill v Carbolic Smoke Ball Co* [1893] 1 QB 256, an advertisement was placed in a newspaper inviting the purchase and use of a device to ward off colds:

> £100 reward will be paid by the Carbolic Smoke Ball Company to any person who contracts the increasing epidemic influenza, colds, or any disease caused by taking cold, after having used the ball three times daily for two weeks according to the printed directions supplied with each ball. £1,000 is deposited with the Alliance Bank, Regent Street, showing our sincerity in the matter.

The plaintiff (Mrs Carlill) saw the advertisement, bought a smoke ball, used it as directed, yet still caught a cold. She sued. The defendant argued that Mrs Carlill did not sufficiently accept the offer as no communication had been received. They also argued that the advertisement was a mere "puff" or exaggeration and not to be taken seriously. The court held for the plaintiff stating that an offer can be made to the whole world, provided its terms make it capable of acceptance and were not too vague (here Mrs Carlill did as required). Further, the court held that the advertisement was not a "puff" as the deposit of the £100 showed the serious intent.

In *Pharmaceutical Society of Great Britain v Boots Cash Chemists (Southern) Ltd* [1953] All ER 482 the defendants (Boots Chemists) sold general pharmacy items as well as prescription and other drugs. The *Pharmacy and Poisons Act 1933* (UK) required that certain drugs had to be sold under the supervision of a registered pharmacist. Customers would select items from the shelves and take them to a cashier's desk at one of the exits where they were paid for. When a drug was involved, a pharmacist supervised the sale at the cash register. The Pharmaceutical Society argued that a drug sale was completed when the customer took an item from the shelf. Therefore the sale would not be supervised as required and a breach of the Act would arise. However, the court held there was no sale effected merely by the customer taking the goods

from the shelf and that no contract was formed until the customer's offer to buy was accepted by the store when the appropriate sale price was paid, and that in this case that took place at the cash register under the supervision of a pharmacist.

In contrast to situations where goods or services are advertised or displayed are situations where a ticket or document of some kind is handed to, or able to be viewed by, the buyer at the time of the contract. Broadly these are called "ticket" cases. Here the purpose of the seller is to include the terms of the contract, or at least indicate where the terms can be inspected, into the agreement between the parties, and to do so at formation of the contract so that those terms will validly bind the buyer. In these circumstances, an offer is in fact being made by the seller and entry to the contract by the buyer/customer, usually by paying or agreeing to pay for the relevant goods or services, amounts to acceptance of those terms.

The importance of the inclusion of terms into a contract at formation is that once formed the terms of a contract determine the rights and obligations of the parties. Generally, terms cannot be added to a contract after formation. An example is *Thornton v Shoe Lane Parking Ltd* [1971] 1 All ER 686; 2 QB 163. The plaintiff (Thornton) drove to the entrance of defendant's multi-storey car park, put the required amount of money into a machine and received a ticket from the machine. At the bottom left-hand corner of the ticket, it stated that the ticket was issued subject to conditions displayed on the premises. A set of printed conditions were mounted on a pillar opposite the machine. These excluded the defendant (Shoe Lane Parking) from liability for injury to a customer. The plaintiff proceeded into the car park and while there suffered personal injury. The defendant denied liability because of the terms of the exclusion clause displayed on the pillar. It argued that these terms formed part of its contract with the plaintiff. The court held that the contract was formed when the ticket was taken from the machine. Lord Denning explained as follows:

> In this case the offer was in the notice at the entrance and was accepted when Thornton drove to the entrance and by the movement of his car, turned the light from red to green, and the ticket was thrust at him. The contract was then concluded, and it could not be altered by any words printed on the ticket itself.

While the basic principles of offer and acceptance remain constant e-commerce has given rise to applications of the principles in new circumstances. The United Nations Commission on International Trade Law (UNCITRAL) has developed rules that are able to be adopted by individual jurisdictions. In Australia, the *Electronic Transactions Act 1999* (Cth) is the relevant legislation and each state has introduced legislation based on the federal Act. An example of the offer/acceptance issue in relation to e-commerce can be found in *Smythe v Thomas* (2007) 71 NSWLR 537; [2007] NSWSC 844. In this case, the defendant had listed an aeroplane for sale by auction on e-Bay with a reserve of $150,000 and a 10-day auction period. The plaintiff placed a bid of $150,000 but the defendant refused to sell and the 10-day period expired. The plaintiff's argument was that the conditions were met; however the defendant argued that the eBay listing was an invitation to treat (inviting offers but not an offer) and

that therefore he (the defendant) could refuse the plaintiff's offer. The court held that in eBay auctions contracts exist between the seller and eBay, the buyer and eBay and between the parties. Particularly, the court held that listing on eBay was an offer not an invitation to treat.

Intention

[2.30] For a valid contract to come into existence, the parties to the contract must intend that the agreement be legally enforceable. Intention is normally observable from the circumstances of the contract. An important distinction is drawn between domestic or social arrangements where there is a presumption against the intention to create legal relations, and commercial situations where the presumption is in favour of the creation of legal relations.

Finding intention in commercial situations does not normally present problems. However, in some cases, arrangements which may seem domestic or social can contain commercial elements, and in these situations, the presumption against intention will be rebutted (overturned). The law does not generally assume that relatives or friends intend their agreements to be contracts. However, if it can be established that the parties did intend their agreement to be legally enforceable, the law will treat it as such. This can occur where a person has forgone a financial opportunity, or incurred expense as the result of an offer by a relative or friend. For example in *Todd v Nicol* [1957] SASR 72, a widow, to avoid living alone in Australia, proposed to relatives in Scotland that if they moved to Australia they could share her home and she would alter her will to pass the home to them upon her death. The relatives accordingly resigned their jobs and moved to Australia. The arrangements did not work out and the court had to decide if the relatives had a binding contract. Normally because the arrangement was between relatives the presumption would be against an intention to create legal relations. But because of the expense and dislocation undergone by the relatives to move to Australia, the court did not apply the presumption and here found that the arrangement was regarded seriously and that an intention to create legal relations arose.

Consideration

[2.40] For the purposes of a valid contract, some benefit or value must be given by each party in exchange for the other party's promise to do, or not do, whatever the agreement requires. This is called consideration. In a normal retail situation, the consideration that passes between the parties amounts to money from the buyer to the seller and goods from the seller to the buyer. As between parties to a contract, consideration does not have to represent the true or real value of the goods or services, merely the agreed value. As such, consideration can be insignificant provided the parties agree. In *Chappell & Co Ltd v Nestle Co Ltd* [1960] AC 87 for the purposes of an advertising promotion by Nestle, chocolate wrappers were included as part of the price (together with an amount of money) payable by customers to purchase certain

musical recordings. A dispute arose between Nestle and the holder of the copyright in one of the musical recordings (a claim for royalties). Nestle argued that the wrappers were worthless and should not be relevant to calculating the royalties payable. The court, however, rejected the argument holding that the wrappers were part of the consideration for the promotion contract.

Consideration may be present or promised in the future but past consideration will not suffice. This means that if a party has already given or performed something that has value that will not be valid consideration for the purposes of forming a contract. Similarly performing a pre-existing obligation or duty will not suffice as consideration.

Other aspects of an enforceable contract

[2.50] Together with the main elements mentioned above, certain other matters must be considered to determine whether a contract has been validly formed and is therefore enforceable. These are:

- the persons entering the contract must have legal capacity, most importantly this relates to the effect of mental incapacity or the age of a party. There is legislation relating to minors contractual capacity, for example *Minors (Property and Contracts) Act 1970* (NSW);
- the contract must not be formed for an illegal purpose. For example, a contract to commit a crime, or that is contrary to public safety, or that compromises the administration of justice, will be unenforceable;
- each party's consent to the agreement must be genuine. In this regard, the contract's validity may be affected by one or more factors that the courts regard as vitiating (removing any real consent between the parties).

Vitiating elements

Mistake

[2.60] If the person makes a mistake of fact, the contract may be void (this means, it never existed), or voidable (capable of being rescinded and thereafter of no legal effect). The types of mistake that have this effect are:

- Common mistake: Both parties are under the same misapprehension (mistaken about same thing). However, a common mistake will not void a contract where a party acts in reliance on another party's promise to their detriment. In *McRae v Commonwealth Disposals Commission* (1950) 84 CLR 377, the parties entered an agreement for the salvage of a sunken oil tanker located, according to the Commission "on Jourmand Reef 100 miles north of Samarai". The plaintiff (McRae) expended a substantial sum of money trying to locate the vessel but did not succeed because the sunken vessel did not exist. The plaintiff accordingly sued in breach of contract for damages and the Commission defended upon the ground

of a common mistake (both parties mistaken as to the existence of the sunken tanker) and thereby a void, and unenforceable, contract. The High Court held that any mistake made was as the result of the Commission's incorrect assertions as to the existence of the vessel and that therefore no common mistake took place and the contract was enforceable;

- Mutual mistake: The parties are at cross-purposes about the subject matter of the transaction;
- Unilateral mistake: One party is mistaken about the terms of the contract or the identity of the other party and the other party knows this, or ought to know it;
- *Non est factum* ("not my deed"): A person signs a document fundamentally different in character from that which they thought they were signing. The defence of *non est factum* will only arise where the person had no ability to understand what they were doing, and applying the defence does not lead to injustice.

Misrepresentation

[2.70] At formation of a contract some of the statements or undertakings made by the parties will become part of the contract (terms); if one party breaches a particular undertaking (breaches a term) the other party will have an action for breach of contract.

However, not all statements or undertakings become terms of the contract. The common law doctrine of misrepresentation applies to statements that induce a person to enter into a contract, but do not become part of the contract itself. Common law misrepresentation is established where the statement relates to a matter of fact (not law, future intention, or opinion), is false, is made with the intention of persuading the other party to act on it, and induces the other party to enter into the contract.

Misrepresentation may be innocent, negligent or fraudulent, and if established a person may be able to rescind (get out of) the contract. There is also the right to claim damages (financial compensation) for any loss suffered as a result of a misrepresentation but only if it arose fraudulently or negligently.

For an innocent misrepresentation it is necessary that the person making the statement did not know it was false, was not careless about its truthfulness and was under no duty to ensure its truth. A negligent misrepresentation will arise where there is a special (often business) relationship between the parties and there was a reasonable expectation that it would be relied upon. Fraudulent misrepresentation requires a court to find that the person making the statement either knew it was false or acted with reckless indifference and was unconcerned with its truth.

In relation to consumer contracts, a party's rights in relation to misrepresentation are largely governed by legislation, particularly the *Australian Consumer Law* (*Competition and Consumer Act 2010* (Cth))—see Ch 34.

Duress

[2.80] A contract will be unenforceable (voidable and thereby able to be rescinded) if it was entered as a result of threats of, or actual, physical harm to a person, or threats or damage to property, or to a person's economic interests. In these situations, there is a lack of free will in entering the contract.

Undue influence

[2.90] The decision to enter into a contract should be freely taken and independent of the interests of the other party to that contract. In certain circumstances, parties to a contract are in a situation where one party may have an influence, an ascendancy, over the other in relation to the decision to enter the contract. The law recognises a number of relevant relationships of influence including parent and dependent child, trustee and trust beneficiary, solicitor and client, religious adviser and follower, doctor and patient. Where a contract involves one of the relevant relationships of influence, and a party alleges that to enforce it is not in their interests, the onus of establishing that the relevant relationship did not induce entry to the contract lies with the party of influence. In other words, the law requires the ascendant (dominant) party to show that no influence was exerted on the other party in relation to the entry into the contract; that is, they will have to rebut (negate or disprove) the existence of influence.

In some cases, undue influence may be raised where the relationship is not one of the relevant relationships of influence. In these situations the person alleging the undue influence will have the onus of proof.

Unconscionable dealing

[2.100] Contracts will not be unenforceable simply because the terms of the contract are harsh or where the negotiations at entry to the contract were robust and one party takes a tough stance in order to secure a good deal. In a broad sense, the law does not seek to interfere with the normal processes of commercial negotiation. However contracts will be unenforceable where one party is at a serious disadvantage or under a special disability, and the stronger party knew or ought to have known about it and takes advantage of the weaker party in a way which is not consistent with good conscience. That is, the contract is unconscionable.

For a court to find unconscionable conduct there must be more than just unequal bargaining power. The disadvantage or disability may involve age, illness, inexperience, lack of education, impaired faculties, drunkenness, illiteracy, or other circumstances to the same effect.

In *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447; [1983] HCA 14 the High Court considered whether an agreement entered into by the parents of an existing customer amounted to an instance of unconscionable dealing. Mr and Mrs Amadio (the respondents in the High Court appeal), an elderly Italian couple of little formal education and limited English language ability executed a guarantee and

mortgage (as security for the guarantee) in favour of the Commonwealth Bank in order to enable an increase in the overdraft facility of a building company operated by their son Vicenzo which the company could then use to pay certain outstanding debts. For the purposes of the execution of the mortgage and guarantee, a bank officer, having an understanding of the difficult financial circumstances of the son's company, visited the Amadio's home. However, the document was not explained to Mr or Mrs Amadio before they signed it, they did not read it, and no copy was left with them.

After the guarantee and mortgage were signed the bank paid out on a number of the son's company's debts and raised the overdraft. However, the company was in a poor financial state regardless and within a short period of time went into liquidation. The bank demanded payment by the Amadios on the guarantee and when it was not met they served notice that they would exercise the power of sale of their property (a commercial building) under the mortgage.

The High Court held that the contract with the bank (the mortgage and guarantee) should be set aside (unenforceable) upon the basis of unconscionable dealing. The Amadios were mistaken as to the extent of their liability under the contract and in relation to the financial standing of their son's company. They did not receive any independent advice. Deane J (at 477) sets out that "they lacked assistance and advice where assistance and advice were plainly necessary if there was to be any reasonable degree of equality between themselves and the bank". Where such circumstances are shown to have existed, an onus is cast upon the stronger party to show that the transaction was fair, just and reasonable. In this case, the bank, as the stronger party, was unable to discharge this onus.

In relation to consumer contracts a party's rights in relation to unconscionable dealing are augmented by legislation, particularly ss 20, 21 and 22 of the *Australian Consumer Law* (*Competition and Consumer Act 2010* (Cth)): see Ch 34.

Terms of the contract

[2.110] Once the essentials of a valid contract are identified, the next step in determining the obligations and rights of the parties will depend on the terms of the contract. Terms can be oral, written or a combination. Both oral and written terms are equally enforceable although there is a distinction between where there is a dispute between the parties and it becomes necessary to establish with precision the terms of the contract. Simply, written terms are easier to prove. Oral terms, if disputed will often require a court to decide between two opposing positions. Obviously, the point of entering into a contract, particularly in the business context, is to be able to provide some certainty as to the requirements of the arrangement. For this reason, most important or valuable contracts are reduced to writing. Where a contract is wholly in writing and intended to include, the entire agreement between the parties then extrinsic evidence (of negotiations etc) is not relevant to establishing its terms. This is the parol evidence rule.

Before a party can enforce a term within a contract it must be established that what is sought to be enforced is actually a term, that is, actually included in the contract.

In this regard, it is important to distinguish between terms and pre-contractual representations. Many matters may be negotiated at entry to a contract but not all become terms. In *Oscar Chess v Williams* [1957] 1 WLR 370, a person sold a motor vehicle to a motor dealer and represented its year of manufacture incorrectly. The owner did not purchase the car new and, relying on information from the previous owner, had made a mistake. The dealer sought to recover damages on the ground that the year of manufacture was a term. However, the court held that the statement was a mere representation and did not become incorporated as a term of the contract. Matters that may warrant consideration where a dispute as to whether pre-contractual statements become terms include the importance of the statement in forming the contract and whether the parties have different levels of expertise as to the contents of the contract. Note though that a pre-contractual representation that does not become a term, may, if it is a misrepresentation, still nonetheless affect the enforceability of the contract.

Terms can be express or implied. Express terms are those actually specified (nominated) by the parties to a contract and can be oral or written. In a general sense, it is up to the parties to create a contract that is clear and represents the agreement between them. Courts will not re-interpret the agreement for the parties but will interpret what the parties have agreed. Where contracts are unclear, they may be unenforceable.

Other than express terms a contract may also contain implied terms. Most in fact do. Terms may be implied into a contract through: business efficacy, that is, matters that were not expressly agreed between the parties but are necessary and obvious to facilitate the performance of the contract or bargain, to make it work; custom or trade usage; previous dealings between the parties. Terms can also be implied by statute and with the increasing impact of consumer legislation such as the *Australian Consumer Law* this is more common. For instance, s 54 sets out a guarantee of acceptable quality and s 55 sets out a guarantee that goods are reasonably fit for any disclosed purpose. See also discussion of s 18 in Ch 34.

Terms will have different effects on the rights of the parties depending on whether they can be categorised as conditions or warranties. In contract law, a term that is a condition will be essential to the performance of the contract; it goes to the core of the contract. A warranty is a less important term. The need to identify the type of term is relevant to when a party alleges a breach. If a term that is a warranty is breached, a party can sue in damages for the loss resulting but cannot terminate the contract. If the term breached is a condition, both damages and termination are available.

A contract often represents the outcome of negotiations between parties and generally each party will seek terms that serve their particular purposes. A contract is a deal, and the law allows, within limits, parties to make whatever deal they like (barring illegality, duress etc). Where one party is able to dictate the terms of a contract, that party may seek to exclude or limit its liability in certain circumstances and where possible. Terms to this effect in a contract are called exclusion or exemption clauses. Generally, where contracts involve writing such as tickets (for concerts, travel) or where

premises are entered (for entertainment, amusement, sport) exclusions of liability are common. They are either in the document itself or attention is drawn to their existence. A principle of interpretation as concerns exclusion clauses is that they will be construed strictly against the party seeking to rely on them (*contra proferentem* rule).

For an exclusion to be binding it must in the first instance be part of the contract. That is, it must be included at formation and the party sought to be bound by it must have reasonable notice. Important here is the difference between written contracts generally and signed contracts. Signing (execution) raises the presumption that the party has read the terms and has agreed to any relevant exclusion clauses. In *Toll (FGCT) Pty Ltd v Alphapharm Pty Ltd* (2004) 219 CLR 165, a credit application contained (what is a reasonably common) clause inviting the applicant to read the conditions of the contract before signing. In the litigation between the parties, the High Court held the terms (including an exclusion clause) were included in the contract and that the signature represents that the party has either read and approved the document, or if not read is willing to take the consequences as notice had been given. "The representation is even stronger where the signature appears below a perfectly legible written request to read the document before signing it" (at 40).

The issue of the time of formation is important as parties cannot add terms to an already formed contract. In *Olley v Marlborough Court Ltd* [1949] 1 KB 532, Marlborough Court Ltd (the appellant) ran a residential hotel where Olley had stayed for several months. In Olley's bedroom was a notice stating that the hotel would not be liable for articles lost or stolen unless handed to the manageress of the hotel for safe custody. Olley left the hotel temporarily, leaving her room key on a key rack in reception. While Olley was away, the hotel staff negligently allowed the room key to be taken which resulted in items being stolen from Olley's room. The hotel argued that the notice (exclusion clause) in the room absolved it from liability as Olley had not deposited any items for safe keeping as directed. The appeal was dismissed and the court held that the hotel was liable for the loss as the exclusion clause was not incorporated into the contract at the time of formation. The contract was formed prior to the occupants entering the room.

Thornton v Shoe Lane Parking Ltd [1971] 1 All ER 686; 2 QB 163 (see also [2.20]) is a case where an exclusion clause was held to have come after formation and was thereby ineffective to limit liability. The clause was one of the terms included in the notice on the pillar near the entrance as the customer drove into the car park. However, the court held that the car park operator had not done enough to bring the terms to the customer's attention and that the contract had in fact been formed prior to the inclusion of such terms. Today of course on entry to a car park a ticket is received noting entry time, terms (mostly exclusion clauses) are displayed prominently and then payment for using the car park takes place on exit from the car park. The terms accordingly form part of the contract.

Although exclusion clauses are construed strictly they are nonetheless very common. However, even though an exclusion clause may be identifiable at formation and thereby from a part of the contract its effectiveness may still be challenged. In

Sydney City Council v West (1965) 114 CLR 481, a motorist drove into the Domain car park in Sydney and took a ticket containing an exclusion clause that set out that the car park operator (Sydney City Council):

> does not accept any responsibility for the loss or damage to any vehicle or for the loss or damage to any article or thing in or upon any vehicle or for injury to any person, however such loss, damage or injury may arise or be caused.

The car was stolen and later damaged. The thief had approached the parking attendant and claimed to have lost a ticket. The attendant issued a new ticket and with this the thief was able to exit the car park with the stolen car. The car's owner brought proceedings against the Sydney City Council for breach of an implied term in the contract to keep the car safe. The Council argued that the exclusion clause relieved it from liability. The High Court held that the exclusion did not apply. It held that the negligence of the car park operator could not be excluded by the contract terms. An exclusion clause cannot apply to protect the party relying on it where the conduct for which protection is sought cannot sensibly be regarded as being included within the performance of the contract.

Note that the *Australian Consumer Law* implies a number of guarantees such as acceptable quality (s 54) and fitness for purpose (s 55), into all consumer contracts. Terms (including exclusion clauses) in consumer contracts which purport to exclude these guarantees are void. However, terms may limit liability for breach of such guarantees, so long as the limits are fair and reasonable (*Australian Consumer Law*, s 64A).

Termination of the contract

[2.120] A contract can be terminated (discharged) in a number of ways. Most usually termination occurs after all parties have carried out their respective obligations—this is termination by performance, and in some instances, part performance (significantly but not totally carrying out of obligations) will suffice.

Contracts can also be terminated by agreement. This can arise either because of the happening of a defined event within the contract itself or the parties can simply agree to terminate. Mutual termination occurs by way of a new contract between the parties to terminate the original one, with the consideration (value given) for the new contract being the abandoning of rights under the original contract. However if one party has already performed their obligations but the other has not, there may be no value to give by abandoning rights and in this situation it may be necessary for the parties wishing to terminate to reduce their agreement to a deed (a written agreement, signed and witnessed, which does not require consideration to be enforceable).

Where a person who has obligations under a contract becomes bankrupt that contract will be terminated by operation of law.

Other ways a contract may be terminated involve conduct that amounts to a breach of a term of the contract, or the happening of an event that effects the carrying out of

the obligations of one or all parties to the contract resulting in the termination of the contract via the doctrine of frustration.

Termination by breach

[2.130] The terms of the contract will determine the obligations of the parties and where one party does not fulfil an obligation a term will be breached entitling the other party to sue for damages, and in cases where the term breached was a condition, also terminate the contract. Where the contract is terminated the rights and obligations under the contract will cease. A condition is a fundamental term that is essential to a party's decision to enter the contract and its breach substantially deprives that party of what they intended to obtain (what they bargained for) under the contract.

Termination may also occur where the contract itself specifies a particular type of breach as having that outcome. That is, the contract will set out that breach of a particular term by one party will enable the other party to terminate.

In most cases, any dispute as to the carrying out of obligations under a contract arises after a term has in fact been breached. However, in some cases a party indicates an unwillingness to continue with the contract generally, or indicates, expressly or impliedly, that certain obligations will not be met. In these circumstances an actual breach of the contract has not yet occurred, but it is obvious that it will in the future. This is referred to as an anticipatory breach and amounts to a repudiation of the contract by the defaulting party. In this situation the innocent party can elect to accept the repudiation (in a sense bring forward the breach), treat the contract as at an end, and sue for all relevant damages. Or, the innocent party may affirm the contract and demand performance (in some cases by way of the equitable remedy of specific performance). A party that affirms must ensure that by doing so they do not compound any loss arising (ie, they must mitigate any loss).

An example of anticipatory breach can be found in *Metro Meat Ltd v Fares Rural Co Pty Ltd* (1985) 58 ALR 111. In that case a contract was entered for the supply of frozen meat at a specific price. Delivery of the meat was to be separated into five instalments (shipments). After three shipments, the supplier informed the buyer that the last two shipments would not be forwarded unless the buyer agreed to pay a higher price. The buyer claimed anticipatory breach. The Privy Council decided in the buyer's favour holding that the conduct of the supplier amounted to repudiation of the contract entitling the buyer to terminate.

Frustration

[2.140] In some situations events will arise that make the performance of a contract fundamentally different to that which was contemplated. In such situations, it may be unjust to require one or both parties to perform the contract. These types of events enable termination of the contract by frustration. It is important that the frustrating event arises independently of the parties, that is, neither party caused, or was responsible for the event taking place.

In *Codelfa Construction Pty Ltd v State Rail Authority (NSW)* (1982) 149 CLR 337, a contract was entered into between railway authority and Codelfa Constructions for the excavation of tunnels for the construction of the Eastern Suburbs Railway in Sydney. The contract provided for Codelfa to complete works by certain dates and complete all work within 130 weeks (ie, the contract contained a time is of the essence clause). Codelfa commenced the work, which was organised into three shifts a day, seven days a week. Unfortunately for those living near to the construction the work was noisy and caused vibrations which led to several applications for an injunction by local residents and Council. An injunction (restricting construction times) was granted with the result that Codelfa was reduced to working six days a week (no work on Sundays) and only two shifts a day (no work between 10 pm and 6 am). At the time of contracting it had been the common assumption of the parties that the work would not be subject to an injunction; this was based on faulty advice.

Codelfa's claim was based on two grounds. Firstly, that the construction hours amounted to an implied term, the breach of which would entitle Codelfa to damages. The High Court rejected this argument on the basis that the term was not an obvious inclusion without more being said about it, and that because the position of the parties was not clear on the issue at formation the term could not be implied to give business efficacy to the contract. Codelfa's alternative argument was that the contract had been frustrated. On this aspect the High Court held that the performance of the contract had been made fundamentally different from that contemplated by the parties. Mason J (at [55]) referred to the outcome of the frustrating event as "radically different".

Where a contract is terminated due to frustration there will need to be some re-organising of the parties rights that arrives at a fair arrangement between them. This is important having regard to the fact that the essence of frustration is an intervening event which is not caused by either party (if one party is at fault it will be a breach of contract and dealt with as explained at [2.130]). Determining the parties' rights following the frustration of a contract depends in some jurisdictions on the common law and in others on legislation, for example the *Frustrated Contracts Act 1978* (NSW).

Remedies for breach

[2.150] As mentioned at [2.130], breach of a term that is defined as a warranty will enable a claim for damages, whereas breach of a condition will give rise to damages plus termination of the contract. These are common law remedies. In contract law, the innocent party will also have recourse to equitable remedies, such as specific performance, and statutory remedies, such as those in the *Australian Consumer Law*.

Damages

[2.160] "Damages" is the term used for money compensation. In contract law, the principle in awarding damages is to put the innocent party in the same position they would have been had the contract been performed. That is, the defaulting party must

compensate the innocent party for the bargain lost. General damages are basically a calculation of what compensation should be paid to the innocent party as a result of the breach. Where an innocent party seeks unliquidated (not specified in the contract) damages, the court, based on the evidence, will decide on the amount of the damages. Where the contract itself sets out the means of calculation of damages, they are referred to as liquidated damages. Regardless of the manner of calculation of damages, there is an underlying duty on the part of a party seeking damages in contract to attempt to reasonably mitigate (not increase) their loss.

Before deciding upon the measure or amount of damages it will be necessary to determine which losses the defaulting party will be liable for. Not all losses resulting from a breach of contract can be compensated. The damage claimed must not be too remote.

In *Hadley v Baxendale* (1854) 156 ER 145, the plaintiffs owned and operated a flour mill in Gloucester. A steam engine was used in the production of the flour. Its crank shaft was broken and the mill owners arranged with a manufacturer in Greenwich to have a new crank shaft made. Before this could be done the manufacturer required the broken crank shaft to be delivered for inspection to allow for the accurate measurement and construction of the new crank shaft.

For the purposes of transporting the broken crank shaft the mill owners contracted with the defendant carrier. The terms of the contract required the crank shaft to be delivered in two days; however in breach of the contract the defendant took seven days to deliver it. Although the defendant was not made aware of the fact, the mill had only one crank shaft and as a result of the delay it was prevented from operating for five days more than expected. It brought proceedings against the defendant carrier for loss of profit.

There had clearly been a breach of contract in the late delivery, but the issue for the court was whether the losses to the plaintiff of the mill ceasing operation for a greater than expected period were compensable or too remote and not attributable to the defendant's breach. The court held that, without specific knowledge of the plaintiff's circumstances, that is, without knowing there was only one crank shaft, it was not possible for the defendant to have reasonably contemplated the loss in the usual course of things when the contract was formed.

Accordingly a breach of contract can result in two types of loss: firstly, loss that arises naturally, that is, occurring naturally from the breach, obvious to a reasonable person, predictable; and, secondly, loss that does not normally arise but that is reasonably foreseeable by the parties at the formation of the contract. Knowledge of the possibility of such loss (including notice by one party) is an important factor in the assessment of whether the loss was in the reasonable contemplation of the parties and a serious possibility of occurring (this was the issue in *Hadley v Baxendale*).

In *Victoria Laundry Ltd v Newman Industries Ltd* [1949] 2 KB 528 the plaintiff operated a laundry and dry cleaning business. Wanting to expand its market, it arranged for the supply of a boiler to be delivered at a specified date. The defendant was aware of the plaintiff's business and that it had planned a rapid expansion. The defendant did not

know however that the plaintiff was negotiating valuable contracts for dyed fabrics. The boiler was not delivered on time, arriving 20 weeks after the specified delivery date and as a result the plaintiff brought proceedings for breach of contract. The Court of Appeal referred to the decision in *Hadley v Baxendale* finding that although the contracts for the dyed fabric, because the defendant was not made aware of them, were not within the expectation or contemplation of the parties, the loss of profits from the delayed delivery was. The losses were within the contemplation of the parties because the defendant should have foreseen that a commercial business planning a rapid expansion in circumstances where the plaintiffs had indicated that the boiler was to be put to immediate use would suffer loss upon non (or late) delivery.

Most awards of damages for breach of contract concern financial loss. Physical injury is also compensable. However, disappointment, distress or injured feelings are rarely within the scope of contractual damages. In this respect, contract differs from tort law (negligence) where an injured party can claim for nervous shock, and not only physical injuries but also psychological or psychiatric conditions are included in the scope of damages available. A reason for the restricted scope of damages in contract law is that in contract a specific agreement with specific terms has been negotiated between parties known to each other, and the parties will have expectations of their rights and obligations. Where there is a breach of contract there is often disappointment; however, to allow compensation for all the psychological possibilities associated with this disappointment would create uncertainty when entering the contract. The outcome of the contract would thereby be unpredictable and as such the bargain made in entering the contract could not be quantified with any certainty. This uncertainty would be a commercial disincentive.

An exception to the general reluctance of the courts to award damages for distress in contract law is in relation to "holiday" cases. In *Jarvis v Swan Tours Ltd* [1973] QB 233, the plaintiff/appellant (Mr Jarvis) booked a holiday on the basis of the material in the travel brochure. Very little of what was promised was satisfactory, none of the food, facilities, entertainment or services met with the description in the brochure. Mr Jarvis claimed damages which included an amount for disappointment suffered as the result of the defendant's failure to provide a holiday experience as proposed. At first instance (the initial trial), Mr Jarvis was awarded some damages but not for disappointment. He appealed. The Court of Appeal held in the Mr Jarvis's favour awarding damages for the absence of certain physical components of the contract together with damages for the disappointment, distress, upset and frustration caused by the breach.

Equitable remedies

[2.170] Together with the common law remedies of damages and termination, a breach of contract can also give rise to equitable remedies. Two important equitable remedies are injunctions and specific performance. An injunction is an order restraining a person from carrying out certain acts, or engaging in certain conduct. Accordingly a party may seek an injunction to stop a breach of contract occurring, or

perhaps to force a person to carry out their contractual obligations. In a broader sense, an injunction can be used to protect a person's legal rights by putting a hold on the infringing conduct (eg, where a party is infringing another's copyright). An injunction will not be granted where to do so would create hardship or injustice, or where it is unlikely the offending conduct will continue. In *Network Ten Pty Ltd v Rowe* (2006) 149 IR 273; [2006] NSWCA 4, a newsreader (Rowe) left one television station (Channel 10) to take up a position at another television station (Channel 9). The previous employer sought an injunction based on the need for Rowe to give adequate notice. Weighing the damage to the plaintiff (Channel 10) of not granting the injunction, against the hardship to the defendant (Rowe) of granting the injunction, the court found in favour of the defendant and held that the prejudice to Rowe exceeded the damage to Channel 10. The injunction was not granted.

An order for specific performance is one that requires a party to a contract to perform the obligations under that contract. Specific performance will not be granted in a number of situations including: where damages are an adequate remedy; where the contract is for personal services. In *Lumley v Wagner* (1852) 42 ER 687, the defendant (Wagner) had entered a contract to sing exclusively at the plaintiff's theatre (and nowhere else) for a period of three months. In breach of her contract, the defendant entered into a further contract to perform during the restricted period at another theatre (Covent Garden Theatre). The plaintiff brought proceedings for breach of contract. The court held that there was a breach, but it was not able to order specific performance of the contract because the contract was for personal services. However, although the court could not make Wagner honour her commitment to sing at the plaintiff's theatre it granted an injunction restraining the defendant from performing at Covent Garden.

Summary—Contract

Parties to a contract will have rights and liabilities as per the terms of the contract

Elements of a valid contract are: offer; acceptance; intention; consideration

Acceptance must relate directly to the offer made

Silence in itself is not a valid acceptance—conduct is required—*Carbolic Smoke Ball*

An intention to create legal relations is required

In commercial situations, but not in domestic situations, the intention is presumed

Consideration, or value passing between the parties, is required

Consideration must be present or in the future, not past

Contracts will not be enforceable where factors removing real consent are absent

Vitiating elements include: misrepresentation, duress, undue influence

Terms of a contract can be oral and/or written; express and/or implied

Terms may be implied from legislation, prior dealing, business efficacy

Exclusion clauses limit liability but are construed strictly against those relying on them

Time of formation of contract is important to inclusion of terms—*Thornton v Shoe Lane*

Terms can be conditions (core) or warranties (non-core)

Breach of condition—damages plus terminate; breach of warranty—damages only

Termination by frustration—contract altering event arising independently of parties

Breach gives rise to damages (compensation)—loss sustained will be direct or indirect

Indirect loss measured by what parties could reasonably contemplate at formation—*Hadley v Baxendale*

Equitable remedies also available such as injunctions and specific performance

3
Tort

[3.10] The law of torts concerns the interaction between rights and duties and provides remedies where individuals or businesses have suffered loss as the result of a breach of a duty owed to them. Unlike contract law, a person suffering a loss in tort does not necessarily have to be in a pre-existing relationship with the person causing the loss, that is, the doctrine of privity is not essential to the law of tort. Further, a breach of contract is not dependant on finding fault whereas in tort, fault, being either intentional or negligent, is required.

There are several areas of tort law, these include: assault (putting a person in reasonable fear of harm), battery (inflicting harm), false imprisonment (unlawful restraint against the will of a person) and nuisance (interference with a person's use or enjoyment of land). However, the largest area of tort law involves the tort of negligence, and this will be the focus of the following discussion.

The law of negligence has arisen out of the common law, that is, cases have over the years established the principles that have guided the courts in determining the rights and duties of the litigants. However, as with many other areas of the common law, legislation has increasingly played a part. Each state and territory of Australia now has legislation impacting the law of negligence. In NSW, this is the *Civil Liability Act 2002* (NSW). The State and Territory Acts (to varying degrees) modify the common law principles. Areas addressed include causation of damage; limits on the right to recover damages in certain defined circumstances such as injuries arising from recreational activities and situations where the defendant is a volunteer or a public authority; restrictions on the upper amounts payable by way of compensation in certain situations such as general or non-economic loss.

Negligence is relevant to a very broad cross-section of activities; for example, it covers the loss suffered when injured in a motor vehicle accident (both physical and psychological), or the loss suffered when a professional gives misleading financial advice, or the loss suffered when a shop fails to take adequate care to warn entrants of faulty flooring. For a court to find negligence, certain elements must be established. Firstly, there must be a duty owed to the plaintiff; secondly, it must be established that there was a breach of that duty; thirdly, the breach must cause the plaintiff's loss (which cannot be too remote and must be foreseeable). The relevant State or Territory civil liability reforms must also be considered if they are relevant to the particulars of the claim. Before a court is able to decide on the outcome of a claim in negligence, the existence or otherwise of a defence must be tested, that is whether the defendant can establish contributory negligence by the plaintiff or voluntary assumption of risk. Finally, the law attempts to ensure that plaintiffs do not exaggerate or compound their loss and accordingly will require plaintiffs to mitigate loss where possible.

Duty of care

[3.20] A duty will arise where there is a foreseeable risk of harm and where there is reasonable proximity between the plaintiff and defendant. These principles formed the basis of the explanation of the duty found in *Donoghue v Stevenson* [1932] AC 562. The plaintiff (Donoghue) and a friend were at the Wellmeadow café in Paisley, Scotland in 1928. The friend ordered a pear and ice cream ginger beer "float" (drink) for the plaintiff. When the ginger beer was poured into her glass, it was alleged the decomposing remains of a snail dropped out of the darkened, opaque bottle. Donoghue had consumed most of its contents before she became aware of the snail. She later fell ill, and a physician diagnosed her with gastroenteritis and shock. Donoghue subsequently took legal action against Mr David Stevenson, the manufacturer of the ginger beer. She lodged a writ in the Court of Sessions, Scotland's highest civil court, seeking £500 damages. Because her friend had purchased the drink, Donoghue could not sue Stevenson for breach of contract (there was no privity). Instead, her claim was that Stevenson had breached a duty of care to his consumers and had caused injury through negligence—an area of civil law which at the time was largely untested.

Donoghue's initial action failed, however she was granted leave to appeal. In the House of Lords, Lord Atkin (in the majority), held that Stevenson should be responsible for the wellbeing of individuals who consume his products, given that they could not be inspected. His judgment included (at 580) what has become known as the "neighbour principle".

> The rule that you are to love your neighbour becomes in law you must not injure your neighbour; and the lawyer's question "Who is my neighbour?" receives a restricted reply. You must take reasonable care to avoid acts or omissions which you can reasonably foresee would be likely to injure your neighbour. Who then in law is my neighbour? The answer seems to be persons who are so closely and directly affected by my act that I ought reasonably to have them in contemplation as being so affected when I am directing my mind to the acts or omissions which are called in question.

The House of Lords returned the matter to the original court for determination on the facts but Stevenson died before finalisation. Proceedings were settled by way of a payment of £200 to Donoghue by Stevenson's estate. Notwithstanding settlement, the civil law tort of negligence had been founded in Lord Atkin's judgment.

The test a court applies is whether a hypothetical reasonable person would have foreseen the possibility of loss or damage in the particular circumstances and taken steps to avoid it. The test of foreseeability does not require a person to foresee the precise consequences rather the general outcome. In *Chapman v Hearse* (1961) 106 CLR 112, a driver, Chapman, driving negligently, collided with another vehicle and was thrown onto the road. A doctor from another car stopped to help and while tending to the injured driver was struck by a car and killed. An issue for the court was whether Chapman owed a duty of care to the doctor. Chapman argued he could not reasonably

foresee that a person helping him could be struck and killed by another vehicle. The High Court held otherwise (at 120): "The particular sequence here was of a class that should have been anticipated when driving negligently—driving negligently could very easily result in someone being run over".

A duty of care will also arise where the damage suffered involves more than physical injury, for example nervous shock. In *Jaensch v Coffey* (1984) 155 CLR 549; [1984] HCA 52, a motorcycle rider was seriously injured in a collision caused by the negligence of Mr Jaensch. The injured party's wife was told of the accident shortly thereafter and taken to the hospital to see her husband. She suffered anxiety and depression as a result of the incident and brought proceedings against Jaensch. The court held that, although she was not at the scene of the accident, Mrs Coffey was at the hospital in the immediate aftermath and that her reaction was both foreseeable and proximate to the incident. Note that civil liability reforms have an impact on nervous shock matters requiring that the plaintiff must show that the nervous shock was reasonably foreseeable by the defendant and that a reasonable defendant would have taken precautions to avoid the risk.

In some instances, financial loss will arise as the result of a person's conduct although no physical injury is involved. This will be either where negligent conduct or negligent advice causes direct or pure economic loss. The cases concerning negligent advice (negligent misstatement) are very relevant for professional advisers. There is a line of cases in which the law was developed. In *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465, a bank incorrectly certified to a company's creditworthiness which led to an advertising agency that had contracted with the company suffering financial loss. The court considered a duty of care arose because of the relationship between the parties, although the matter was not decided in the advertiser's favour because the bank could rely on an exclusion of liability. In *Mutual Life & Citizens' Assurance Co Ltd v Evatt* (1968) 122 CLR 556, the High Court held that a person giving serious advice in a business context (in this case the financial standing of a company) will owe a duty of care. Although this decision was reversed on appeal to the Privy Council (such appeals are no longer possible), the High Court was able to affirm its position in the case of *L Shaddock & Associates Pty Ltd v Parramatta City Council (No 1)* (1981) 150 CLR 225. In that case, advice was sought by a developer in relation to redeveloping certain land for commercial purposes. The Parramatta City Council was asked whether there were any proposals for road widening in relation to the land. The Council replied, both verbally and in writing, that no proposals for road widening existed. This advice was incorrect and as a result certain parts of the land became unsuitable for development thereby causing the developer financial loss. The High Court held that the Council owed a duty of care to give accurate advice in the circumstances as it was the competent authority and had the relevant skill in relation to the request. Importantly, the High Court found that the Council either knew or should have known that the developer had intended to rely on the information. That is, reliance was reasonably foreseeable.

An important part of the existence of a duty of care for advice is that the advice was sought or requested from the defendant. In *San Sebastian Pty Ltd v Minister*

Administering Environmental Planning and Assessment Act 1979 (1986) 162 CLR 340, a developer was aware of a Planning Authority plan encouraging the construction of high-density office blocks. The developer purchased land for this purpose but the plan was subsequently abandoned and the developer suffered financial loss. The High Court, although it did not rule out the possibility of a duty arising where information was volunteered, held that in this case the absence of evidence that the developer requested the relevant information meant that a duty on behalf of the Planning Authority did not arise.

Breach

[3.30] Once it is established that a duty of care exists, it will be up to the plaintiff (party suffering the loss) to prove that the duty has been breached. The risk produced by the defendant's conduct and the probability of its occurrence must be weighed against the harm to be avoided. The standard to be applied is that of the reasonable person; this is an objective test not necessarily concerned with the specific characteristics of a particular defendant but of a hypothetical person in the defendant's position. Whether a duty is breached is not tested by what a particular defendant thought or considered an appropriate response. This would make assessing breach too uncertain (for instance, different people have different ideas as to a safe driving speed). The circumstances of the risk and the manner in which a reasonable person would respond to the risk are relevant. In *Hackshaw v Shaw* (1984) 155 CLR 614, Deane J (at 662-663) set out "The measure of the discharge of the duty is what a reasonable man would, in the circumstances, do by way of response to the foreseeable risk".

Factors which may be relevant to consider in determining if and how a reasonable person would have responded to a risk include the probability of the risk arising; the magnitude or gravity of the harm that could reasonably flow from the risk; the expense inconvenience and difficulty in eliminating the risk; and the importance or utility of the defendant's conduct. In *Bolton v Stone* [1951] AC 850, the issue of the probability of the risk was considered. In that case, a person was injured by a cricket ball that was hit out of the boundary of a cricket ground during a match. The evidence in the matter indicated that very few balls had ever been hit beyond the boundary. Accordingly, the probability of the event occurring was low and this reflected on the level of risk. The court held that such a low level of risk entitled a reasonable person in the defendant's position to disregard it. Thereby, no breach of duty arose.

However, in some circumstances, even though the risk of the event occurring is low the seriousness of injury possible may mean that a breach of duty arises. In *Paris v Stepney Borough Council* [1951] AC 367, the plaintiff, who was blind in one eye, was carrying out his duties as a fitter for the defendant Council. The Council was aware of the plaintiff's condition. While hammering, a rusty bolt piece of metal struck the plaintiff in his good (sighted) eye. As a result, he became totally blind. The plaintiff alleged that the Council was negligent in not supplying or requiring the wearing of protective goggles. The court found that negligence existed and that a reasonable

person in the Council's position should have been influenced not simply by the probability of the event but also by the gravity should such an event occur.

It should be noted that the fact that the risk could be avoided by doing something in a different way does not necessarily give rise to liability. However, the fact that a risk is easy to eliminate will make it less likely that a defendant's failure to avoid the risk or take precautionary steps will be justifiable.

Note that civil liability legislation in place in the States and Territories deals to different extents with the issue of breach. For example, in NSW, a person is not negligent in failing to take precautions against a risk of harm unless the risk was foreseeable, not insignificant and a reasonable person would have taken those precautions (s 5B *Civil Liability Act 2002* (NSW)).

Causation

[3.40] Once a breach of duty is found, a plaintiff must show that the breach caused the damage suffered. An important test to apply to determine a connection between breach and damage is the "but for" test. This is that causation will exist where the damage would not have occurred but for the act of the defendant. However, although the "but for" test can provide a framework for tying a breach to loss or injury, it has several qualifications. The scope of the liability, or remoteness of damage, is relevant, and for this purpose, the issue is whether the damage was reasonably foreseeable. The evidence adduced during a hearing will have an effect on the court's decision of what was, or was not, reasonably foreseeable. In *Overseas Tankship (UK) Ltd v Morts Dock & Engineering Co Ltd (The Wagon Mound No 1)* [1961] AC 388, a ship taking on cargo in Sydney Harbour negligently allowed oil to spill into the water. The oil floated under a wharf where welding was taking place. Molten metal fell from the welding onto cotton waste floating on the oil spill. As a result, the oil ignited and damaged the wharf. The court heard evidence that oil would not normally ignite on water and accordingly held that the damage was not reasonably foreseeable. However, in a separate matter arising from the same facts (*Overseas Tankship (UK) Ltd v Miller Steamship Co Pty Ltd (The Wagon Mound No 2)* [1967] AC 617), the owner of a ship damaged by the fire was able to adduce evidence of a real risk of fire resulting, and in that case, the court found the damage reasonably foreseeable.

Intervening events that break the causal chain, or unauthorised, unknown or uncontrolled criminal activities, will impact on a court's decision as to whether an outcome was reasonably foreseeable.

In *Modbury Triangle Shopping Centre Pty Ltd v Anzil* (2000) 205 CLR 254, a person employed by a tenant of a shopping centre was injured when he was assaulted in the shopping centre car park at night. It was alleged that but for the poor lighting in the car park the injuries would not have taken place. That is, the plaintiff argued that the lack of lighting caused the assault. The High Court held that although the poor lighting may have had an impact on the event occurring it did not in itself cause the plaintiff's injuries.

Civil liability legislation

[3.50] There are a number of areas of negligence affected by the civil liability reforms (note that States and Territories do not have identical legislation). Broadly, the statutory provisions are consistent with common law principles. An example of matters affected include:

- Volunteers and good samaritans—generally acts or omissions arising in emergencies where a person is assisting a person who is at risk do not incur civil liability;
- Dangerous recreational activity—a person will not be liable in negligence for harm suffered by another as a result of an obvious risk in a dangerous recreational activity. This aspect of civil liability legislation is similar to the common law defence of voluntary assumption of risk. The idea that no wrong could be done to a person who consents to that wrong enabled in some cases a defendant to avoid liability entirely. A plaintiff will need to show that any losses are not the result of their own negligence and that it is reasonable to impose a duty on the defendant;
- Professional negligence—a professional does not incur liability in negligence arising from the provision of a professional service if it is established that the person acted in a manner that, at the time the service was provided, was widely accepted in Australia by peer professional opinion as competent professional practice. In *Walker v Sydney West Area Health Service* [2007] NSWSC 526, a patient with a mental health disorder committed self-harm following discharge from hospital, and it was alleged in proceedings against the area health service that if appropriate medication (such as anti-depressants) and counselling had been available the (self-inflicted) injuries would not have been sustained. The court considered evidence of how the hospital had weighed the importance of the plaintiff's particular issues. These included known alcohol problems, the benefits of further treatment, and the plaintiff's psychological condition while in hospital. As a result, the court held that the defendant hospital had in fact acted in a manner accepted by peer professional opinion as competent.

Contributory negligence

[3.60] Where two parties interact, for example in business, as road users, or providing professional advice, losses that arise are not always attributable to one party only. Accordingly, the law enables a defendant in proceedings for negligence to allege that the damage caused was either wholly or partly the fault of the plaintiff. In this situation, an assessment of the damages that would have been awarded if there had been no fault on the plaintiff's part is made and then that amount is reduced by the percentage of the plaintiff's contribution.

Vicarious liability

[3.70] In a normal employer/employee situation (that is, a master/servant relationship as opposed to an independent contractor arrangement), the employer will control the

manner in which the employee undertakes their employment and will benefit from the results of the employment. In this situation, the law considers it reasonable to attribute liability to the employer for any loss caused by the employee's negligence. The fact that it will be the employer who is in the position to insure against such outcomes is also relevant to the employer's liability. This concept is referred to as vicarious liability. The employer is vicariously liable for the negligent acts of the employee while the employee is acting within the course of their employment. Much commercial, particularly corporate, liability in negligence arises as the result of this principle.

Vicarious liability is important where a plaintiff cannot identify the exact person committing the breach. In *Cassidy v Ministry of Health* [1951] 1 All ER 574, the plaintiff entered hospital for an operation to fix two stiff fingers. Following the operation by a doctor employed by the hospital, the desired result was not achieved. Instead of fixing two stiff fingers, the outcome of the operation and hospitalisation left the plaintiff with four stiff fingers and little use of his hand. The plaintiff alleged that a person or persons involved with his treatment had been negligent and brought proceedings against the hospital. Even though it was impossible to identify the actual cause of the damage, the court held the defendant hospital vicariously liable for the negligence.

Summary—Tort

For a tort (civil wrong) to arise, there must be fault (negligent or intentional)

Areas of tort law include: negligence, assault, false imprisonment

Elements of negligence: duty; breach; causation of loss

A duty of care is owed to those reasonably contemplated as effected by your conduct—*Donoghue v Stevenson*

Duty owed when giving advice—where reliance is foreseeable—*Shaddock v Parramatta City Council*

Breach of duty depends on objective test—what a reasonable person would do to avoid risk

Issues of probability of risk arising; gravity of harm—*Paris v Stepney Borough Council*

Breach must cause loss—would loss not have occurred "but for" the conduct

Defence of contributory negligence—plaintiff partly responsible for loss

Employers will generally be liable for employees' negligence—vicarious liability

Note that civil liability legislation affects common law negligence

4
Agency

[4.10] The law of agency is relevant to the liability of partnerships and companies. Agents (partners/directors) bring principals (partnerships/companies) into contractual relations with third parties. The existence of an agency relationship will determine the rights of the parties involved.

An agency can be created expressly either in writing, orally or by Deed. Less often an agency can also come into existence by way of estoppel (see *Freeman and Lockyer* below); operation of law (need to preserve another person's property) or ratification. Other than companies and partnerships, examples of where agency relationships will arise are real estate agents; solicitors; insurance brokers; employees or independent contractors, but only where acting within the scope of their employment; under a power of attorney (by Deed). The parties to an agency (principal and agent) will have fiduciary obligations involving, among other things, the need to avoid a conflict of interest.

An agency will arise by:

Actual Authority: Here, the agreement will be clear and express. It can be written and/or oral. Actual authority can also be implied from the situation and will include conduct necessary to achieve the purpose of the agency.

Ostensible (or Apparent) Authority: The principal creates a situation in which it looks (to third parties) like the agent has authority even though in fact the agent does not (or has exceeded the authority given). The elements of establishing ostensible authority are: that the principal represents that the agent has authority, that the third party is aware of this representation and that the agent acts as an agent.

Ratification: Agency by ratification will arise where the agent acts without authority (or exceeds authority) but the principal later claims the benefit of the transaction. For a valid agency, by ratification, the following must be established: that the agent acts as an agent, that the principal exists at time of transaction (this is the common law position but note that the *Corporations Act 2001* (Cth) provides an exception [12.20]), that the principal has legal capacity, that the principal knows of the transaction at the time of the ratification and that the ratification relates to the whole transaction.

Where an agent has actual authority but does not disclose to the third party, that a principal exists (that is, the third party is unaware of the agency) then not only will the principal be bound by the contract created but so will the agent. This is referred to as the doctrine of undisclosed principal. An example of an agent becoming liable under a contract is where an undisclosed principal cannot meet its commitments to a third party because of insolvency. In *Clarkson, Booker Ltd v Andjel* [1964] 2 QB 775,

prior to judgment being obtained against the principal, it was placed into liquidation. The court held that the third party (plaintiff) could accordingly proceed against the agent (defendant). In some situations, an agent will inform a third party that they have authority to enter a transaction when in fact authority does not exist. Where the third party relies on the representation and suffers loss, the agent will be liable in damages to the third party for a breach of warranty of authority.

The duties of an agent include: following the principal's instructions; acting in person; acting in good faith; disclosing any personal interest; not taking secret profits and exercising reasonable care and skill. An agent's rights as regards the principal include the right to remuneration, and the right to indemnity and reimbursement.

The concept of agency is important because it creates the link between the actions of an individual and an organisation. A partner's act may bind the partnership and a director's act may bind the company. Outsiders (third parties) will not necessarily be able to deal with every partner in a partnership or, where a company is involved, the entire board of directors. As such, contracts with these organisations will generally be entered into by their representatives, that is, by their agents. An example of the importance of finding agency in relation to companies arises in *Freeman and Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480. In that case, the board of directors allowed a director to act as a managing director though he was not formally appointed. The court held that the director had ostensible (apparent) authority to act in the usual manner of a managing director and found that agency existed. The company (principal) had held out (represented) that an agency existed and therefore could not deny the directors (agent) authority where the third party had entered an agreement on the basis of the representation. This principle is referred to as estoppel. The company was accordingly bound by the contract entered by the director.

Summary—Agency

Agents enter contracts on behalf of principals

Agency will arise through actual authority, ostensible authority or by way of ratification

In a situation of an undisclosed principal, an agent may become personally liable

An agent owes a duty to follow instructions and has a right of indemnity

Partners will be agents of their partnership, and directors will be agents of their company

5
Comparison of Business Organisations

[5.10] There are several ways of running a business. A person can trade on their own account as a sole trader, join together with others to form a partnership or register and run (alone in some cases, or with others) a company. All of these forms of business can return profit to their participants. In contrast, an association (voluntary, unincorporated or incorporated) does not enable the distribution of profit to its members.

Those participating in a venture may place varying relevance on different aspects depending on matters particular to that business. For example, a business that seeks to expand rapidly and will need to bring in ongoing expertise may need a business structure that has a multiple profit sharing capacity. A company suits this purpose as participants in profit (shareholders) will hold shares in proportion to their ownership and take their profit accordingly. Small businesses are usually operated through a sole proprietor, a partnership or a proprietary company. Large businesses will usually be operated through either a proprietary company, or through a public company which then enables the business to raise funds by the sale of shares to the public.

In sole proprietorships and partnerships, the participants are exposed to personal liability, and creditors can look to their private assets to recoup outstanding debts. Companies are popular forms of business because of their characteristic (in most cases) of protecting those who participate in the company (members), and generally those who run the company (directors), from personal liability to outsiders for company debts. Whereas the focus of this book is on companies, other non-company business forms are discussed where applicable.

To make informed decisions about suitable business structures, an ability to compare the various means of running a business, and the characteristics of each, is essential. In this context, the formalities of companies may be compared to, for example, the simplicity of a sole proprietorship. Matters that may be relevant to making a choice between various forms of business include: the underlying nature or characteristics of the business, the impact of the law, the difficulty and cost of setting the business up, whether the form chosen allows for the business to be carried on in perpetuity, whether the business chosen will provide sufficient protection from personal liability, the extent of control, the level of formality required, whether the business is capable of expansion, the ease with which it can be transferred and what rules apply when the business ceases.

Characteristics of businesses other than companies

[5.20]

Criteria for Comparison	Association	Sole Trader	Partnership
Nature			
What are the characteristics of the business and do they suit the individual's goals?	Unincorporated—usually small, informal, no business purpose. Incorporated—minimum membership requirement, more complex regulation. In either case not set up for profit.	One person has sole control, takes the profit and is liable for the losses.	The relation which exists between persons carrying on a business in common with view of profit—*Partnership Act* in each State and Territory. General partnership limit of 20 partners.
Law			
Is the law complex and will regulatory compliance be costly?	Each State and Territory has associations incorporation legislation. This provides a framework and is cheaper than company registration.	If own name not used, business names legislation will apply. The relevant statute is the *Business Names Registration Act 2011* (Cth). It creates a federal (national) register of business names.	The *Partnership Act* in each State and Territory will apply. Certain parts can be varied by agreement between partners.
Setting Up			
What expense is involved and how quickly can the business be operational?	Unincorporated—set up foundation committee and rules. Incorporated—apply to relevant Fair Trading office.	No formalities other than may specifically apply to the type of business chosen.	Written partnership agreement is advisable to minimise disputes between partners.
Continuity			
Does the business continue if the owners change?	Unincorporated—no continuity, existence depends on membership. Incorporated—separate legal entity thereby perpetual succession.	Once the business is sold and there is a new proprietor in law, the old business ceases.	A partnership is the sum product of its partners. Once partners leave or new partners arrive in law, there is a new partnership.

Criteria for Comparison	Association	Sole Trader	Partnership
Liability			
What is the likelihood and extent of an individual's liability?	Unincorporated—liability is uncertain; may be the common fund or committee. Incorporated—members liability is limited. Association itself will be liable as per relevant associations incorporation legislation.	Sole proprietors have unlimited, personal liability. Creditors can enforce against their personal assets and pursue bankruptcy.	Partners have unlimited, personal liability. Pursuant to the *Partnership Act* in each State and Territory individual partners liability will be joint (contractual) or joint and several (tort or fraud).
Control			
How is control organised and what powers will management have?	A committee of members will be elected to manage the association.	The proprietor has sole control over all aspects of the business. He or she can delegate tasks to employees.	This will be determined by the partnership agreement if there is one otherwise the *Partnership Act* in each State and Territory sets out the rules.
Formalities			
What level of compliance is required? For example is ongoing financial reporting essential?	Unincorporated—depends on type of activity but usually minimal formalities. Incorporated—as per associations incorporation legislation.	Depends on type of business. Some sole proprietors (eg solicitors) have many formalities. Business names legislation will apply if relevant.	Professional partnerships are subject to various formalities. The *Partnership Act* in each State and Territory will apply and in some cases business names legislation.
New Participator			
What factors relate to introducing a new person into the profit-making structure?	The association rules will determine membership matters. However, members do not share in profit.	A new participator in profit will change the nature of the business. A sole proprietorship is about one person taking profit.	New partners may join the firm and their share of profit will be determined by agreement. They may bring expertise, capital or clients.
Sale of Business			
Is the business easily transferred to new proprietors?	Unincorporated—difficult as there is no separate existence. Incorporated—sale is possible.	The sole proprietor has full control over the sale of the business.	The partnership is not a separate legal entity and any sale must be by agreement between the partners.

Criteria for Comparison	Association	Sole Trader	Partnership
Cessation			
When and how does the business cease and what are the procedural requirements?	Unincorporated—the rules will determine. Incorporated—the relevant associations legislation deals with winding up.	The proprietor will determine when the business ceases. Employee entitlements may exist upon cessation.	The *Partnership Act* in each State and Territory deals with cessation and with adjustment of rights following dissolution.

For a table setting out the characteristics of a company using the same criteria for comparison, see [8.70].

Associations

[5.30] There are two types of voluntary associations. Neither can be formed for a trading purpose nor are members entitled to a distribution of profit. An unincorporated association is the original form and developed as a means by which parties with an interest in common could share that interest. The characteristics of a voluntary unincorporated association include: a minimum membership of two persons, and limited members' rights. A committee of members will control the association; however, the status of the committee, particularly as to liability for debts of the association, has in the past been uncertain. More certainty has been introduced into the legal position of associations with the availability of registration under one of the various State and Territory associations Acts. In NSW, the relevant statute is the *Associations Incorporation Act 2009* (NSW). For incorporated associations, the terms of the legislation provide formality not evident in unincorporated associations. Liability is determined by the association rules and many characteristics of incorporated associations are similar to companies. The minimum membership in each State varies. In NSW and Victoria, it is five. An example of an incorporated association may be an organisation formed by, and for, those with a common interest (which can be in some instances quite large) such as "Australian Radio Yachting Association (Inc)".

Increasingly small non-profit unincorporated associations are choosing to convert to incorporated associations or companies limited by guarantee. The reasons why this is occurring, some of which are outlined in the following journal article extract, give an insight into the increasingly regulatory commercial environment.



[McGregor-Lowndes M and Hannah F, "Unincorporated associations as entities: A matter of balance between regulation and facilitation?" (2010) 28 *Company and Securities Law Journal* 197 at 201.]

For non-profit organisations, the drivers to incorporation are many and varied, but include:

The fear of liability: this was at the heart of the 1980s initiation and reform of incorporated association regimes across Australia. First, it permitted many formerly

exposed organisations to obtain limited liability for management committees and members. Secondly, insurance is much easier to arrange through an incorporated body because of business usage and a legal impediment for unincorporated associations taking out insurance.

Funding requirements: it is now a pervasive practice that government or philanthropic funders will only make grants to those organisations with corporate status. This appears to be because of the need for certainty in legal relations.

Licences: it is becoming increasingly common for government agencies issuing licences or approvals to require a corporate persona. These licences include fundraising, liquor, charity gaming, machine gaming and various council approvals.

Appearance before tribunals and inquiries and radical action: there is a growing driver to incorporation for NIMBY (not in my back yard), environmental, social justice and community development groups. The need for a corporate persona when purporting to represent a group of persons before the courts and a growing number of government ad hoc inquiries and royal commissions has become apparent.

Sole trader

[5.40] This type of business is controlled by a single individual who is entitled to all of the profit but is also liable personally for losses. Of course, as with all businesses, insurance is available to minimise the risk of personal liability. Sole proprietorships are generally small businesses with minimal formalities and the advantage of flexibility. Note though that solicitors, accountants and similar professionals that set up as sole practitioners will be subject to often complex rules determined by the relevant professional body. All businesses are subject to general commercial laws and sole proprietors are no exception. Formalities may include the need to register for an Australian Business Number (ABN) and where applicable GST.

Joint venture

[5.50] The characteristics of joint ventures include the contractual nature of the arrangement and the fact that participants do not have fiduciary obligations. An example may be two companies joining together for a common but usually isolated undertaking for joint profit. In *United Dominions Corporation Ltd v Brian Pty Ltd* (1985) 157 CLR 1, those two companies, together with another, entered into a joint undertaking, which they referred to as a "joint venture". On an application by Brian Pty Ltd (that it had been cut out of the profits), the court determined that regardless of what the undertaking was called, it had all of the hallmarks of a partnership and accordingly the parties' rights were to be determined upon partnership principles.

Partnership

[5.60] The law of partnership is useful as an introduction to company law. There is a statutory basis to both, and in a broad sense both partnerships and companies rely

on the idea of a pooling of resources to create profit. All partnerships to some extent are affected by partnership legislation. Each State and Territory in Australia has a separate Act (all of which are similar and in this Chapter are referred to collectively as "*the Partnership Acts*"). In NSW, the legislation is the *Partnership Act 1892* (NSW). A partnership is not a separate legal entity and partners have unlimited personal liability. Note that in the Australian States but not in the Territories, the formation of a limited partnership is possible comprising a general partner (with unlimited personal liability) and one or more limited partners (whose contribution toward partnership liability is fixed). However, limited partners cannot take part in the management of the partnership, and if they do they become liable as general partners.

The *Partnership Acts* define a partnership as the relation which exists between persons carrying on a business in common with a view to profit. Pursuant to **s 115** of the *Corporations Act 2001* (Cth), a partnership or association that has an object for gain and has more than 20 members must be incorporated. Accordingly, the maximum number of members in a general partnership formed for profit-making purposes is 20. However, this maximum can be exceeded in professional partnerships, such as those of accountants and lawyers. Rules for determining the existence of profit are set out in the *Partnership Acts* and focus on the issue of profit sharing. For instance, s 2 of the *Partnership Act* (NSW) states that the receipt of a share of the profits of a business is prima facie evidence of partnership. There is also guidance on when a partnership may not arise: sharing gross returns does not of itself create a partnership (sharing net returns is much stronger evidence); a contract for the remuneration of a servant or agent by a share of the profits does not of itself make the servant or agent a partner; and the receipt of a debt by instalments (the repayment of a loan) from accruing profits does not of itself make the recipient a partner.

Regardless of any understanding between the parties, it is up to the court, if a dispute arises, to determine the true construction of a document purporting to be, or not to be, evidence of a partnership. So, even though there may be an express provision to the effect that the parties are not partners this can be ignored if the court decides otherwise. In *Re Megevand; Ex parte Delhasse* (1878) 7 Ch D 511, an amount was lent to two persons for the purposes of carrying on their partnership business. The advance was expressed to be by way of a loan and was not to constitute the lender as a partner. The partnership agreement set out that the lender was to take a fixed proportion of profit, could inspect the firm's books, and in certain circumstances would have the option of dissolving the partnership. The loan was not repayable until after dissolution of the partnership and was, as far as relevant, the firm's only capital. The court held that contrary to the express intention of the parties the arrangement was not that of debtor/creditor but rather formed a partnership. Here, the lenders inclusion in the management structure of the partnership mitigated against the denying of the partnership form.

Agency is the foundation of partnership liability and a partner who is acting in the usual course of the partnership business will be an agent for the purposes of binding

the firm (a partnership is called a "firm"). The focus of the *Partnership Acts* on agency is closely connected to the concept of ostensible or apparent authority. In s 5 of the *Partnership Act* (NSW), the acts of a partner who does any act for carrying on in the usual way business of the kind carried on by the firm of which that partner is a member, binds the firm and the other partners. When bringing a partner's actions within the bounds of apparent authority, and therefore finding they fall within business of the kind carried on by the partnership, the courts have taken a broad approach. For instance, in *Mercantile Credit Co Ltd v Garrod* [1962] 3 All ER 1103, the facts concerned two partners conducting a motor servicing business. The agreement specified that the firm did not buy or sell motor vehicles, however, contrary to this one of the partners sold a vehicle. The purchaser became aware of the partnership agreement restriction and commenced proceedings against the partnership for the return of the purchase price. The court held that even though the partner's actions were not in accordance with the partnership agreement and without the others partner's knowledge, the partnership was bound. Although the particular business did not normally engage in selling cars, the court held that to an outsider the partnership was the type of business that could be expected to sell cars.

A partnership can incur contractual liability in the normal course of its business and this is referred to as "joint" liability. For instance, s 9 of the *Partnership Act* (NSW) sets out that every partner is liable jointly with the other partners for all debts and obligations of the firm while the partner is a partner. That is, the partners will all, as a group, be liable. If the partnership trades under a business name (firm name), then the outsider may sue by using the firm name. If the conduct giving rise to the liability involves a wrongful act or omission by a partner or partners, such as the commission of a tort (negligence) or fraudulent conduct, then pursuant to the *Partnership Acts*, all of the partners will be jointly and severally liable, meaning they will all together (jointly) be liable but also each partner, individually or separately, will be liable for the loss to the outsider. The issues of acting within the ordinary course of the partnership business, and apparent authority, are relevant to any determination of whether joint and several liability arises. The relevant sections in the *Partnership Act* (NSW) are ss 10, 11, and 12.

A partner will not be liable for past partnership debts when joining the partnership, however, any debts incurred while a partner (during the partnership) can still be enforced by a third party even if the particular partner has retired. In this regard, s 17 of the *Partnership Act* (NSW) sets out that liability does not arise by admission alone, nor does liability cease by retirement alone. Liability may even apply to post-retirement debts unless adequate steps are taken to notify customers/clients of the partnership of that particular partner's retirement. For instance, s 36 of the *Partnership Act* (NSW) indicates the manner, via advertisement, in which a partnership can notify outsiders of a change in its constitution (membership).

Partnerships are in essence contracts between members of the partnership and like any contract the terms agreed between the partners can be as complex or otherwise as they see fit. Partnership agreements can be wholly in writing, and in

complex arrangements formal written agreements are preferable, or they can be very simple, and in some cases formed with no written terms at all. This will be the case where the partnership arises by implication from the conduct of the parties. The role of the *Partnership Acts* is to create certainty for, and protect, outsiders dealing with the partnership (the sections regarding joint, and joint and several liability are relevant here and are not open to modification by the partnership) and to provide a foundation to, and augment, partnership agreements where necessary. For example, in the absence of an agreement to the contrary, the *Partnership Acts* set out rules such as equal sharing of profits and losses. The *Partnership Act* (NSW) sets out in s 24 that subject to any agreement to the contrary all partners share equally in capital and profits, are entitled to be indemnified by the firm for liability incurred in the ordinary and proper conduct of the business, and may take part in management. Accordingly, unless, for example, partners expressly indicate the manner of profit sharing applicable in their partnership the default position is equality. However, it follows that a section such as s 24 of the *Partnership Act* (NSW) will have no effect on distribution of profit where the partners have decided upon the issue in the partnership agreement.

Importantly, partners owe each other a fiduciary duty and this is reinforced in the *Partnership Acts* by the prohibition upon a partner competing with the firm. The existence of a fiduciary relationship between partners is a relevant distinction between partnerships and joint ventures. In *Canny Gabriel Castle Jackson Advertising Pty Ltd v Volume Sales (Finance) Pty Ltd* (1974) 131 CLR 321, an agreement was entered into by the relevant parties to assign a half interest in certain contracts (concerning concerts by overseas entertainers) and to perform the contracts as a "joint venture". Funds advanced were described as a loan to the joint venture. The issue for the court involved which party had the greater entitlement to the box office receipts and this in turn involved deciding if certain parties were joint venturers. The court did not consider the mere naming of the enterprise a "joint venture" definitive and instead examined the relationship between the parties, which, it was held, had all the hallmarks of a partnership. The particular matters considered were: entering into a commercial enterprise with a view to profit; sharing profits; that disputes were to be settled by arbitration suggesting individual input into the conduct of the business; an attempted assignment of a half interest, which indicated a partnership relationship; and that, apparent in the written agreement, each participant was concerned with all other participants' financial stability.

An example of the liability of partners can be found in the matter of *Polkinghorne v Holland* (1934) 51 CLR 143. In that case, a solicitor in a legal partnership (ie a law firm), "Holland and Whitington", advised a client to enter certain transactions that resulted in that solicitor deriving a personal advantage. The transactions did not benefit the client and she suffered loss. The partner who had provided the inappropriate advice had left the firm when the losses became known and could not be traced. His partners were sued. The court held that where the partner was acting within the ordinary course

of the business, agency existed and the remaining partners were liable. Although some of the advice given was held to be outside of the firm's business, the investment advice was within the scope of a solicitors' practice and resulted in the remaining partners being jointly and severally liable.

Company

[5.70] The *Corporations Act* defines a corporation in **s 57A** as including a company. Also included in the definition of a corporation are any other bodies corporate (incorporated in Australia or elsewhere) and certain unincorporated bodies that may sue or be sued and may hold property in the name of their secretary or other office holder. Companies exist as and from registration. This is a formal process carried out through the Australian Securities and Investments Commission (ASIC). Once a company is formed, it has a separate legal personality resulting in advantages and obligations. The most obvious advantage is the existence of limited liability for shareholders of companies with limited liability and the protection of the corporate veil generally. A lower tax rate (compared to the top marginal rate) and dividend imputation are also benefits. Companies have an ongoing existence and this is referred to as perpetual succession.

All companies must have a registered office that is searchable through ASIC. Financial and reporting requirements will be more substantial for public companies than for proprietary companies; however, all companies will be subject to formalities and certain record keeping requirements. Although public companies have no limit on their maximum membership, there are limits on the size of proprietary companies and requirements concerning directors, meetings, fundraising and cessation for all companies.

An example of a public company is National Roads and Motorists' Association Ltd. An example of a proprietary company is Air Water Pty Ltd.

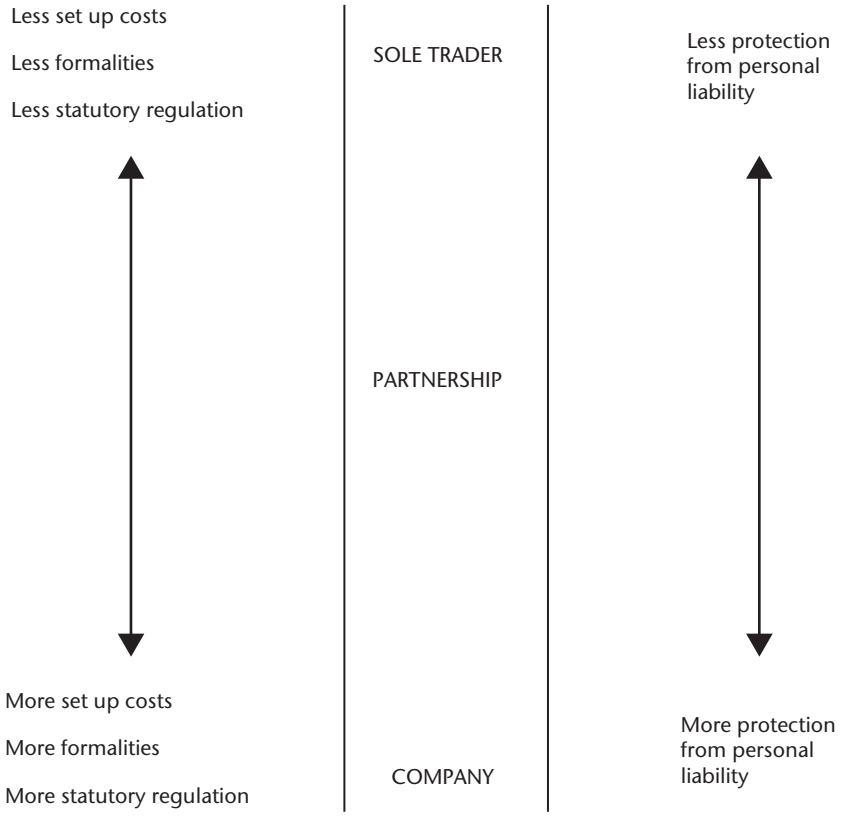
Trading trusts

[5.80] The term "trading trust" refers to a business structure that comprises a formal trust arrangement where the trustee is a company. A trust is not a separate legal entity. The parties to a trust are the settlor, who creates the trust; the trustee, who administers the trust funds; and the beneficiaries, who have an equitable interest in the trust property. The trustee is deemed to be the legal owner of the trust property, and the creation of a corporate trustee can provide benefits if the trust is used to carry on business with the use of the trust funds. Issues regarding the indemnity of the trustee and liability of directors of trustee companies are dealt with in the *Corporations Act*.

Generally, to the outsider, the trustee company would look just like any other company (for example, Topline Pty Ltd). However, the mechanisms and effect of the trust set-up would be particular to each trust arrangement.

Choice of business structure

[5.90]



Summary—Businesses other than companies

Associations

Not for profit for members

Incorporated associations are governed by legislation in each State

If incorporated, members liability is limited, and the association can be sued

Sole Traders

Take profits, bear losses, unlimited personal liability, minimal formalities

Partnerships

The *Partnership Acts* set out important principles—partners may vary certain provisions but not those that relate to the rights of outsiders to bring actions

Partnership exists if two or more persons carry on a business with a view to profit

Partners are agents of the partnership when carrying out usual partnership business

Partners' liability is joint, or joint and several

Example of a case on partnership liability—*Polkinghorne v Holland*

Partners have unlimited personal liability

Partners may be liable to clients after leaving the partnership

Partners are fiduciaries, joint venture participants are not

Example of a case on partnerships and joint ventures—*UDC v Brian*

6
History and Legislative Framework of Company Law

Factors in the development of company law

[6.10] The modern company form arose predominantly during the 19th century as a response to an entrepreneurial need for a business structure that enabled a pooling of investment, the separation of management and ownership, and the transferability of interests. Prior to the introduction of company legislation, which occurred in the middle of the 19th century, other forms of business vehicles, such as the joint stock company, had existed with characteristics similar to the modern company.

In England, Royal Charter enabled the creation of non-trading commercial, and non-commercial, entities. This, however, limited overall commercial development, and by the 16th century, overseas exploration had laid the foundation for joint stock companies to flourish. Excessive financial speculation, particularly in overseas ventures, resulted in economic crisis in the early 18th century. In response, and to limit joint stock activity, the English parliament introduced the *Bubble Act* in 1720. In the 19th century, the industrial revolution created the need for company-like structures to carry out large projects. Accordingly, the *Bubble Act* was repealed in 1825 to encourage development. Until 1844, incorporation was still a privilege bestowed by the parliament, however, the *Joint Stock Companies Registration & Regulations Act 1844* (UK), *Limited Liability Act 1855* (UK), and then the *Companies Act 1862* (UK) gave rise to incorporation as of right.

Australia is a common law country and took its company law from England. Until the second part of the 20th century, Australian company law was administered on a State-by-State basis without much integration between the individual States. However, gradually during the latter part of the 20th century, in response to matters such as the growing international economic presence of Australia and the need to enforce company law nationally, a federal scheme became necessary. The path to a federal company law was not smooth and several unsuccessful schemes failed before the introduction of the current legislation in 2001. During the late 19th century, each State (NSW, Vic, etc) had separate company law legislation. In 1901, Australia became a federation, although the States' corporate powers remained unchanged, with each State retaining its own companies Act. Initial attempts to nationalise company law can be found in the *Uniform Companies Code* which was introduced in 1961 and the National Co-operative Scheme in 1978. Both were schemes aimed at aligning the corporate legislation of each individual State with that of the other States. However, both failed to unify Australian company law. A further attempt at unification of company law

failed when the *Corporations Act 1989* (Cth) was held invalid. The Corporations Law scheme introduced in 1991 promised much but also failed. However, it was inevitable that eventually a federal scheme would emerge and this occurred in 2001 with the *Corporations Act 2001* (Cth). This is referred to herein as the *Corporations Act*.

The law in the *Corporations Act* is set out in chapters, parts and sections. For example, **Chapter 2D** is titled "Officers and Employees", **Pt 2D.1** is titled "Duties and Powers", and within that part is **s 182** titled "Use of position—civil obligations". Most references to the *Corporations Act* will be by section number although sometimes groups of sections are referred to by the chapter or part they are contained in. Note that when a section is from the *Corporations Act* it will be identified in this book simply by the section number – for example **s 182**.

Company law and the Australian Constitution

[6.20] The development of the Australian legal system has been influenced by the balance of power between the Commonwealth (federal) and the State governments. The introduction of the Australian Constitution pursuant to the *Commonwealth of Australia Constitution Act 1900* (UK) provided for the division of powers, although the issue of the federal government's right to control companies legislation was only effectively resolved in 2001. Several important issues arose during the 20th century. Of particular relevance is the manner in which the Commonwealth's power to enact companies legislation was expressed in the Constitution.

The Australian Constitution

Corporations Power

Section 51: The Parliament shall, subject to this Constitution, have power to make laws for the peace, order and good government of the Commonwealth with respect to: …

(xx) Foreign corporations, and trading or financial corporations formed within the limits of the Commonwealth.

[6.30] In relation to interpretation of this section of the Constitution and its effect on the development of company legislation in Australia, see *New South Wales v Commonwealth* (1990) 8 ACLC 120. In that case, the High Court held that the Commonwealth parliament did not have power to pass a law dealing with all aspects of company law. The word "formed" in s 51(xx) of the Australian Constitution restricted the federal government in relation to matters concerning the setting up of a company. A similar conclusion had been reached by the High Court at the beginning of the 20th century in *Huddart Parker and Co Pty Ltd v Moorehead* (1909) 8 CLR 330.

The Commonwealth accordingly failed to secure confirmation of its national scheme as a result of the decision in *NSW v Commonwealth*. Following the decision, various negotiations took place with the State governments resulting in the introduction of the Corporations Law scheme in 1991. This scheme is no longer in existence, although it provided an effective foundation (eventually, a flawed one) for the introduction of substantial change to company law during the 1990s.

The Corporations Law scheme to the Corporations Act

[6.40] The Corporations Law scheme was for a large part of the 1990s considered effective and this resulted from the combination of a number of factors that distinguished it from previous schemes. In the first instance, enforcement of the Corporations Law was organised on a national basis, and Commonwealth administrative and criminal law applied exclusively to the legislation. Offences were treated as offences against Commonwealth law, and the investigation and prosecution of criminal offences was carried out by federal authorities. An important aspect of the Corporations Law scheme was that State Acts covering company law contained provisions that resulted in their automatic amendment to correspond to any changes in the federal legislation. Organisational stability was created by the Corporations Law scheme being overseen by one federal minister and administered nationally by ASIC.

The Corporations Law scheme was based on the assumption that regardless of the effect of the constitution, agreement between the States and the Commonwealth could provide an appropriate foundation for a national company law. However, the lack of a constitutional foundation for the Corporations Law scheme gave rise to instability in the legal system (both administratively and substantively), and in 1999 and 2000, this resulted in challenges to the validity of the scheme.

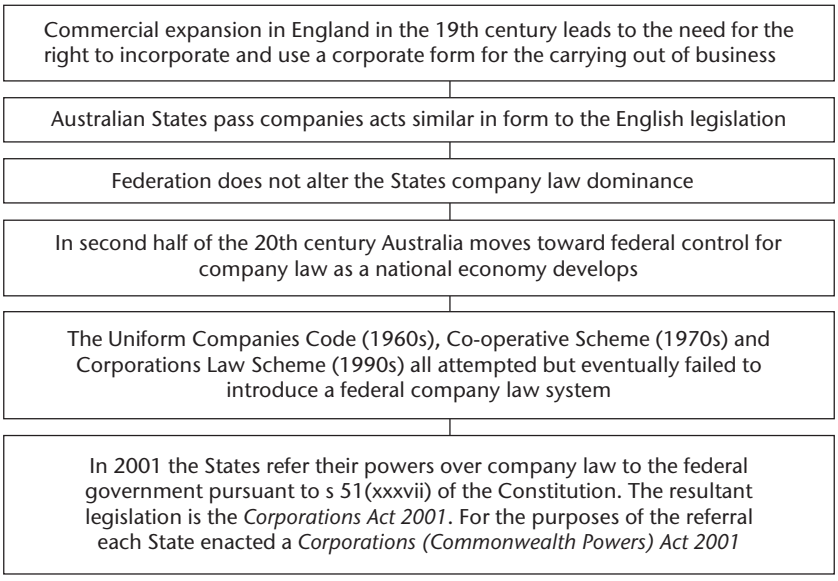
In *Re Wakim; Ex parte McNally* (1999) 198 CLR 511, the High Court held the scheme of cross-vesting of powers between States and the Federal Court invalid. Under the Constitution, the Federal Court did not have power to decide matters that were exclusively within the States' jurisdiction. In *R v Hughes* (2000) 202 CLR 535, the High Court held that ASIC, as a federal regulator, was unable to enforce what were, in actuality, State corporations Acts, and that in general the constitutional aspects of the administration of the Corporations Law scheme lacked foundation.

The uncertainty in relation to the national scheme necessitated a referral of power by the States to the Commonwealth pursuant to s 51(xxxvii) of the Constitution. This became effective in July 2001 and has been extended each five years. The most recent extension is to 2021. A more permanent way for the Commonwealth government to achieve dominance over corporations legislation would be by means of a referendum to amend s 51(xx) of the Constitution. However, there is no certainty that such a referendum would succeed.

The federal legislation resulting from the referral of power is the *Corporations Act 2001*.

Steps to a national company law in Australia

[6.50]



Reform

[6.60] Company law has been changing with increasing speed since the 1960s. Not only have there been several schemes underpinning corporate legislation (*Uniform Companies Code*, National Co-operative Scheme, Corporations Law scheme and currently the *Corporations Act*) but the legislation itself has been constantly amended to respond to changing circumstances and philosophies.

Important changes to the legislation in the last 25 years have arisen from:

- the *First Corporate Law Simplification Act 1995* (Cth);
- the *Company Law Review Act 1998* (Cth);
- the *Corporate Law Economic Reform Program Act 1999* (Cth);
- the *Financial Services Reform Act 2001* (Cth);
- the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (Cth);
- the *Personal Properties Securities Act 2009* (Cth);
- the *Corporations Amendment (Future of Financial Advice) Act 2012* (Cth);
- the *Corporations Legislation Amendment (Deregulatory and Other Measures) Act 2015* (Cth);

- the *Insolvency Law Reform Act 2016* (Cth);
- the *Treasury Laws Amendment (2017 Enterprise Incentives No 2) Act 2017* (Cth);
- the *Corporations Amendment (Crowd-sourced Funding for Proprietary Companies) Act 2018* (Cth).
- the *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Act 2019* (Cth).

The *Corporate Law Economic Reform Program Act 1999* was the first reform under the Corporate Law Economic Reform Program (CLERP). In 2004, a further CLERP reform (CLERP 9) gave rise to the *CLERP (Audit Reform and Corporate Disclosure) Act 2004*.

The *CLERP (Audit Reform and Corporate Disclosure) Act 2004* amended various sections of the *ASIC Act 2001* (Cth) and the *Corporations Act*. Its main focus was in relation to audit reform, particularly issues of auditor independence and rotation; however various other areas were also targeted including extending the continuous disclosure provisions to include liability for individuals involved in a contravention, disclosure of directors' remuneration in certain circumstances and improving members rights to information and participation in general meetings.

Much of the impetus behind the CLERP 9 reforms stemmed from large corporate collapses (such as the fallout from the HIH Insurance Limited crash in 2001 – see [20.20]) and the related issue of the independence of auditors (addressed in the Ramsey Report *Independence of Company Auditors* (2001)). Where audit statements are not reflective of a company's true financial position, neither the company's members nor the market generally can accurately assess the company's worth as an investment.

The process of changing and improving company law is ongoing. For example, during 2007, the *Corporations Amendment (Takeovers) Act 2007* dealt with the role and powers of the Takeovers Panel; the *Corporations Legislation Amendment (Simpler Regulatory System) Act 2007* (Cth) covered a wide range of amendments including altering the requirements for classification as a small proprietary company in **s 45A**; and the *Corporations Amendment (Insolvency) Act 2007* (Cth) focused on improving creditors outcomes and deterring misconduct. In 2008, and in response to the negative effects of short selling in an uncertain financial market, the *Corporations Amendment (Short Selling) Act 2008* (Cth) was introduced. During 2009, the *Corporations Amendment (No 1) Act 2009* (Cth) introduced an amendment recognising the increasing internationalisation of company law by including in the category of persons disqualified from managing corporations in **s 206B** those persons who have been disqualified under an order made by a foreign court.

Changes to the *Corporations Act* in relation to security interests resulting from the *Personal Property Securities Act 2009* (Cth) were introduced by the *Personal Property Securities (Corporations and Other Amendments) Act 2010* (Cth) and the *Personal Property Securities (Corporations and Other Amendments) Act 2011* (Cth). Provisions reflecting ASIC's increased role in the regulation of the stock market and its ability to make rules in relation to issues of market integrity were introduced into the *Corporations*

Act pursuant to the *Corporations Amendment (Financial Market Supervision) Act 2010*. The *Corporations Legislation Amendment (Deregulatory and Other Measures) Act 2015* (Cth) removed from the *Corporations Act* the controversial "100 member rule" which allowed any 100 shareholders regardless of their percentage of total shares to call a general meeting. The *Insolvency Law Reform Act 2016* brings a number of changes to the details of the processes of insolvency and the regulation and requirements of registered liquidators.

Parliamentary reform of company law relies on recommendations and advice from statutory and other bodies. The Corporations and Markets Advisory Committee (CAMAC), which has ceased operations, was previously an important source of corporate reform. It was set up in 1989 to provide independent advice to the Australian Government regarding issues that arise in relation to corporations and financial markets. As of April 2019, another review body, the Parliamentary Joint Committee on Corporations and Financial Services, also ceased operations. Currently, the principal review and advisory body is the Commonwealth Treasury. An example of the referral and consultation process can be seen in relation to the introduction of the *Corporations Amendment (Insolvency) Act 2007*. As a result of a referral from the Parliamentary Secretary to the Treasurer, CAMAC considered issues raised by insolvency stakeholders (parties having an interest in the insolvency process). The referral included matters concerning publication of insolvency notices, restrictions on the voting rights of directors and related parties in certain situations, and administrator remuneration. Following the consultation process, the amending Act was approved by the Commonwealth Parliament and thereafter the *Corporations Act* was amended accordingly. In 2012, as the result of a referral from the Parliamentary Secretary to the Treasurer, the Federal Government sought consideration of matters relating to annual general meetings. Relevant to the inquiry was: the future of the AGM in Australia; the risks and opportunities presented by advances in technology; and the challenges posed to the structure of the AGM by globalisation, including international share ownership.

More recently, changes to the insolvent trading regime, including broadening protections for directors, were introduced by *Treasury Laws Amendment (2017 Enterprise Incentives No 2) Act 2017*; and in the area of corporate funding, the *Corporations Amendment (Crowd-sourced Funding for Proprietary Companies) Act 2018* has extended the benefits of crowdfunding to small proprietary companies thereby facilitating smaller start-ups and encouraging entrepreneurship.

An important characteristic of the law can be seen in the ability of parliament to respond to matters of public importance within the context of an individual piece of legislation. An example of this can be seen in the amendments introduced into the *Corporations Act* by the *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Act 2019*. This Act amends, significantly, penalties under the *Corporations Act*. Driving the amendments were concerns at the conduct of some corporate managers and arose from recommendations by the ASIC Enforcement Review Taskforce, and in the light of the public interest generated by the Royal

Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Final report February 2019).

Changes to the *Corporations Act* are constant. Each year parliament considers proposals to improve the law, either by the introduction of new legislation or the amendment of existing legislation. It is likely that change comes more quickly today than in the past. The corporate environment, globalisation, government agendas, business practice, regulator's focus, and investigation capabilities all play a part. There are increasingly more companies, more directors, more corporate stakeholders (including shareholders), and as a result more issues that need to be resolved. The law must change to fulfil its function.

Summary—History and legislative framework

Companies developed in England—a continuing characteristic has been pooled resources and transfer of interests

In Australia, the wording of s 51(xx) of the Constitution restricted a truly national scheme

Cases concerning problems with a national scheme: *Re Wakim*; *R v Hughes*

Solution was referral of power regarding corporations by the States to the Commonwealth Government

The current federal legislation is the *Corporations Act 2001*

Company law is being constantly reformed to meet changes

Example of an Act amending company law—*CLERP Act 1999*

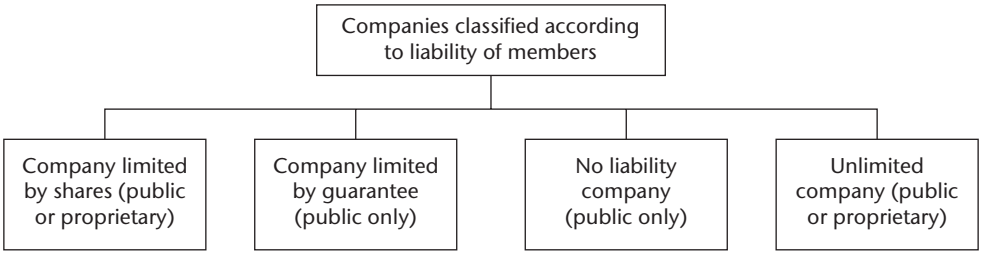
Government advisory bodies consider reform proposals and recommend amendments to the law

7
Types of Companies

Classification according to liability of members

[7.10] Companies are registered at the Australian Securities and Investments Commission (ASIC). There are four types of companies that are classified according to the extent of the liability of their members:

- companies limited by shares;
- companies limited by guarantee;
- unlimited companies; and
- no liability companies.



The most popular type of company is the company limited by shares. In these companies, pursuant to **s 516**, shareholders' liability is limited to the unpaid value of their share (which is generally nil).

A person is a member of a company in accordance with **s 231** if they are a member upon registration, become a member after registration and have their name entered on the register of members or become a member when a company limited by guarantee converts to a company limited to shares under **s 167**. Members are participants in the company enterprise. The members of a company limited by shares (which account for approximately 99% of companies) will be shareholders. A company limited by guarantee does not have a share capital and therefore its members are not shareholders.

Prior to 1 July 1998, a company could be registered as limited by both shares and guarantee (public or proprietary). This is no longer available. However, those existing at that date were able to continue in their existing form.

Based on ASIC statistics, by the beginning of 2020 there should be around 2.8 million companies that have been registered in Australia, with new company registrations increasing by over 100,000 per annum. The number of new registrations has grown over recent years and this trend looks likely to continue into the future. It underlines

both the usefulness of companies as commercial vehicles and the need for continuous attention to the legislature and procedures under which companies are regulated.

Classification according to public status

[7.20]

Proprietary companies	Public companies
Smaller business.	Larger entity, subject to fundraising provisions.
There are many more proprietary companies than public companies.	
Minimum number of members one.	Minimum number of members one.
Limit on maximum number of members **s 113**. Note crowd-sourced funding exception.	No maximum number of members.
May be small or large **s 45A**.	May be listed (ASX) or unlisted.
Generally small Pty companies and some large Pty companies need not appoint an auditor.	External auditor required. More financial and reporting requirements. Increased disclosure obligations.
Pty Limited.	Limited.
More flexibility regarding altering the replaceable rules.	Accountability and transparency means less flexibility and certain internal rules are mandatory.
Directors can be entrenched and become directors for life.	Directors can always be removed by resolution.
At least one director (residing in Australia). If crowd-sourced funding applies two directors required.	At least three directors (two residing in Australia).
Company secretary not required.	At least one company secretary.
No AGM needed (unless required by its constitution).	AGM required.
Cannot issue shares to general public **s 113(3)**. See exceptions in that sub-section including crowd-sourced funding.	Issue shares to public and, as such, are publicly funded.

Proprietary companies

[7.30] The definition of a proprietary company is set out in **s 113**. A company may be (or remain) registered as a proprietary company if it:

(1) has no more than 50 non-employee shareholders. Note that there are certain qualifications in the section including that any CSF (crowd-sourced funding) shareholder is not to be counted in this total; and

(2) does not engage in activity that would require disclosure to investors under **Ch 6D** of the *Corporations Act 2001* (Cth). The effect of this is that proprietary companies cannot offer shares to the general public. There are exceptions to this restriction if the offer of shares is: to existing shareholders; to employees of the company or a subsidiary; a CSF offer (see [14.30]).

Proprietary companies limited by shares are the most popular form of corporate vehicle. Shares may be issued to investors/contributories as fully paid or partly paid. Where shares are partly paid the company may make a call (demand) on the shareholder to pay the balance owing. A shareholder has a general liability pursuant to **s 515** to contribute to the company's property an amount sufficient to pay the company's debts and liabilities, and the costs, charges and expenses of a winding up. However this general liability is qualified in **s 516** which sets out that if a company is limited by shares, members need only contribute any amount unpaid on their shares upon winding up of the company. Proprietary companies can be small or large (**s 45A**). The requirements for a company to be categorised as a small proprietary company are set out in **s 45A(2)**. Provided that two out of the three criteria in the section are met the company will be a small proprietary company. Two criteria concern financial matters (consolidated revenue, and consolidated gross assets) and the other whether the company has fewer than 50 employees. Small proprietary companies are not required to have financial records audited (there are some exceptions). In this regard, they are "private companies" generally without the need to inform outsiders of their financial situation. If a proprietary company does not satisfy the requirements in **s 45A(2)**, it will be considered a large proprietary company pursuant to **s 45A(3)**.

Since 1995, it has been possible to form a one-person proprietary company. **Section 201A** sets out that a proprietary company must have at least one director who must ordinarily reside in Australia, and **s 114** requires a company to have at least one member. The director and the member can accordingly be the same person in a proprietary company. Although public companies also only need one member (**s 114**), a public company must have three directors. Overall, proprietary companies are generally small having only a few shareholders and are the most popular way to run small businesses. The *Corporations Act* reflects the smaller scale of proprietary companies by simplifying various obligations. For example, the need to hold an extraordinary general meeting to pass a resolution may be negated provided all shareholders sign a document confirming their support for the resolution proposed (**s 249A**).

***Corporations Act 2001* (Cth), s 45A**

Small proprietary company

(2) A proprietary company is a small proprietary company for a financial year if it satisfies at least 2 of the following paragraphs:
  (a) the consolidated revenue for the financial year of the company and the entities it controls (if any) is less than $25 million, or any other amount prescribed by the regulations for the purposes of this paragraph;

(b) the value of the consolidated gross assets at the end of the financial year of the company and the entities it controls (if any) is less than $12.5 million, or any other amount prescribed by the regulations for the purposes of this paragraph;
(c) the company and the entities it controls (if any) have fewer than 50, or any other number prescribed by the regulations for the purposes of this paragraph, employees at the end of the financial year.

Note: A small proprietary company generally has reduced financial reporting requirements (see subsection 292(2)).

Public companies

[7.40] There are two types of public companies: listed and unlisted. A listed company's shares are traded on the stock exchange. Generally larger than proprietary companies, public companies are subject to greater regulatory control. This is particularly so in relation to listed public companies that will have the added burden of compliance with the ASX Listing Rules. Individuals and corporations acquire shares in public companies for investment purposes but because of their size, particularly where listed companies are concerned, they often have little or no personal contact with management. However, the availability of a ready market for securities (which include shares) is an attraction for investors, who, if dissatisfied with the capabilities of management, can offer their shares for sale on the open market.

Section 162 enables a company to change to a different type of company by passing a special resolution. Pursuant to this section (and **ss 163** and **164**) a proprietary company limited by shares whose growth strategy includes raising capital by offering its shares to the public and perhaps an eventual listing on the stock exchange may convert to a public company.

An example of the wider regulation of a public company in the *Corporations Act* can be seen in the requirements as to the opening hours of its registered office. Whereas proprietary companies also have registered offices, they do not have the same detailed opening hour requirements.

***Corporations Act 2001* (Cth), s 145**

Opening hours of registered office of public company

(1) The registered office of a public company must be open to the public:
(a) each business day from at least 10 am to 12 noon and from at least 2 pm to 4 pm; or
(b) at least 3 hours chosen by the company between 9 am and 5 pm each business day.
(2) If the company chooses its own opening hours, the hours must be specified:
(a) if the company is to have its own opening hours from its registration—in the application for registration of the company under section 117 (normal

registration process) or the notice lodged under section 5H (registration of body as company on basis of State or Territory law); or

(b) if the company changes its opening hours after its registration—in the most recent notice of change of opening hours lodged with ASIC under subsection (3).

(3) The company must lodge notice of a change in the opening hours of its registered office with ASIC before the day on which a change occurs. The notice must be in the prescribed form.

(4) An offence based on subsection (1) or (3) is an offence of strict liability.

Note: For strict liability, see section 6.1 of the Criminal Code.

Summary—Types of companies

Companies classified by members' liability:

- Limited by shares (public or proprietary)—most common form of company
- Limited by guarantee (public)
- Unlimited companies (public or proprietary)
- No liability companies (public)

Companies classified by public status:

- Public companies—larger, raise funds by issuing shares to the public, listed (ASX) or unlisted, more regulation
- Proprietary companies—limits on size **s 113**, small or large **s 45A**, no public fundraising (note exception of crowd-sourced funding)

8
Registration and Its Effects

The registration process

[8.10] A company comes into existence by way of a process of registration carried out through ASIC. It is possible to register a company electronically via the ASIC website. In certain commercial situations, it may be more efficient for those wishing to commence business through a company structure to purchase a company that has already been formed but has not traded; these are called "shelf companies". As companies have perpetual succession, any liabilities attaching to the company are not extinguished merely because the shareholders change. Accordingly, the relevance of the company never having traded is that it will not have incurred any liabilities. The purchase of a company involves, in essence, a transfer of shares, a change of directors and a change of registered office.

For the purposes of registration:

- An application is lodged with ASIC pursuant to **s 117**. The application must state the type of company that is proposed to be registered and provide details of the members, directors and company secretary.
- The company can adopt an available name (see **Pt 2B.6**) or use the Australian Company Number (ACN) which is allocated upon registration. A company name will not be permitted if it is identical to another that is either registered under the *Corporations Act 2001* (Cth) or under relevant business names legislation.
- There is a requirement that a company has a registered office (**s 121**). This is an address to which notices may be sent and importantly where legal process (such as an application to wind up the company) can be served.
- A fee is payable.
- Registration by ASIC is carried out under **s 118** following an application under **s 117**.
- An ACN is allocated (**s 118(1)(a)**). This is a nine-digit number. The ACN must appear on all public documents and all documents lodged with ASIC.
- A Certificate of Registration including the company's name, type and ACN is issued (**s 118(1)(c)**).
- A common seal is optional (**s 123**). **Section 127** sets out that a company may execute a document with, or without, a common seal and prescribes the manner of execution in each case.

- The effect of the process of registration is that pursuant to **s 124** the company has the legal capacity and powers of an individual and is recognised as a separate entity for legal purposes.

ASIC assists in the registration of companies by providing explanations and guides to simplify the process of registration. This is achieved by way of Information Sheets, links and other material accessible on the ASIC website. For example, in relation to starting a company:

Step 1: Decide if a company structure is the best alternative for the operation of the business and best suits the needs of those persons seeking registration. In this context, ASIC recommends seeking professional advice. As an officeholder, such as a director, extensive legal obligations apply. As the *Corporations Act* is federal legislation, once registered, the company can conduct business throughout Australia without needing to register in individual states and territories.

Registering a company is not the same as registering a business name. Registration or use of a business name does not create a legal entity (only registering a company creates a legal entity), or allow the use of privileges to which a company is entitled, such as a corporate tax rate or limited liability. Registration of a business name is necessary unless a business is conducted under the name of the person or persons involved; or, if conducted by a company, under the full company name.

Step 2: Choose a company name—not all names are available (eg, the word "Royal" cannot be included) and a company name is not registrable if an identical name exists.

Step 3: Decide how to operate your company—this involves consideration of whether to retain the replaceable rules in the *Corporations Act* or adopt a company constitution.

Step 4: Understand your obligations as an officeholder.

Step 5: Get consent from officeholders, members and occupiers (such as the proprietor of the company's proposed registered office).

Step 6: Register your company either through a private service provider that uses software with direct access to ASIC systems or register directly with ASIC by completing Form 201; or register online using the Australian Government's Business Registration Service (BRS).

Step 7: Understand your legal obligations regarding your company name (which must be on display where the company conducts business), and obligations regarding the company's Australian Company Number (ACN—allotted on registration and to be displayed on all public documents) and Australian Business Number (ABN—used to identify both business names and companies).

The company as an individual

[8.20] Following registration with ASIC, a company adopts a legal status. The powers and abilities of a company are set out in **s 124**. By equating company status to that

of a human for legal and commercial purposes, the *Corporations Act* is recognising the significance of companies in the commercial environment as well as providing them with the capacity to carry out the purposes for which they were formed.

According to **s 124**, a company has the legal capacity of an individual. However, pursuant to that section it also can:

(1) issue or cancel shares in itself (share capital);

(2) issue debentures (loan capital);

(3) grant options over unissued shares;

(4) distribute company property among members;

(5) grant a security interest in uncalled capital;

(6) grant a circulating security interest over the company's property (to secure company borrowing);

(7) arrange for the company to be registered in another jurisdiction; and

(8) do anything it is lawfully authorised to do.

As can be seen, although companies are equated in law to an individual they in fact have certain attributes, such as the ability to issue shares, that individuals (humans) do not. Conversely, we have physical attributes that allow us to act in ways impossible for artificial entities such as companies. Note though, that the law is progressively finding ways to attribute human activities, such as assault, to companies by statutory means. An example of the application of statutory law in this manner can be seen in the *Criminal Code* (*Criminal Code Act 1995* (Cth)).

The popularity of companies in commercial environments owes much to the matters that flow from their legal status. However, any comparisons between companies and other forms of business will also require consideration of the downsides of the company form. For example, companies generally have high establishment and administration costs. All companies other than small proprietary companies will have ongoing financial reporting obligations and, as registration confers various privileges on both the company itself and its members, the *Corporations Act* imposes a wide range of sanctions including the imposition of criminal penalties in certain circumstances.

A company is a vehicle for the carrying out of business activity. It is a separate legal entity and this characteristic underpins much of its relevance in the commercial environment.

An important case in identifying the separate legal entity status of a company is *Salomon v Salomon & Co Ltd* (1897) AC 22. In that case, Mr Salomon, a sole trader, formed a company (Salomon & Co Ltd) that then purchased his boot manufacture business. At the time of setting up the company, the relevant English legislation required a minimum of seven shareholders. The initial shareholders were Mr Salomon who held 20,001 of the 20,007 issued shares and the remaining six shares were held as to one each by his wife and five children. Mr Salomon was managing director and

his two eldest sons were directors. Mr Salomon sold his business to the new company for almost £39,000, of which debentures worth £10,000 were issued in his favour. He accordingly was a secured creditor of the company. He had transferred his business to the company and the company was indebted to him. Debentures are evidence of security over company assets and gave Mr Salomon, as a creditor, certain priority rights over the company property.

Downturn in the leather merchant industry created financial strain on the company which led Salomon to borrow £5,000 from a lender, Broderip. As a condition of the loan Salomon granted Broderip security rights by way of a mortgage over his debentures.

The company's financial position did not improve and it was not able to pay the interest due to Broderip in relation to the debentures. As a result, the insolvent company was wound up and a liquidator appointed. The liquidator found £6,000 worth of assets for distribution to creditors. Of that amount the liquidator paid out the £5,000 owing to Broderip. Salomon claimed the remaining £1,000 as beneficial owner of the debentures. The liquidator opposed Salomon's claim and sought to use the £1,000 to pay out other creditors.

Both of the High Court and the Court of Appeal held against Mr Salomon. However on further appeal to the House of Lords the Court held in Salomon's favour. The House of Lords held that the company had been validly formed pursuant to the relevant legislation. There was no fraud as the setting up of the company complied with the *Companies Act 1862* (UK) and in the Court's opinion it was not contrary to the intention of the legislation for a trader to benefit from limited liability and obtain priority as a debenture holder over other creditors.

The company was a separate legal entity and distinct from its shareholders and directors. The company had been validly incorporated and accordingly the benefits of the corporate structure, which separated Mr Salomon the individual from his role as controller of the company, were available. Lord Macnaghten stated (at 51):

> The company is at law a different person altogether from the subscribers to the memorandum; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or a trustee for them.

The principle from *Salomon v Salomon* has been applied in many cases. In *Macaura v Northern Assurance Co Ltd* [1925] AC 619, timber owned and insured by Mr Macaura was transferred by him to a company and shares issued to him as a consequence. The timber was destroyed by fire and the court held that because the company was a separate legal entity it could not claim under Mr Macaura's insurance and, as he no longer owned the timber, he had not suffered a claimable loss (note that the *Insurance Contracts Act 1984* (Cth) would assist Mr Macaura if the same scenario took place in Australia today). In *Lee v Lee's Air Farming Ltd* [1961] AC 12, Mr Lee converted his aerial topdressing business into a company and then as the governing director of the company listed himself as an employee. While flying his plane in the course of the

company's business he crashed and was killed. His wife made a workers compensation claim which was rejected by the insurers on the ground that Mr Lee could not be a worker if he had full control of the company (ie, he could not employ himself). The court rejected the insurer's argument and held that as a separate legal entity the company was distinct and separate from Mr Lee, its founder. In other words, Mr Lee did not employ himself, the company employed him.

In *R v Goodall* (1975) 11 SASR 94; 1 ACLR 17 the principle from *Salomon v Salomon* was applied in relation to a director's fraudulent conduct. The director of a limited company was charged with fraudulent conversion under the relevant criminal statute. It was alleged that the company had received moneys for investment and that the directors controlling the company had fraudulently converted the funds and that the accused director had aided and abetted the commission of the offence by the company and was therefore liable to be prosecuted and punished as a principal offender. It was contended on behalf of the accused director that as he controlled the company he could not aid and abet the commission of an offence by the company by the same act or conduct which constituted the commission of the crime by the company itself. Bray J, in giving judgment for the Crown to proceed with the prosecution set out observations in relation to *Salomon v Salomon*.

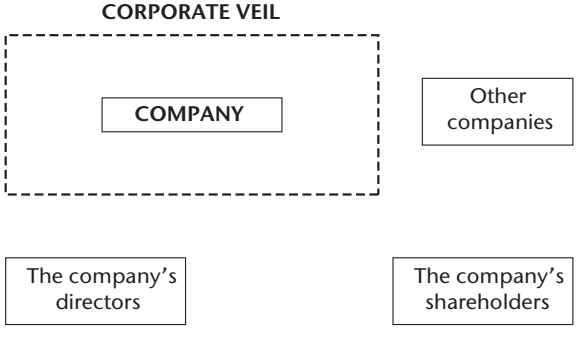
> In any event, with great respect to those who think otherwise, my view is that the logical consequence of *Salomon's Case* is that the company, being a legal entity apart from its members, is also a legal person apart from the legal personality of the individual controller of the company, and that he in his personal capacity can aid and abet what the company speaking through his mouth or acting through his hand may have done. I am fortified in this conclusion by the decision of the Privy Council in *Lee v Lee's Air Farming Ltd*. There their Lordships held that the governing director of a company could enter into a contract of service with the company so as to entitle his widow to workmen's compensation in consequence of his death in the service of the company, even though he made all the relevant decisions and did all the relevant acts with regard to the contract of employment in the name of the company. Their Lordships said, [at 26]:
>
> > When, therefore, it is said that "one of his first acts was to appoint himself the 'only pilot of the company' " it must be recognised that the appointment was made by the company, and it was none the less a valid appointment because it was the deceased himself who acted as the agent of the company in arranging it. In their Lordships view it is a logical consequence of the decision in Salomon's case that one person may function in dual capacities.
>
> My view therefore is that the controller of a company can aid and abet the company in the commission of a crime and that his own acts can constitute both the commission of the crime by the company and the aiding and abetting of it by himself as an individual.

The *Corporations Act* confirms the separate legal status of a company. Upon registration, a company comes into existence (**s 119**) and accordingly:

- It is capable of performing all the functions of a body corporate (this includes issuing shares, granting circulating security interests).
- It is capable of suing and being sued. This allows it to enforce its legal rights and allows others to pursue their legal rights in relation to claims in contract and tort.
- It has perpetual succession. Shares may change hands in an existing company but the corporate entity continues without change of legal status. A company will cease to exist upon deregistration (**s 601AD**) and thereafter all of its property vests in ASIC. Although the company will no longer be liable following deregistration, officers of the company may still be held liable in relation to matters occurring prior to deregistration.
- It has power to acquire, hold and dispose of property. Accordingly those purchasing property from a company will receive valid title.

The corporate veil—companies are separate legal entities

[8.30] As the company is a separate legal entity it is distinct and separate, not only from other companies but also from its own members and directors. This separation is referred to as the corporate veil. Like the transparency of a real veil outsiders can see that individuals (directors) manage the company but must accept that these individuals are not the company for the purposes of contracting and (sometimes to their frustration) liability. Nonetheless the court will lift the corporate veil if it is used for fraud or to avoid a contractual or a legal obligation. In *Gilford Motor Co Ltd v Horne* [1933] Ch 935, the terms of a service agreement entered into by the managing director (Horne) prohibited him from soliciting or enticing customers from the company after termination of his appointment. After he resigned he set up his own company and began contacting clients of his former company. The court held that the new company was merely a "sham" and that the new company and Horne should be seen



as one and the same. Accordingly the corporate veil between the two was lifted and a breach of the service agreement found. In *Creasey v Breachwood Motors Ltd* (1992) ACLC 3,052, an employee brought a successful action against a company for wrongful dismissal. However, to avoid the consequences attaching to the order the company ceased operations and transferred its business to another company. The court lifted the corporate veil between the two companies holding the second company liable for the amount owed to the employee. Under **s 588G**, the court will lift the corporate veil making directors personally liable if they allow the company to trade while insolvent.

When and how the corporate veil is lifted must take into account a question of balance in relation to the role of directors. If the veil always remains intact, outsiders will suffer if directors use it as a shield to protect themselves from the results of negligent or fraudulent management or improper conduct. If the veil is lifted too freely, a disincentive to take on corporate managerial functions will exist.

Business structures with layers of corporate entities are commonplace in the commercial marketplace. In some cases, these structures aim to distil or conceal personal responsibility. Companies are abstractions, artificial, they are legal individuals but not humans. The corporate veil is the gatekeeper of corporate artificiality and has historically been a benefit for directors and a sometime burden for outsiders. However, there is a danger that the protection offered by the corporate veil may give rise to an overconfidence by those involved in a company resulting in conduct which would be avoided on a personal level nonetheless being undertaken through the company structure.

Companies have many advantages, lower tax rates, perpetual succession, and separate legal entity status. In return, the law expects those who run them not to abuse these privileges. In *ASIC v Managed Investments Ltd and Ors (No 9)* [2016] QSC 109, the issue for the Supreme Court of Queensland involved the conduct of officers of MFS Investment Management (MFSIM). The company was responsible for managing the investment fund Premium Income Fund which held millions of dollars of investors' funds through many self-managed super funds. The use of subsidiaries and unlisted management investment schemes in the corporate framework may have provided the sense of security that led the directors to misappropriate funds by falsifying and backdating company documents. Directors and other officers received substantial penalties (disqualifications, fines and liability for compensation). Douglas J concluded: "This remains a sorry tale of the misuse of other people's money by those who should have known better" [at para 1619].

There is also a connection between the effect of the corporate veil and the idea of a corporate culture. The failings of companies are often attributed to a poor corporate culture. However, the normalising of the idea may have contributed to the lack of responsibility shouldered by those within company management. Poor culture within a company often simply means a failure of ethical standards by one or all of company management. Yet the focus on "culture" may act as a diversion from individual conduct and the failure to act ethically.

Examples of the misuse of the corporate veil include the incidence of fake directors, the use of companies to escape obligations, and phoenixing. Phoenixing is when

directors strip insolvent companies, avoiding employee obligations and cease to trade, but then form new companies to take their place. This relies on the separate legal entity status of a new company, and the effect of the corporate veil between the old and new companies to avoid the responsibilities of the previous, insolvent, company.

An aim of corporate regulation is to ensure directors act appropriately and that the benefits offered to companies are not misused for personal gain. There are various ways to achieve this, such as the penalties evident in the *Corporations Act*. An additional approach that has been suggested is the introduction of a director identification number (DIN) which would require directors to disclose more detailed information when a company was registered. Proposed amendments to the legislation were introduced into Parliament to this effect but at this stage have not proceeded.

Corporate group structures

[8.40] Companies may use a group structure for the purposes of carrying out and integrating their business activities. This will involve a parent or holding company having a controlling interest in one or more subsidiaries. Overall, control of group policy rests with the holding company.

There are benefits that arise from group structures such as organisational advantages and the capacity to isolate risky commercial undertakings by having the responsibility for these transferred to certain subsidiaries. The essence of the holding company's protection is the fact that the subsidiary is a separate legal entity and that the corporate veil creates a legal distinction between parent and subsidiary. Note though that the deliberate use of group structures to avoid liability may justify a court lifting the corporate veil and treating the companies effectively as partners for the purposes of liability.

A subsidiary cannot be a shareholder of its holding company (**s 259B(1)**). There are exceptions in **s 259B(2)** such as where a resolution is passed at a general meeting of the holding company.

A company that is 100% owned by its holding company is called a wholly owned subsidiary and in such cases the *Corporations Act* allows more decision making control to rest with the holding company. In this regard, directors of wholly owned subsidiaries who act in accord with the wishes of the holding company may be protected from actions for breach of their duty to act in good faith in the best interests of the subsidiary company in circumstances where the constitution of the subsidiary expressly authorises the conduct, the director acts in good faith and the subsidiary is not insolvent (**s 187**).

***Corporations Act 2001* (Cth), s 46**

A body corporate (in this section called the first body) is a subsidiary of another body corporate if, and only if:

(a) the other body:
    (i) controls the composition of the first body's board; or

(ii) is in a position to cast, or control the casting of, more than one-half of the maximum number of votes that might be cast at a general meeting of the first body; or
(iii) holds more than one-half of the issued share capital of the first body (excluding any part of that issued share capital that carries no right to participate beyond a specified amount in a distribution of either profits or capital); or
(b) the first body is a subsidiary of a subsidiary of the other body.

In certain circumstances the court has considered it appropriate to lift the corporate veil where a subsidiary has acted as an agent for its parent company. This principle of implied agency was used in *Smith Stone & Knight Ltd v Birmingham Corp* [1939] 4 All ER 116 where it was held that the subsidiary carried on business as agent for its parent company. The court considered these issues: whether the profits were treated as profits of the parent; whether the persons conducting the business were appointed by the parent; whether the parent was the "brain" of the project; whether the parent governed the venture and the input of capital; whether the profits arose from the parent's skill; and whether the parent was, in effect, in control. However this does not mean that agency will equate subsidiaries with their parent companies automatically, or even regularly. In *Briggs v James Hardie & Co Pty Ltd* (1989) 16 NSWLR 549, Rogers AJA set out (at 577):

> In the result, as the law presently stands, in my view the proposition advanced by the plaintiff that the corporate veil may be pierced where one company exercises complete dominion and control over another is entirely too simplistic. The law pays scant regard to the commercial reality that every holding company has the potential and, more often than not, in fact, does, exercise complete control over a subsidiary.

Trustee companies—liability of directors

[8.50] Trusts, like companies, are artificial legal creations. The trustee holds the funds on behalf of the beneficiaries. Legal ownership rests with the trustee and as such trust funds may be used in accordance with the terms of the trust instrument. Trusts are usually set up in writing, although in some situations the court will infer a trust arrangement even though not expressly set out. This provides a remedy where directors use company funds for their own benefit and contrary to the interests of the company. This is called a "constructive trust" (the court imposes the trust arrangement to achieve a just (fair) result as between the parties—the company being the beneficiary of the trust).

Trust arrangements with corporate trustees given the power to carry on business (sometimes called "trading trusts") are used extensively.

Creditors can look to the trust assets (the trust fund) if the trustee company has no funds of its own or insufficient funds to cover the liability that arises but only when

the corporate trustee has, in entering the contract, acted within the terms of the trust (ie, within its powers). This principle was confirmed in *Broomhead (JW) (Vic) Pty Ltd v JW Broomhead Pty Ltd* (1985) 3 ACLC 355.

However, where the trustee exceeds its powers, the law seeks to protect the fund for the beneficiaries, guarding it from the actions of wayward trustees. In such situations, the trust fund will not be accessible to the creditors leaving unsecured trust creditors in a particularly vulnerable position. The *Corporations Act* protects unsecured creditors in these situations pursuant to **s 197**.

Where a corporation is acting as a trustee and incurs liability and is not entitled to be fully indemnified out of the assets of the trust in respect of the liability, and the corporation cannot discharge the liability, then the directors are liable individually and jointly with the corporation (**s 197**). This is an instance of the lifting of the corporate veil between trustee companies and their directors. In *Edwards v Attorney-General (NSW)* (2004) 50 ACSR 122; [2004] NSWSC 272, it was held that liability in **s 197** related only to a breach of trust and the section itself notes that a person will not be liable merely because there are insufficient trust assets out of which the company can be indemnified.

Regarding indemnities of directors, see **Pt 2D.2.** Basically a company cannot exempt a person (including a director) from liability to the company incurred in their capacity as an officer of the company.

In certain situations directors of trustee companies will owe their duties to the beneficiaries of the trust. In *Hurley v BGH Nominees Pty Ltd (No 2)* (1984) 2 ACLC 497, the court considered the issue in relation to directors of a trust who took for themselves benefits arising from the company's role as trustee.

Characteristics of companies

[8.60]

Nature	
What are the characteristics of the business and do they suit the individual's goals?	Companies are separate legal entities. There is a corporate veil between the company and its members, and its managers. Because companies are legal individuals liability attaches to the company itself (there are some exceptions). Companies can range from small (effectively private) to large (with many investor/shareholders).
Law	
Is the law complex and will regulatory compliance be costly?	The *Corporations Act* regulates corporate liability. All companies and their directors have obligations but public companies listed on the stock exchange have the most complex regulatory and disclosure requirements. Large companies particularly have numerous financial, legal, and administrative obligations and compliance is a significant cost of running such organisations.

Setting up	
What expense is involved and how quickly can the business be operational?	Companies are registered at ASIC. There is a fee payable upon registration and relevant procedure and formalities are set out in both the *Corporations Act* and at the ASIC website. Registration is mostly quick and can be completed online. Forming a public company may require a disclosure document such as a prospectus.
Continuity	
Does the business continue if the owners change?	Companies have perpetual succession which means they exist until they are deregistered. Shareholders may change, however the company (as a separate legal entity) continues.
Liability	
What is the likelihood and extent of an individual's liability?	Generally the participants in a company (shareholders and directors) have the protection of the corporate veil. Companies limited by shares (the most common form) provide shareholders with liability limited to the unpaid value of their share. Directors are mostly free of company liability however certain conduct such as failing to act in good faith or for a proper purpose, or insolvent trading, are targeted by the *Corporations Act* exposing directors to disqualification, fines, and in some cases prison.
Control	
How is control organised and what powers will management have?	Shareholders elect directors who will have the power to manage the company. Certain important matters such as amending the company's constitution will be for shareholders to decide but day-to-day management, including entering contracts and taking legal proceedings, are carried out (or delegated) by the directors.
Formalities	
What level of compliance is required? For example is ongoing financial reporting essential?	Because of the level of regulation in the *Corporations Act*, and the fact that public companies are investment vehicles for large numbers of people, the law relevant to companies generally is more complex than for other forms of business. Although reporting requirements for small proprietary companies are not excessive, for public companies financial reports and audits are required and for listed public companies disclosure and financial requirements are substantial.
New participator	
What factors relate to introducing a new person into the profit-making structure?	A company's capital is divided into shares which can be acquired. Where a company seeks capital, it will look for investors. Once a person is a shareholder, they have certain entitlements to sharing profit (dividends). Shares can be issued by the company itself or shares can be transferred by existing members.

Sale of business

Is the business easily transferred to new proprietors?	Sale of the business of a company is achieved by the transfer of its shares. Once shares change hands, the company has new owners/ stakeholders, and these shareholders will have membership rights including the right to participate in the election or removal of directors.

Cessation

When and how does the business cease and what are the procedural requirements?	Companies no longer exist when they are struck off the Register. The most usual way this occurs is through the processes of liquidation. Companies can place themselves into voluntary liquidation or creditors can bring court proceedings where debts are outstanding and seek an order that a company be wound up. Although companies can, in some circumstances, be wound up when they are solvent, it is common that proof of the company's insolvency is required.

Summary—Registration and its effect

Companies are registered (formed) at ASIC (**s 117**)

Companies exist until deregistered (they have perpetual succession)

Companies are legal individuals: they can sue and be sued, they can own property, they can issue shares (**s 124**)

Companies are separate legal entities, separate from their members and from other companies

The corporate veil protects (in most cases) company management from liability

Example of a case identifying the corporate veil: *Salomon v Salomon*

Examples of when the corporate veil will be lifted: fraud, insolvent trading

A subsidiary (**s 46**) is a company controlled by another (holding/parent) company

Directors of trustee companies may incur liability if no indemnity from trust assets permitted (**s 197**)

9
Constitution and Replaceable Rules

From articles to the replaceable rules

[9.10] Companies are artificial. They need internal rules that assist in both procedural and substantive functions. The company constitution serves this purpose.

Prior to the introduction of the *Company Law Review Act 1998* (Cth) companies had:

- a memorandum, which regulated relationships with outsiders; and
- articles of association, which regulated the relationships between the company and its members and officers, and between members and members. Generally, proprietary companies adopted part or all of Table A, which was in the First Schedule of the applicable corporations legislation. Table A dealt with matters such as transfer of shares; proceedings at meetings, appointment, removal and remuneration of directors, powers of directors, notices, etc.

Since 1 July 1998 (commencement of the *Company Law Review Act*), companies no longer have a memorandum (where originally a company's objects were set out) or articles. Memorandums are abolished. The matters previously set out in the memorandum (such as particulars of directors) are now considered sufficiently covered in the documents lodged with ASIC upon a company's registration. However, some companies are still required to include their objects in the company constitution. For example, **s 112** sets out that a no liability company must state in its constitution that its sole objects are mining purposes, and **s 150** enables a company limited by guarantee to drop the word "Limited" from its name provided that its constitution requires it to pursue charitable purposes only. The articles of association have been superseded by the "replaceable rules" which are located, where relevant, throughout the *Corporations Act 2001* (Cth). Note that those companies already in existence on 1 July 1998 were able to retain their articles unless they repealed them.

Replaceable rules adopted on registration

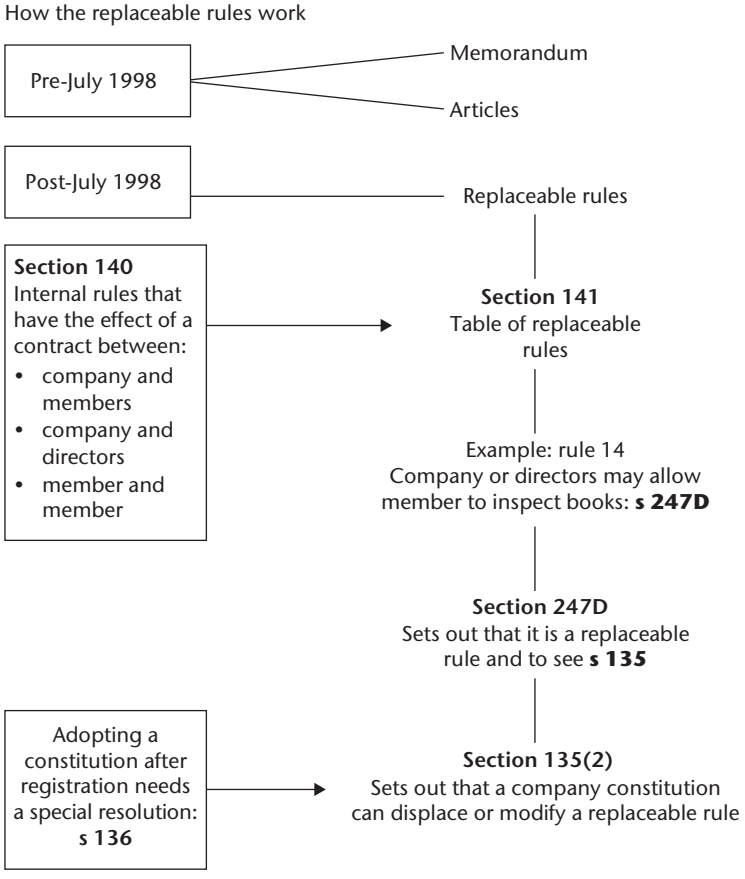
[9.20] Upon registration, companies automatically take the replaceable rules and these now function as the basic rules of internal management or corporate governance. **Section 141** sets out the index to the replaceable rules. Each of the replaceable rules is located in that part of the *Corporations Act* relevant to the content of the rule.

A company may also determine its corporate governance structure by adopting a constitution at the time of registration where the members agree in writing. After a

company has been registered, a constitution may be adopted by replacing some or all of the replaceable rules. **Section 135(2)** allows for the displacing or modification of the replaceable rules in this way. The capacity of a company to adopt a new, or repeal or modify an existing, constitution is set out in **s 136**. A special resolution (75% majority) is required. Accordingly, the company's internal rules as found in the *Corporations Act* are referred to as the replaceable rules. If a company decides to have a set of internal rules that differs (in whole or in part) to the replaceable rules, those internal rules are referred to as its constitution.

Note that not all aspects of a company's governance are covered in the replaceable rules or its constitution. There are many matters that relate to governance (such as the rights of members) that are set out in the *Corporations Act* that are neither replaceable rules nor can be altered by the adoption of a constitution.

How the replaceable rules work



[9.30] Members of a company can enforce their rights under the company's constitution and replaceable rules. Members are entitled to rely on the company functioning in accordance with its internal rules.

***Corporations Act 2001* (Cth), s 136**

Constitution of a company

(1) A company adopts a constitution:
   (a) on registration—if each person specified in the application for the company's registration as a person who consents to become a member agrees in writing to the terms of a constitution before the application is lodged; or
   (b) after registration—if the company passes a special resolution adopting a constitution or a court order is made under section 233 that requires the company to adopt the constitution …

(2) The company may modify or repeal its constitution, or a provision of its constitution, by special resolution.

Note: The company may need leave of the Court to modify or repeal its constitution if it was adopted as the result of a Court order (see subsection 233(3)) …

***Corporations Act 2001* (Cth), s 140**

Effect of constitution and replaceable rules

(1) A company's constitution (if any) and any replaceable rules that apply to the company have effect as a contract:
   (a) between the company and each member; and
   (b) between the company and each director and company secretary; and
   (c) between a member and each other member; under which each person agrees to observe and perform the constitution and rules so far as they apply to that person.

(2) Unless a member of a company agrees in writing to be bound, they are not bound by a modification of the constitution made after the date on which they became a member so far as the modification:
   (a) requires the member to take up additional shares; or
   (b) increases the member's liability to contribute to the share capital of, or otherwise to pay money to, the company; or
   (c) imposes or increases restrictions on the right to transfer the shares already held by the member, unless the modification is made:
      (i) in connection with the company's change from a public company to a proprietary company under Part 2B.7; or
      (ii) to insert proportional takeover approval provisions into the company's constitution.

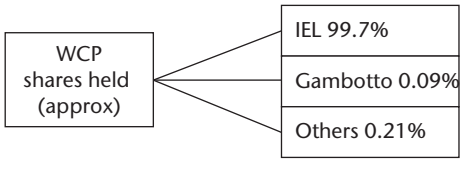
A member's contractual rights in **s 140** to enforce the replaceable rules or a constitution are subject to the fact that both of the replaceable rules and the constitution if a company has one, can be amended provided a special majority of 75% of the members vote to do so. Note that the rights of directors are also protected by this section. For example, the directors can rely on the contractual right created by **s 140** in relation to their right to remuneration in **s 202A**. In *Lion Nathan Australia Pty Ltd v Coopers Brewery Ltd* (2006) 156 FCR 1; [2006] FCAFC 144, the court considered a pre-emption procedure in a company's constitution and held that the constitution should not be considered narrowly but be construed so as to give it business efficacy, in other words, a businesslike interpretation. The result is that the constitution will take effect as an ordinary contract and be interpreted accordingly. Although the meaning and effect of the constitution are to be assessed objectively, this case is authority for the proposition that where it is appropriate to have regard to surrounding circumstances, prior versions may be relevant in assisting the court to understand the textual development of the constitution.

Section 140 also protects members from amendments to the company's constitution that impose restrictions or burdens that did not exist when the member took up the shares in the first place. A member is not bound by a modification made after becoming a member that requires the taking up of additional shares; that increases the member's liability to contribute to the share capital of the company; or that imposes or increases a restriction on the right to transfer shares already held.

Amending the constitution

[9.40] The company constitution can be amended by special resolution pursuant to **s 136(2)**. This ability to amend has been considered in a number of cases. An example is the matter of *Gambotto v WCP Ltd* (1995) 182 CLR 432. In that matter, Industrial Equity Limited (IEL) had a large controlling interest in WCP Ltd (WCP). An alteration to the company's constitution was proposed that would have the effect of forcing out minority shareholders by a compulsory acquisition (expropriation) of their shares.

IEL was the parent/holding company of WCP but WCP was not a wholly owned subsidiary. The amendment of the constitution would achieve this and produce taxation and administrative advantages. Mr Gambotto challenged the amendment. The High Court held that the amendment was invalid. The traditional test for determining the validity of an amendment to the constitution had been set out in *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656 and included whether the amendment was for the benefit of the company as a whole. The High Court in *Gambotto v WCP* did not consider this test to be appropriate where the amendment involved the expropriation of shares or the valuable rights attaching to them.



Gambotto v WCP [1995] 182 CLR 432 (Mason CJ, Brennan, Deane, Dawson and McHugh JJ)

At 434, 435, 444, 445, 448, 453

Extract of Facts

WCP was a limited liability company. Its principal business was property development. It had an issued capital of 16,980,031 ordinary shares of 20 cents each. As at 16 April 1992, Acmex Investments (No. 4) Pty Ltd ("Acmex Investments") and its associates, which were wholly-owned subsidiaries of Industrial Equity Ltd, held 99.69 per cent of those shares. Seventy-one persons held the other 50,590 shares of which Giancarlo Gambotto and Eliandra Sandri held 15,898. Gambotto had held his shares since about 1970, Sandri, her shares since about 1987.

On 16 April 1992, the secretary of WCP gave notice to its members that a general meeting of the company would be held on 11 May 1992 for the purpose of considering and, if thought fit, passing a special resolution to insert a new art 20*a* in the articles of association. The proposed article empowered any member who was entitled to 90 per cent or more of the issued shares of the company to acquire all the other shares in the company at the price of $1.80 per share. It authorised the majority member before 30 June 1992 to lodge a notice in writing with the company of an intention to acquire the minority shares. The notice was to be accompanied by a stamped transfer, executed under the common seal of the majority member on behalf of each holder of the remaining shares as transferor and on its own behalf as transferee, together with payment for the shares. Upon the receipt of the notice, the company was required to register the majority member as the holder of the minority shares and to cancel the share certificates of the shareholders. The company was also required within fourteen days to inform the minority shareholders of the transfer and their entitlements and obligations arising out of the transfer.

The notice of the meeting was accompanied by a valuation of the shares of the company prepared by a firm of accountants. The valuation showed that, at 8 April 1992, the principal assets of the company and its subsidiaries were seven tracts of land. The book value of the land was $15,035,000, but its market value was estimated to be $25,977,000. The report stated that the company had been selling off its land in recent years and that "there is no intention of continuing the property development business" once the sales had been completed. It concluded that, of the various methods of share valuation that might be used, "the net asset value basis to [sic] the most appropriate for the purpose of this valuation". It declared that, on a net asset value basis, the fair value of the shares was $1.365 per share. It did not include "the future income tax benefit as a separate asset". At no stage of the proceedings was it suggested that $1.365 was not the fair value of the shares.

On 6 May 1992, Gambotto and Sandri commenced proceedings in the Equity Division of the Supreme Court of New South Wales to restrain the company from resolving to alter the articles to add art 20*a*. Upon the company undertaking not to transfer the minority shares, the meeting was allowed to take place on 11 May. Gambotto and Sandri did not attend. The resolution for the insertion of art 20*a* was

declared carried after three minority shareholders, holding 7,900 shares, voted in favour of it. The majority shareholder did not vote on the resolution.

Extract from Judgment
Mason CJ, Brennan, Deane and Dawson JJ
The test for determining whether an expropriation is valid

In the context of a special resolution altering the articles and giving rise to a conflict of interests and advantages, whether or not it involves an expropriation of shares, we would reject as inappropriate the "bona fide for the benefit of the company as a whole" test of Lindley MR in *Allen v Gold Reefs of West Africa Ltd*. The application of the test in such a context has been criticised on grounds which, in our view, are unanswerable. It seems to us that, in such a case not involving an actual or effective expropriation of shares or of valuable proprietary rights attaching to shares, an alteration of the articles by special resolution regularly passed will be valid unless it is ultra vires, beyond any purpose contemplated by the articles or oppressive as that expression is understood in the law relating to corporations. Somewhat different considerations apply, however, in a case such as the present where what is involved is an alteration of the articles to allow an expropriation by the majority of the shares, or of valuable proprietary rights attaching to the shares, of a minority. In such a case, the immediate purpose of the resolution is to confer upon the majority shareholder or shareholders power to acquire compulsorily the property of the minority shareholder or shareholders. Of itself, the conferral of such a power does not lie within the "contemplated objects of the power" to amend the articles.

The exercise of a power conferred by a company's constitution enabling the majority shareholders to expropriate the minority's shareholding for the purpose of aggrandising the majority is valid if and only to the extent that the relevant provisions of the company's constitution so provide. The inclusion of such a power in a company's constitution at its incorporation is one thing. But it is another thing when a company's constitution is sought to be amended by an alteration of articles of association so as to confer upon the majority power to expropriate the shares of a minority. Such a power could not be taken or exercised simply for the purpose of aggrandising the majority. In our view, such a power can be taken only if (i) it is exercisable for a proper purpose and (ii) its exercise will not operate oppressively in relation to minority shareholders. In other words, an expropriation may be justified where it is reasonably apprehended that the continued shareholding of the minority is detrimental to the company, its undertaking or the conduct of its affairs—resulting in detriment to the interests of the existing shareholders generally—and expropriation is a reasonable means of eliminating or mitigating that detriment.

Accordingly, if it appears that the substantial purpose of the alteration is to secure the company from significant detriment or harm, the alteration would be valid if it is not oppressive to the minority shareholders. So, expropriation would be justified in the case of a shareholder who is competing with the company, as was the case in *Sidebottom v Kershaw, Leese & Co* [1920] 1 Ch 154, so long as the terms of expropriation are not oppressive. Again, expropriation of a minority shareholder could be justified if it were necessary in order to ensure that the company could

continue to comply with a regulatory regime governing the principal business which it carries on. To take a hypothetical example: if the conduct of a television station were the undertaking of a company and a renewal of a television licence under a statute depended upon the licensee's entire share capital being held by Australian residents, the expropriation of foreign shareholders who are unwilling to sell their shares to Australian residents might be justified assuming it is fair in all the circumstances …

The validity of art 20a

As the appellants did not contend that the expropriation was not fair in the sense explained above, the validity of art 20*a* hinges on whether the respondents have proved that the amendment was not made for a proper purpose. The immediate purpose of the amendment was to allow the expropriation by the majority shareholder of the shares held by the minority, including the shares held by the appellants. There is no suggestion that the appellants' continued presence as members puts WCP's business activities at risk or that the appellants have in some way acted to WCP's detriment. Nor is there any suggestion that WCP sought 100 per cent ownership in order to comply with a regulatory regime. All that is suggested is that taxation advantages and administrative benefits would flow to WCP if minority shareholdings were expropriated and WCP were to become a wholly-owned subsidiary of IEL In our view, however, that cannot by itself constitute a proper purpose for a resolution altering the articles to allow for the expropriation of a minority shareholder's shares. In that regard, it is not irrelevant to note that it is difficult to conceive of circumstances in which financial and administrative benefits would not be a consequence of the expropriation of minority shareholdings by a majority shareholder.

Accordingly, we would hold art 20*a* invalid and ineffective on the basis that it was not made for a proper purpose …

McHugh J

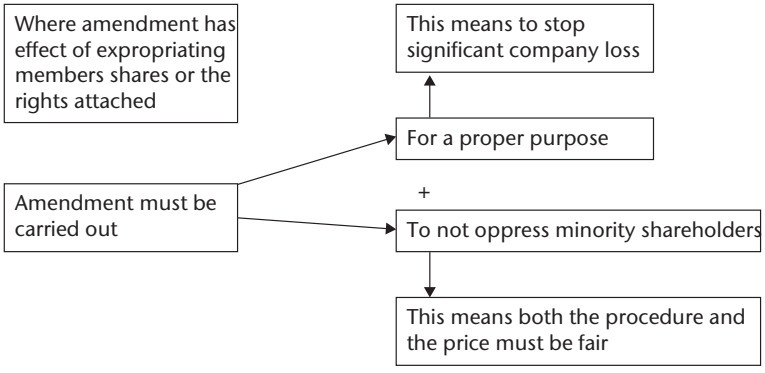
In the present case, the principal goal sought to be achieved by the alteration was in my view a legitimate business objective and one that would justify the expropriation of each appellant's shares provided that it was otherwise fair to *that* person. The alteration of the articles and the expropriation of the minority shares would enable the company to save over $4 million in taxes.

In my opinion, however, the company has failed to prove that the expropriation was not oppressive. It is true that upon the evidence before the Court and having regard to the concessions of the appellants the price of $1.365 per share may well have been a fair price for the shares. But the onus is on the company to prove that the price was fair, that the appellants have been dealt with fairly and that a full disclosure of all matters in relation to the alteration and expropriation has been made. The evidence falls far short of proving that the company and the majority shareholders have dealt with each appellant fairly. Almost no attempt was made to make the full disclosure that is required in this class of case.

It follows that the resolution adopting art 20*a* was invalid. The appeal should be allowed.

Expropriation of minority share rights

[9.50] The High Court in *Gambotto v WCP Ltd* held that although the amendment would be beneficial from a taxation and administrative point of view, it was not necessary to save the company from any significant loss nor was the continued participation of Mr Gambotto as a shareholder detrimental to the company's financial position (the company was profitable). Therefore the amendment was not for a proper purpose and accordingly invalid. The result of this was that the expropriation of share rights was defeated.



The principle arising from *Gambotto v WCP Ltd* has been applied in a number of other matters concerning amendment of the constitution and the position of shareholders. For example, in *Grey Eisdell Timms v Combined Auctions Pty Ltd* (1995) 13 ACLC 965, a special resolution was passed amending the company's constitution so as to limit any one shareholder (other than the managing director) to 10% of the issued capital and to expropriate the shares of a particular group of shareholders (those who were not pawnbrokers). The court held that the amendment was not justified on several grounds including that such an amendment was not necessary to protect the company's business. Therefore the amendment was not carried out for a proper purpose in accordance with the meaning of that phrase as set out in *Gambotto v WCP Ltd*.

As can be seen from the preceding paragraph, one part of the test in *Gambotto v WCP* formed the basis of the decision in *Grey Eisdell Timms v Combined Auctions Pty Ltd*. The other important part, requiring that the amendment must be fair in the circumstances and not oppressive, was relevant to the court's decision in *Bundaberg Sugar Ltd v Isis Central Sugar Mill Co Ltd* (2006) 62 ACSR 502; [2006] QSC 358. In that case, the defendant, a sugar milling and production company seeking to maintain its cooperative status, included in its constitution (articles) a provision requiring the forfeiture of all of the shares of members who did not supply sugar to the company. The court held that from the proper purpose aspect the provisions in the constitution were valid because unless all of its shareholders were suppliers the company would not satisfy

the requirements for cooperative status, thereby suffering substantial disadvantage. However, the shareholders forced to forfeit their shares received no compensation, and accordingly the court did not consider that the company satisfied all parts of the principle from *Gambotto v WCP* because the operation of the constitution (in forcing a forfeiture without compensation) was not fair to the non-supplying members.

Bundaberg Sugar Ltd v Isis Central Sugar Mill Co Ltd [2006] QSC 358 (Chesterman J)

Extract from Judgment

At [89]-[94]

Section 120 [*Sugar Industry Act 1999* (Qld)] allows as deductions against the assessable income of a co-operative company the rebates or bonuses it pays to its shareholders "on business done by shareholders with the company", and repayments by the company of moneys loaned to it by a government of the Commonwealth or a state.

The defendant has for many years taken advantage of deductions allowed by s 120 to such good effect that despite making substantial annual profits it has paid no income tax. It is to maintain its status as a co-operative company that the defendant has utilised the provisions of articles 29, 30, 31 and 32 to forfeit the shares of members who have ceased to be suppliers. It is not just the plaintiffs who have been subjected to the operation, or threatened with the operation, of those articles.

The continued shareholding by persons who do not supply sugar to the defendant would be detrimental to the company and the conduct of its affairs (the loss of the valuable tax deductions) if it were to lose its co-operative status. It is reasonable for it to preserve that status by doing business only with its members. To that end it forfeits the shares of members who cease to supply it with sugar cane.

The plaintiffs' real complaint was that the articles allowed the majority shareholders to oppress the minority by expropriating their shares without any corresponding obligation to compensate them for the loss. As I have pointed out, unless the forfeited shares are resold the member whose shares are forfeited goes completely without recompense. This is, I think, an infringement of the *Gambotto* principle.

The consequence is not, in my opinion, that articles 29(2), 30(2) or 31(1) are invalid. These operate to allow a forfeiture, but there is no complaint about that. The complaint is about forfeiture without compensation. That can occur by operation of article 32(1). The articles are capable of working fairly and without oppression to a member who ceases to be a supplier and whose shares are forfeited. If the shares are sold, as they may be pursuant to article 32(1) then the proceeds of sale are paid to the former member who thus receives fair recompense for their loss. This last statement may require one qualification. The recompense will be fair only if the shares are sold for their market value but article 32(1) is clearly subject to an implication that any sale of forfeited shares must be honest and the result of a reasonable attempt by the directors to obtain market value. It is only if the forfeited shares are disposed of other than by sale that there can be oppression to the expropriated shareholder.

Accordingly article 32(1) is invalid only when the power it confers is invoked with respect to shares forfeited for non-compliance with a notice given pursuant to article 29(2) and to the extent that it permits the directors to dispose of the forfeited shares except by sale.

Summary—Company constitution

A company is an artificial entity, its set of internal rules is its constitution

Companies formed prior to 1998 had Articles of Association

Now on formation the replaceable rules in the *Corporations Act* apply

The constitution and replaceable rules bind the company, they form a contract enforceable by the members (**s 140**)

Amendment is by special resolution of the members (**ss 135, 136**)

General test for amendment—*Allen v Gold Reefs*

Expropriation of minority rights—*Gambotto v WCP*

Test in *Gambotto*—amendment must be fair and for a proper purpose

10
Company Liability in Contract

The authority to contract

[10.10] In the first instance, the board of directors has power to contract on behalf of the company. Pursuant to **s 198A** (a replaceable rule) the business of the company is to be managed by or under the direction of the directors. Therefore the directors as a group have actual authority. The board can appoint a managing director pursuant to **s 201J** and, in addition to the conferral of power, set the terms (including the level of remuneration) of the managing director's appointment. Further, the board may confer on the person appointed any or all of their powers: **s 198C** (replaceable rule). An act of a procedural nature may still be effective notwithstanding that a director has been invalidly appointed (**s 201M**).

In *Freeman and Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480, the court held that a director, who with the acquiescence of the board of directors had acted as a managing director (although never formally appointed) had authority to manage the affairs of the company and accordingly could bind the company in contract. In essence, the company was holding itself out through the person who acted as the managing director. The court held that the board of directors had the actual authority to contract and that they had represented that the individual director had the relevant authority by their conduct.

In *Crabtree-Vickers Pty Ltd v Australian Direct Mail Advertising & Addressing Co Pty Ltd* (1976) 50 ALJR 203, a management committee (comprised of two directors and one non-director) was established by the board of directors. The non-director on the management committee, being held out by one of the directors on the management committee, purported to enter a contract on behalf of the company. The court (applying the reasoning of Diplock LJ in *Freeman and Lockyer*) held that the contract was not binding on the ground that the actual authority to contract on behalf of the company rested with the management committee set up for that purpose and that even though the individual director purporting to hold out on the company's behalf had acted in a managing director's role (though not formally appointed), this did not (in the situation where a specific management committee existed) confer authority on him. Only those with actual authority can delegate the ability to contract.

Note that in *Pacific Carriers Ltd v BNP Paribas* (2004) 218 CLR 451; [2004] HCA 35, the High Court held that even though the person executing the document (Ms Dhiri) lacked express actual authority, the company (a bank) had made a representation (held out) about her authority by equipping her with a title, status and facilities and by failing to put in place any means to protect outsiders from unauthorised conduct.

***Corporations Act 2001* (Cth), s 127**

Execution of documents (including deeds) by the company itself

(1) A company may execute a document without using a common seal if the document is signed by:
   (a) 2 directors of the company; or
   (b) a director and a company secretary of the company; or
   (c) for a proprietary company that has a sole director who is also the sole company secretary—that director.

Note: If a company executes a document in this way, people will be able to rely on the assumptions in subsection 129(5) for dealings in relation to the company.

(2) A company with a common seal may execute a document if the seal is fixed to the document and the fixing of the seal is witnessed by:
   (a) 2 directors of the company; or
   (b) a director and a company secretary of the company; or
   (c) for a proprietary company that has a sole director who is also the sole company secretary—that director.

Note: If a company executes a document in this way, people will be able to rely on the assumptions in subsection 129(6) for dealings in relation to the company.

(3) A company may execute a document as a deed if the document is expressed to be executed as a deed and is executed in accordance with subsection (1) or (2).

(4) This section does not limit the ways in which a company may execute a document (including a deed).

***Corporations Act 2001* (Cth), s 128**

Entitlement to make assumptions

(1) 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) A person is entitled to make the assumptions in section 129 in relation to dealings with another person who has, or purports to have, directly or indirectly acquired title to property from a company. The company and the other person are not entitled to assert in proceedings in relation to the dealings that any of the assumptions are incorrect.

(3) 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) 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.

The assumptions in s 129

[10.20] When outsiders deal with the company, they are entitled to rely on certain matters even if they are not actually aware of them. In **s 129**, there are assumptions that may be made. These are:

(1) that the company's constitution and any provisions of the *Corporations Act 2001* (Cth) that are applicable as replaceable rules have been complied with;

(2) that directors and company secretaries who are noted on ASIC records are duly appointed with relevant authority to perform their customary duties;

(3) that a person held out by the company as an officer or agent will be duly appointed with relevant authority to exercise all of the powers customarily exercised by that kind of officer;

(4) that an officer or agent will properly perform their duties;

(5) that a document is duly executed (without common seal) if it appears that it bears the signature of two directors or one director and the company secretary in accordance with **s 127(1)** or; if only one director/secretary the signature of such person in accordance with **s 127(1)**;

(6) that a document is duly executed with common seal if it appears that the seal is affixed and witnessed by two directors; or one director and the company secretary in accordance with **s 127(2)** or; if only one director/secretary that person in accordance with **s 127(2)**; and

(7) that an officer or agent with authority to issue a document can warrant its authenticity.

The assumptions in **s 129** may be made even if the officer or agent of the company acts fraudulently or forges a document (**s 128(3)**). However, **s 128(4)** does not entitle an outsider to rely on the assumptions in **s 129** if they knew, or suspected, that the assumptions were incorrect. This restriction would also apply to the application of **s 128(3)**. The party seeking to disentitle reliance on the assumptions bears the onus of proof. Accordingly, as it will be the outsider (eg, a bank or other financier) who seeks to rely on the assumptions it will be the company that will seek to adduce evidence establishing knowledge or a suspicion on the part of that outsider.

The way in which the exceptions to the statutory assumptions in **s 129** are interpreted differs from the common law position (see under "The indoor management rule" at [10.30]), which was based on whether the outsider ought to have known about the irregularities. A reasonable person test was applied to the actions of the outsider. However, this was not the approach taken in *Soyfer v Earlmaze Pty Ltd* [2000] NSWSC 1068 where it was held that **s 128(4)** requires proof of actual knowledge or suspicion, rather than reasonable knowledge or suspicion. Accordingly, it can be said that a person "suspects" in the terms of **s 128(4)** when it can be inferred that the person formed a positive opinion that there was something irregular about the appointment or the scope of authority. Merely failing to enquire as to the authority of the company's agent will not in itself disentitle the outsider to the benefit of the **s 129** assumptions. Nor does a person lose the benefit of the assumptions merely because suspicion should have been aroused in the particular circumstances. This issue was considered in *Sunburst Property Pty Ltd v Agwater Pty Ltd* [2005] SASC 335, a case concerning the enforceability of an agreement between vendors of land and a water

infrastructure company. The agreement between the vendors, Sunburst Properties, and Agwater Pty Ltd, the first defendant, included a provision for sale of property and apportionment of the proceeds. The issue for the court was whether Agwater's entry into the agreement was authorised or otherwise binding on the company. The court found that the persons who purported to enter the agreement for Agwater were directors at the time of the contract; however it added that if for any reason this were not the case then the receivers and managers of Sunburst Properties were entitled to make the assumption that they were.

Sunburst Property Pty Ltd (in liq) v Agwater Pty Ltd [2005] SASC 335 (Gray J)

Extract from Judgment

At [178]-[182], [184] and [185]

Section 128(4) appears to place the burden on the company to establish the person's subjective knowledge or suspicion that the s 129 assumptions relied on were incorrect …

The joint-sale agreement was purportedly entered into by Agwater under the hands of Mr Crosby and Mr Marshall. Under s 127(1) of the *Corporations Act*, a company may execute a document without using a common seal if the document is signed by two directors of the company …

Mr Heard gave evidence that he instructed that a search be made of the company register concerning Agwater when it became likely that he was to be appointed to the receivership of the assets and undertakings the subject of the National Australia Bank debenture …

The search of the company register revealed that Mr Crosby, Mr Marshall, Mr Garrett and Mr Sandow were directors of Agwater. However, according to Mr Heard, he was informed at this time, probably by John Hart, that Mr Garrett and Mr Sandow had resigned from the directorship of Agwater and all the companies in the Sunburst Group.

On 17 July 2003, the date of his formal appointment, Mr Heard attended the offices of the Braidwood Group. He was introduced to Mr Crosby as a director of Agwater. Mr Marshall introduced himself as a director of the companies over which he was appointed, and also as a director of Agwater …

The evidence establishes that it appeared, from information provided by Agwater to ASIC, that Mr Crosby and Mr Marshall were directors of Agwater, and that Sunburst Properties and its receivers and managers, Mr Dwyer and Mr Heard, neither knew nor suspected that they had not been properly appointed. Although the company search undertaken on Mr Heard's instruction revealed Mr Garrett and Mr Sandow to be directors of Agwater, this fact could only be of significance if it meant that Mr Heard "knew or suspected" that Mr Crosby or Mr Marshall was not a director of Agwater. As earlier indicated, I accept Mr Heard's evidence that he neither knew nor suspected any such thing. Mr Heard had been informed that Mr Garrett and Mr Sandow had resigned as directors of Agwater, and Mr Garrett made no attempt to assert that he was a director until after the execution of the joint-sale agreement. In the circumstances, I am not satisfied that the search had the requisite effect.

> Once it appears from information provided by a company to ASIC which is then publicly available that a person is a director or a secretary of a company, a third party can assume that the director or secretary has been duly appointed and has the authority to exercise the powers and duties customarily exercised or performed by a director of a similar company. This assumes the absence of any indicators or information to the contrary. In the circumstances, Sunburst Properties and its receivers and managers were entitled by virtue of s 129(2) of the *Corporations Act* to assume that Mr Crosby and Mr Marshall had been duly appointed and had the authority to exercise the powers and duties customarily exercised or performed by a director of a similar company. Because they could make this assumption, Sunburst Properties and its receivers and managers were entitled by the cumulative operation of ss 129(2) and 129(4) to assume that Mr Crosby and Mr Marshall were properly performing their duties as directors, and by the cumulative operation of ss 129(2) and 129(5) to assume that the document had been duly executed.

The indoor management rule

[10.30] In *Royal British Bank v Turquand* (1856) 119 ER 886, the court held that a company could not avoid a contract merely because its directors had not acted in accordance with its constitution. In this case, the company's constitution comprised in a deed of settlement which allowed the board of directors to borrow amounts as authorised by a resolution of the general meeting of the shareholders. Two directors on behalf of the company borrowed money from a bank using the company's common seal. There was no authority given by the general meeting as required. The company refused to repay the loan and argued that the bank had constructive notice of the constitution and should have been aware of the lack of authority. It was held that an outsider need not inquire into whether such a resolution had in fact been passed. The bank could still enforce its contract with the company because the passing of the resolution was a matter internal to the company. Accordingly where there are persons conducting the affairs of the company in a manner that appears to be entirely consistent with the constitution, then those dealing with them are not affected by any irregularities in the internal management of the company.

Note that in **s 129(1)** this common law indoor management rule has been codified when dealing with the company and it forms one of the several assumptions that can be relied upon by an outsider.

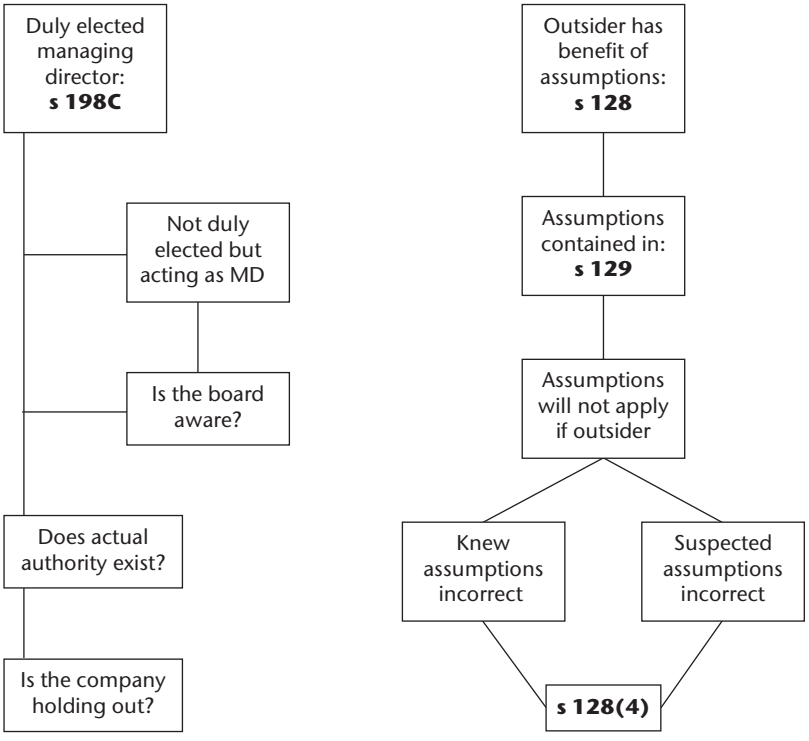
The indoor management rule enables outsiders to rely on the appearance of regularity in relation to company business. This reliance does not place any affirmative duty on the outsider to necessarily seek out the company constitution. However, the existence of the indoor management rule in the common law and in **s 129(1)** does not mean that every time a company officer enters a contract the outsider will be able to enforce that contract regardless of the conduct of the officer, or for that matter regardless of the outsiders own conduct.

The common law approach to issues of reliance and disentitlement to the assumptions of a party contracting with the company can be seen in *Bank of New Zealand v Fiberi Pty Ltd* (1994) 12 ACLC 48. In this case, the company constitution set out that the company seal could be affixed to documents if authorised by the board with the signatures of a director and the company secretary. The company seal was affixed to a mortgage by a person not properly appointed as an officer of the company in breach of the constitution. The court found that the benefit of the assumptions was to be withdrawn because the outsider did not act reasonably in the circumstances to discover the actual position as to the authority of the officer. Note that even though this "reasonable person" test of whether a suspicion exists has some parallels to how the term "suspect" is used in certain parts of the *Corporations Act* (**s 588G**—insolvent trading) it is not applicable to **s 128(4)** where an actual suspicion is required.

The *Corporations Act* seeks to balance the interests of outsiders who contract in good faith with the interests of shareholders who elect directors to manage in good faith. It does this by firstly allowing the outsider the benefit of the assumptions in **s 129** but then withdrawing such benefit if the outsider knew or suspected any irregularity in the manner of contracting (**s 128**).

Enforcing contracts with the company

[10.40]



Summary—Company liability in contract

Agency issues are relevant to a company's liability in contract

Compliance with the company constitution may be assumed—this is indoor management rule

A case on the indoor management rule: *Royal British Bank v Turquand*

Cases dealing with authority to contract and the concept of a holding out—*Freeman and Lockyer*; *Crabtree-Vickers*

The board of directors manage the company: **s 198A**

The board may elect a managing director: **s 201J** and **s 198C**

Company execution of documents is set out in **s 127**

The *Corporations Act* creates assumptions in favour of outsiders dealing with the company

The assumptions are set out in **s 129** and include reliance on the appearance of execution as in **s 127**

The benefit of the assumptions are lost if knowledge or suspicion of an irregularity exists: **s 128**

Example of a case concerning the assumptions: *Soyfer v Earlmaze*

11
Company Liability in Tort and Crime

[11.10] As a separate legal entity, a company will not only be liable in contract but also in tort (predominantly negligence) and pursuant to various regulatory statutes (eg, statutes concerning road safety, manufacture and sale of goods, protection of the environment). Often liability of companies arises as a result of the principle of vicarious liability where the act of an employee carried out in the course of employment will create liability in the body corporate. In these circumstances, the company will be liable but, in a technical sense, the act giving rise to the liability is not its act (it is the act of a separate legal person—the employee). Vicarious liability is a very common way for companies to become liable in tort and also under statute.

In some instances where liability arises under statute, there has been a difficulty in identifying who the company actually is (ie, who represents it, who is its directing mind and will) for the purposes of the particular offence. In relation to criminal matters, the isolating of the directing mind and will of the company has often proven difficult. The organic theory of corporate liability equates the acts of the organs of the company (generally the board) with the company itself. The board becomes the company's directing mind and will, its brain, giving direction to its activities. If the offence is committed by the directing mind and will, it is taken to have been committed by the company. The issue in relation to the liability of the company under the organic theory is whether the person committing the offence can be identified as the company's brain, or whether, as was the situation in *Tesco Supermarkets v Nattrass* [1972] AC 153, that person must be seen as "another person" in a legal sense and separate to the company. The facts of that case involved the store manager (an employee) of a large chain of supermarkets advertising goods for sale in a manner that misled or deceived consumers. The House of Lords held that the store manager did not have the requisite responsibility or control of the company's operations to be identified as the controlling mind and will of the company. The Tesco board had set up a "chain of command" and, while still remaining in control of the overall operations of the company, had not delegated its functions or responsibilities. Accordingly the acts of the store manager could not be said to be the acts of the company itself.

More recently, courts have taken a slightly more flexible approach to associating the actions of employees with the directing mind and will of the company. In *ABC Development Learning Centres Pty Ltd v Wallace* [2006] VSC 171; [2007] VSCA 138, a young child escaped from a childcare centre without staff being aware. The child was found, but the company (ABC) was still prosecuted under the *Children's Services Act 1996* (Vic) which required the company to take reasonable precautions and adequately supervise children in its care. The company argued that the failure to supervise was the fault of the staff themselves and not the fault of the company. The decision at

first instance (confirmed on appeal) applied the reasoning in *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 2 AC 500 where the Privy Council recognised the need to apply a "special rule of attribution" where to do otherwise would frustrate the policy or intent of the relevant statute. The Victorian Supreme Court came to the same result though in a slightly different way. The Court held that even where the employees are low-level the company will still be identified with their actions where, in relation to statutes of a regulatory nature, the manner of the offence and the policy objectives of the statute warrant that the company be held accountable. Accordingly, the company was held to have breached the statute.

ABC Developmental Learning Centres Pty Ltd v Wallace [2007] VSCA 138 (Maxwell P, Chernov and Neave JJA)

Extract from Judgment

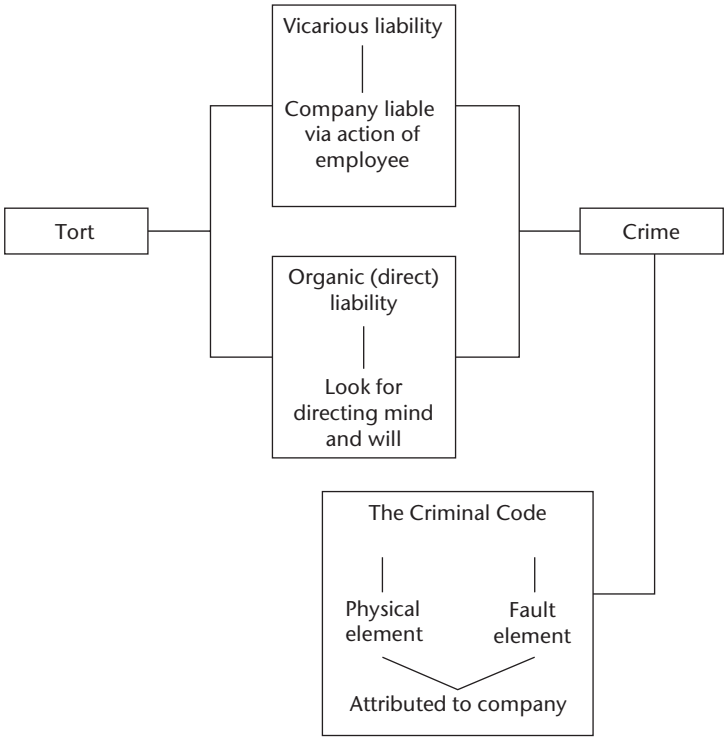
At [19]

Under s 27(1) [of the relevant Act], the proprietor has a duty to ensure—that is, make certain—that a certain state of affairs exists viz adequate supervision of all children. Unless there is adequate supervision, the company is in breach. Liability under the section does not depend upon any failure by the company itself, meaning by those persons who "embody the company". If it is proved that there was not adequate supervision, it is immaterial where in the organisation the failure occurred.

The need to hold companies liable for their actions, and avoid the negative consequences of the strictness of the organic theory of corporate liability, has prompted the courts and Parliament to focus on the culture of corporate behaviour and hold companies accountable for their agents and employees. Pursuant to the *Criminal Code* contained within the *Criminal Code Act 1995 (Cth)* criminal liability arises when both a physical and a fault element exist. A physical element involves the offence being committed by an employee, agent or officer acting within the actual or apparent scope of their authority. A fault element will arise where the company's board of directors or a high managerial agent intentionally, knowingly or recklessly carried out or engaged in the relevant conduct or the company expressly, tacitly or implicitly authorises or permits the commission of the offence or in fact fails to create or maintain a corporate culture that requires compliance. Accordingly, there is the possibility of the application of certain criminal offences to a company directly without the need to identify a particular senior officer as acting as its directing mind and will.

The *Criminal Code* addresses failures in the organisational mechanisms of a company by targeting its corporate culture, defined in s 12.3 of the *Criminal Code*, as including an attitude, policy, rule or practice. The part played by a high managerial agent, defined as an employee, agent or officer assumed to represent the company, may be relevant to identifying a corporate culture. In certain circumstances involving mistakes of fact, defences are available (s 9.2 and s 12.5).

The *Criminal Code* is relevant to both corporate and individual conduct and sets out the general principles of criminal liability that apply to criminal offences in the *Corporations Act*, and other Commonwealth legislation. Certain sections of the *Corporations Act* include physical or fault elements for the purposes of the application of the *Criminal Code* in relation to an offence based on that section (eg **s 1041E**). Note, that pursuant to the *Criminal Code* the legislation creating the offence may provide that there is no fault element for one or more physical elements (strict liability offence).



Summary—Company liability in tort and crime

Vicarious liability—the company is liable through its employees

Direct or organic liability—requires identifying the directing mind and will

Example of a case concerning organic liability—*Tesco*

The *Criminal Code* targets corporate culture

Liability under the *Criminal Code* requires a physical element and a fault element

12
Promoters and Pre-Registration Contracts

Liability of promoters

[12.10] Promoters are persons who form companies and attend to matters necessary to commence the company's business. In some cases, as was the situation in *Tracy v Mandalay Pty Ltd* (1953) 88 CLR 215, a person can be classified as a promoter if they merely profit from the venture without taking any active part in setting the company up. Promoters are subject to fiduciary obligations and therefore must act in good faith and avoid conflicts of interest when promoting a company, including in the period before the company is registered. In *Tracy v Mandalay*, a company purchased land for the construction of a block of flats in Potts Point. The land was then sold at a profit to another company, Mandalay Pty Ltd. The company would erect the building and then invite investors to acquire shares which would entitle them to occupy one of the flats. A change in planning laws prevented the construction of the flats and as a result proceedings were brought by Mandalay against the promoters who included persons who took no active part in the project but nonetheless would profit from it.

Tracy v Mandalay Pty Ltd (1953) 88 CLR 215
(Dixon CJ, Williams and Taylor JJ)

Extract from Judgment

At 240-242

Promoters may sell their property to the new company but they are under a fiduciary duty to disclose to the new company that they are doing so and under a duty to place it in a proper position to decide whether to accept the offer or not by appointing an independent board and fully disclosing the whole position to that board …

It is clear [from cases that were cited] that in the absence of approval by an independent board after full disclosure sales by a promoter of his property to the new company are in the same position as any other sales by a trustee of his property to a person towards whom he stands in a fiduciary relation. That is to say they are voidable at the mere option of the purchaser …

In the present case Salon was admittedly a promoter of the plaintiff. He was directly responsible for its incorporation. It was on his instructions that the memorandum and articles of association were prepared and registered and incorporation effected. Some of the other defendants also took an active part in the promotion of the plaintiff, and we shall refer shortly to some of these activities. But it is not only the persons who take an active part in the formation of a company and the raising of

> the necessary share capital to enable it to carry on business who are promoters. It is apparent from the passage cited that persons who leave it to others to get up the company upon the understanding that they also will profit from the operation may become promoters

In *Aequitas v AEFC Leasing Pty Ltd* [2001] NSWSC 14, Austin J considered the question of who were promoters for the purposes of the law of fiduciary duties. He noted that promoters of a company or other business enterprise were regarded as within a category of accepted fiduciary relationships in *Elders Trustee Co Ltd v EG Reeves Pty Ltd* (1987) 78 ALR 193 and that it followed that once a person was identified as a promoter, fiduciary duties automatically attach without the need to find any specific undertaking in the particular instance. The essence of a promoter's obligation is disclosure of matters relevant to investors, particularly when those matters go to contracts entered by the company with the promoters. For example, in *Erlanger v New Sombrero Phosphate Co* (1878) 3 App Cas 1218, promoters (through a syndicate) sold land (an island) to a newly formed company whose directors were nominated by the syndicate. The sale price turned out to be considerably more than the land was worth. The House of Lords rescinded the contract on the basis of the promoters' non-disclosure. Together with the need for full disclosure, promoters setting up a company must ensure that the newly formed board is independent of their influence.

Enforceability of pre-registration contracts

[12.20] The common law position in relation to pre-registration contracts was somewhat uncertain because of the application of the doctrine of agency by ratification. Basically, a contract made on behalf of a company before it was registered (incorporated) meant that no principal was in existence at that time (companies are artificial and only exist once created). In this situation, the common law of agency would not recognise that ratification was possible. The allocation of liability to individuals in cases where persons entered contracts in the expectation of the imminent formation of a company was often decided on the grounds of whether the person intended to be personally bound by, and intended to take the benefit of, the particular contract. For example, in *Kelner v Baxter* (1866) LR 2 CP 174, the court held the persons who entered the contract were liable when the company failed to perform its obligations. However in *Black v Smallwood* (1966) 117 CLR 52 no liability was attributed to the individuals who entered a contract on the mistaken belief that the company had been formed. The *Corporations Act 2001* (Cth) overcomes these uncertainties by providing for an exception to the common law doctrine of agency by ratification.

In **s 131**, issues concerning contracts before registration are dealt with. That section sets out that:

- where a contract is entered into on behalf of a company before it is registered, it is bound if it registers and ratifies within the time agreed or within a reasonable time;

- if the company is not registered or fails to ratify (if formed) within a reasonable time, the person who entered the contract is liable;
- if the company ratifies but fails to perform the contract the person who entered the contract may, if the court determines, still be liable.

The person who entered the contract may avoid liability where, pursuant to **s 132**, a party to the pre-registration contract executes (signs) a release in their favour. This section also sets out that the person who entered the contract has no right of indemnity against the company.

Accordingly, a company can take the benefit of a contract entered on its behalf provided the terms of the section are satisfied. Note that the ease with which companies can be formed today, and the ready access to "shelf" companies, would generally provide ample opportunity for persons taking on a corporate project to adopt a company structure quickly.

Summary—Promoters and pre-registration contracts

Promoters are fiduciaries

Promoters must disclose relevant matters to investors

The board of the new company set up by the promoters must be independent and free of their influence

Pre-registration contracts can be ratified pursuant to **s 131**

The company will then be bound under the contract

The person who entered the pre-registration contract may be released from liability **s 132**

13
Company Financing

[13.10] To carry out normal business activity, companies need to raise capital. Larger companies particularly require adequate capital reserves in order to underpin investment strategies. Companies raise capital in two main ways: by selling shares to the public (share or equity capital) or by borrowing from banks or other finance providers. It is also possible in public companies to borrow from a number of individual investors by way of a debenture issue. Capital raised by borrowing is called loan or debt capital. Companies also use amounts earned in previous financial periods as a source of capital.

The relationship between debt capital and equity capital can be referred to as the gearing ratio.

Companies formed for commercial purposes will have varying financial needs at different stages of their development. A proprietary company will normally be funded by a bank overdraft and perhaps shareholders' loans. As a company expands, it may need access to other and more diverse sources of finance. Accordingly, a proprietary company may convert to a public company (**ss 162** and **163**) and offer shares or debentures to investors on the open market to fund its business. Note that under certain conditions both unlisted public companies and proprietary companies may make use of crowd-sourced funding options (**Pt 6D.3A**).

When public companies seek capital by inviting investment from the general public, factors concerning adequate disclosure are important. The *Corporations Act 2001* (Cth) seeks to protect investors by way of the fundraising provisions in **Ch 6D**.

Comparison of share and loan capital

[13.20] Whereas shareholders providing share capital are members of the company with all attendant rights under the *Corporations Act*, debenture holders providing loan capital are merely creditors of the company, their rights reliant on the terms of the debenture. Shareholders are participants in the company enterprise; creditors are outsiders. The rights of those who provide loan capital depend on the terms of the contract that gives rise to the funding arrangement. Their return is determined, as to time and amount, by the contract. As such, there is an element of certainty in relation to their investment. Those who provide share capital are clearly dependant on the fortunes of the company as to whether a dividend will be payable or not. A dividend is a share of the company's profit and the expectation of a dividend is an important factor in the decision to acquire shares.

A major difference between those who provide equity capital and loan capital is that creditors have a right to be paid before members receive any return of their capital. This is particularly so in relation to insolvent companies as it is a basic assumption that investing in shares carries risks and that if a company fails, the investment will be lost. The right of creditors over members is contained in **s 563A** which sets out that payment of a "subordinate claim" against a company is to be postponed until all other claims against, or debts payable by, the company have been satisfied. A "subordinate claim" includes a claim by a person in their capacity as a member, whether by way of dividends, profits or otherwise, or any other claim that arises from buying or holding the shares.

The issue of the relevant priorities between shareholders and creditors of an insolvent company has been considered by both the High Court and Parliament. The outcome of this has been the confirmation that shareholders' claims rank after creditors' claims. The issue was initially raised in *Sons of Gwalia Ltd v Margaretic* (2007) 231 CLR 160; [2007] HCA 1 where a shareholder's rights in a claim concerning misleading and deceptive conduct by the company were equated to those of the ordinary creditors for the purposes of proving (verifying) a debt under a proposed deed of company arrangement where the company was in voluntary administration. In this case, the shareholder claimed that he was misled into purchasing shares because the company's officers had failed to properly disclose the company's capacity to meet certain contracts it had made in relation to the sale of gold.

Mr Margaretic sought compensation for the price of his shares, which were worthless once the company entered voluntary administration. His claim was based on various sections of the *Corporations Act* and the *ASIC Act 2001* (Cth) that dealt with misleading or deceptive conduct and failure to provide continuous disclosure to the market. The High Court (by majority) stated that their task was not to decide on the fairness of shareholders claiming as creditors but to decide if Mr Margaretic's claim was bought in his capacity as a shareholder in terms of **s 563A** (as it was then). The High Court held that the claim was not bought in the capacity of a shareholder, thereby giving Mr Margaretic the status of an unsecured creditor. Relevant in this regard was the fact that the provisions dealing with misleading or deceptive conduct are not limited in their operation to shareholders.

A report, "Claims by Shareholders against insolvent companies: Implications of the Sons of Gwalia decision" (CAMAC, December 2008), supported the High Court's position. It set out that restricting shareholders' rights in situations where a company was in financial distress would undermine the legislative initiatives that provide shareholders with redress in respect of corporate misconduct. However, the decision in *Sons of Gwalia* raised substantial commercial concern as it affected the traditional relationship between a company's members and its creditors, particularly in regard to the insolvency of a company. This concern prompted continued resistance to the decision in the business sector and resulted in the federal government introducing legislation (effective December 2010) to overcome (and in effect, reverse) the High Court's decision, and restore creditors' priority in **s 563A**.

***Corporations Act 2001* (Cth), s 563A**

Postponing subordinate claims

(1) The payment of a subordinate claim against a company is to be postponed until all other debts payable by, and claims against, the company are satisfied.
(2) In this section:

"claim" means a claim that is admissible to proof against the company (within the meaning of section 553).

"debt" means a debt that is admissible to proof against the company (within the meaning of section 553).

"subordinate claim" means:

(a) a claim for a debt owed by the company to a person in the person's capacity as a member of the company (whether by way of dividends, profits or otherwise); or
(b) any other claim that arises from buying, holding, selling or otherwise dealing in shares in the company.

Membership of a company

[13.30] The rights arising from the provision of loan capital are based on the law of contract; however they do not result, as does the provision of share capital, in membership of the company. A person is a member of a company if they were a member at registration or if at any time after registration they acquired shares and were entered on the register of members (**s 231**). Benefits of company membership include the right to vote, the right to a dividend, and the right to bring an action against or on behalf of the company under a number of sections of the *Corporations Act*, including a statutory derivative action under **s 236**. The register of members is kept at the company's registered office and can be inspected by members free of charge. Shares are personal property and are transferable in accordance with the company's constitution (**s 1070A**). Shares are not deemed to be transferred until details have been entered on the company's register of members and in this regard **s 1072F** imposes certain criteria.

***Corporations Act 2001* (Cth), s 1072F**

Registration of transfers (replaceable rule—see section 135)

(1) A person transferring shares remains the holder of the shares until the transfer is registered and the name of the person to whom they are being transferred is entered in the register of members in respect of the shares.
(2) The directors are not required to register a transfer of shares in the company unless:
    (a) the transfer and any share certificate have been lodged at the company's registered office; and
    (b) any fee payable on registration of the transfer has been paid; and

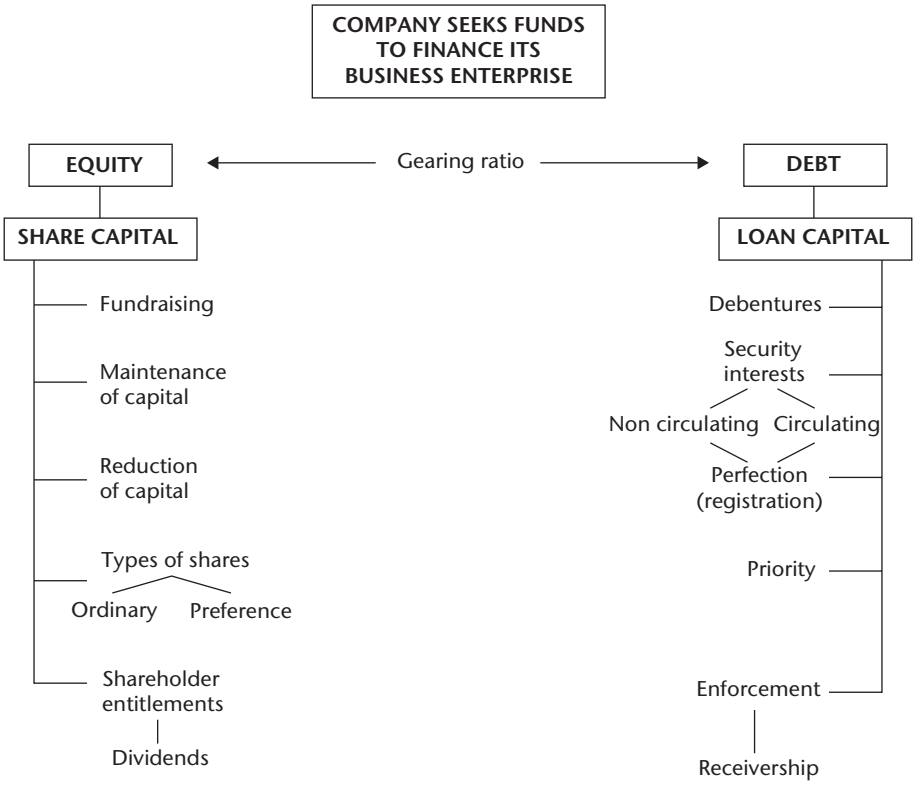
(c) the directors have been given any further information they reasonably require to establish the right of the person transferring the shares to make the transfer.

(3) The directors may refuse to register a transfer of shares in the company if:
(a) the shares are not fully-paid; or
(b) the company has a lien on the shares.

(4) The directors may suspend registration of transfers of shares in the company at the times and for the periods they determine. The periods of suspension must not exceed 30 days in any one calendar year.

Whereas listed public companies cannot generally include in their constitution a restriction on the transfer of shares, proprietary companies can, and an example of this is in **s 1072G** where directors of proprietary companies can refuse to register a transfer of shares for any reason. This section is a replaceable rule.

Where directors refuse to register a transfer of shares, **s 1071F** enables the transferee shareholder to apply to the court and if the court is satisfied that the refusal to register the transfer was without just cause, the court may order that the transfer be registered or make such order as it thinks just and reasonable, including an order providing for the purchase of the shares by a specified member or by the company itself. The shareholder seeking registration has, in the first instance, the onus of showing an absence of just cause on the part of the directors. Failure by the directors to give their reasons for refusal does not of itself prove there is no just cause, particularly where the constitution does not require reasons for refusal to be given. However, the failure to provide reasons may assist in the drawing of an inference that there is no just cause for refusal: *Beck v Tuckey* (2007) 213 FLR 152; [2007] NSWSC 1065. Further, if a reason is given it will then be open to the court to consider the relevance or otherwise of the reason.



Summary—Company financing

Companies finance through a mix of debt and equity

Debenture holders (loan capital) are creditors of the company

Share capital is provided by investors (shareholders)

Shareholders' return is tied to company performance

Shareholders are listed on the register of members (**s 231**)

Directors in a proprietary company may refuse to register a transfer of shares (**s 1072G**)

14
Fundraising

Disclosure

[14.10] Public companies raise capital by offering securities to investors. The term "security" is defined for the purposes of **Ch 6D** in **s 761A** and includes a share, a debenture or an option to acquire either.

Disclosure in the appropriate form is required pursuant to **s 707** if the person making the offer controls the company; and if the securities are either not quoted or if quoted they are not for sale in the ordinary course of trading on the ASX (if the securities are quoted on the ASX their market value would be readily observable, thereby disclosure unnecessary); and unless the offer of securities is excluded under **s 708** or **s 708AA**. For example, the following offers do not need disclosure:

- small scale offerings falling within the 20 investors/$2 million ceiling;
- offers to sophisticated investors whose minimum investment is $500,000; or who have net assets of at least $2.5 million or a gross income for each of the last two financial years of at least $250,000 (these are the current amounts as set out in the *Corporations Regulations 2001* (Cth));
- offers to persons associated with the company, such as directors.

The key aspect of the fundraising provisions is to ensure investors are sufficiently protected when acquiring securities. It is also important to ensure that the costs involved for companies are minimised and that costs bear a relationship to the level of fundraising proposed. Accordingly, **Ch 6D** provides for four types of disclosure documents as set out in **s 709**. These are:

- Prospectus—this is the most complex and detailed form of disclosure and the content required is set out in **ss 710** and **711**. A prospectus must contain all the information that investors and their professional advisers would reasonably require to make an informed assessment of matters including: the rights and liabilities attaching to the securities; and the assets and liabilities, financial position and performance, profits and losses and prospects of the company issuing the securities. Relevant to such disclosure is the nature of the securities, matters that likely investors may reasonably be expected to know, and the fact that certain matters may reasonably be expected to be known to the relevant professional advisers. **Section 710** underlines the aims of the fundraising provisions in that it requires disclosure of clear and detailed information so that investors can be confident in their decision.

- Short form prospectus—information that has been lodged in a document with ASIC can be referred to in a short form prospectus without the need to set it out again (**s 712**). The reference must identify the prospectus and inform of the right to obtain a copy of the prospectus.
- Profile statement—subject to ASIC's approval, a profile statement providing a summary of the offer may be prepared (content **s 714**). A prospectus is still lodged with ASIC. A profile statement must state the nature of the risks involved in investing in the securities, give details of all amounts payable in respect of the securities, and state that a copy of the profile statement has been lodged with ASIC.
- Offer information statement (OIS)—used instead of a prospectus if the amount to be raised is $10 million or less (content **s 715**).

***Corporations Act 2001* (Cth), s 715**

Contents of offer information statement

(1) An offer information statement for the issue of a body's securities must:
  (a) identify the body and the nature of the securities; and
  (b) describe the body's business; and
  (c) describe what the funds raised by the offers are to be used for; and
  (d) state the nature of the risks involved in investing in the securities; and
  (e) give details of all amounts payable in respect of the securities (including any amounts by way of fee, commission or charge); and
  (f) state that:
    (i) a copy of the statement has been lodged with ASIC; and
    (ii) ASIC takes no responsibility for the content of the statement; and
  (g) state that the statement is not a prospectus and that it has a lower level of disclosure requirements than a prospectus; and
  (h) state that investors should obtain professional investment advice before accepting the offer; and
  (i) include a copy of a financial report for the body; and
  (j) include any other information that the regulations require to be included in the statement.

(2) The financial report included under paragraph (1)(i) must:
  (a) be a report for a 12 month period and have a balance date that occurs within the last 6 months before the securities are first offered under the statement; and
  (b) be prepared in accordance with the accounting standards; and
  (c) be audited.

(3) The statement must state that no securities will be issued on the basis of the statement after the expiry date specified in the statement. The expiry date must not be later than 13 months after the date of the statement. The expiry date of a replacement statement must be the same as that of the original statement it replaces.

Note 1: Subsection 716(1) requires the statement to be dated.
Note 2: Section 719 deals with replacement statements.

Regulation and liability concerning fundraising

[14.20] Fundraising is regulated to provide an equitable market and protection for investors. To achieve this goal:

- advertising is regulated pursuant to **s 734**. More stringent conditions exist before a disclosure document is lodged than after. However, the general principle in relation to all advertising is that the decision as to whether to participate in the offer or not should be made by the investor after consideration of the relevant disclosure document and not based on the material in advertisements or publicised in any summary format. To this end, **s 734(2)** sets out that where a disclosure document is required a person must not advertise the offer or intended offer. However there are exemptions to this prohibition in **s 734(2A)** which sets out that **s 734(2)** does not apply if the advertising or publicity is authorised in **s 734(4)**, **(5)**, **(6)** or **(7)**. For example, a disclosure document that has been lodged with ASIC may be disseminated without contravening **s 734(2)**.
- liability is imposed for contravention in **Pt 6D.3**. Note **s 728**, particularly regarding misleading or deceptive statements. A forecast will be misleading where there are no reasonable grounds for making the statement or where the assumptions underlying the risks are not clearly expressed. Civil penalties apply to the section. Also note **ss 1041E** and **1041F** targeting prohibited conduct relating to securities. Pursuant to **s 1041F** a person must not induce another to deal in financial products (this includes invest) by making or publishing a statement, promise or forecast if they know, or are reckless as to whether, that statement is misleading, false or deceptive. The section also deals with dishonestly concealing facts.
- where a person suffers loss or damage as the result of an offer of securities under a disclosure document contravening **s 728**, the persons liable are set out in **ss 729** and **730** and these include directors and those persons (experts) named in the disclosure document who have provided a statement that is included in the document.
- defences are available in **ss 731**, **732**, **733**. **Section 731** relates to prospectuses and provides that an offence pursuant to **s 728** is not committed where due diligence is proven. This involves making all inquiries that were reasonable in the circumstances as well as believing on reasonable grounds that the statement was not misleading or deceptive. **Section 732** deals with offer information statements and profile statements and sets out that a person does not commit an offence if they can prove that they did not know that a statement was misleading or deceptive; or can prove they did not know there was an omission. **Section 733** provides a general defence for all disclosure documents where reasonable reliance on others sufficiently distinct from the individual or company can be proven.

Breach of the provisions can result in any of the following: an injunction, corrective advertising, stop orders, civil liability, fines, and in some cases imprisonment. **Section 728(3)** sets out that an offence is committed if a misleading or deceptive

statement in a disclosure document, or an omission from a disclosure document, is materially adverse from the point of view of an investor. The relevant penalty in **Sch 3** is 15 years imprisonment. In *Fraser v NRMA Holdings Ltd* (1995) 55 FCR 452, the company issued a prospectus to enable the raising of funds as part of a restructuring, however failed to outline in the prospectus the disadvantages of the restructure. The court held that this failure amounted to misleading and deceptive conduct. The prospectus advised members of the motoring group that they would be "better off" as a result of the reorganisation and would receive "free shares" in the new company formed.

Fraser v NRMA Holdings Ltd (1995) 55 FCR 452 (Black CJ, von Doussa and Cooper JJ)

Extract from Judgment

At 486 and 487

The prospectus as a whole, but particularly in the President's letter and the Information to Members, strongly encourages a favourable response to the proposed restructure and conveys the recommendation of the majority of each board that under it the members will be "better off". We agree with the trial judge that the prospectus does not attempt to explain or quantify why this will be the case beyond the statement that the wealth of the NRMA organisation will be unlocked by giving each member the share entitlement identified on that member's onsert.

On p 6 of the prospectus, when repeating the recommendation of the Boards which was stated on p 1, it is said "The NRMA Boards have carefully considered the advantages and disadvantages of the proposal and have concluded that this proposal is in the best interests of members and the NRMA". Here is a statement that there are disadvantages to be considered, yet nowhere in the prospectus are the disadvantages identified, explained or compared with the perceived advantages. On p 11 the prospectus says the NRMA has considered the advantages and disadvantages of a range of *other* options and concluded that the share issue and listing on the Stock Exchange is in the best interests of members of the NRMA Five other options are discussed. This discussion fails to identify what the disadvantages of the recommended proposal might be …

This discussion fails to state, at least in any meaningful way, the disadvantages about the proposed restructure which the Boards had recommended, and fails to refer to the matters identified in the applicants' submissions. At p 15, where the prospectus for the first time discloses that three of the 16 directors of the Association and one of the 11 directors of Insurance are against the proposal, there is no statement of the dissenting directors—reasons which could serve to redress the failure of the prospectus otherwise to inform the members about the disadvantages of the proposal.

The prospectus asserts that under the proposed restructure members will be "better off" and strongly recommends a "yes" vote. In these circumstances the failure to identify and inform members about disadvantages of which the directors making the recommendation were aware was to leave the members in a half light which had the potential to lead them to think that the unidentified disadvantages, whatever they might be, must be ones that they would not treat as significant in relation to the rights being given up and the new rights to be acquired in a public

> listed company. This is more particularly so when it is remembered that, contrary to the notion engendered by the persistent use of the phrase "Free Shares", the shares might be acquired without significant loss or outgoing, the rights that would be surrendered were significant ones which were material to the members of Association in making a properly informed judgment.

Accordingly, public companies invite investment and raise share capital by offering securities for sale and the *Corporations Act 2001* (Cth) ensures that investors are protected by requiring disclosure pursuant to **Ch 6D**. The process of offering shares to the public by a new company is referred to as a "float". This process is also described as an IPO (initial public offering).

Large floats often involve substantial publicity. In September 2009, the department store Myer released its prospectus and offered its shares to both institutional (large investors such as superannuation funds) and retail (smaller, mostly individuals) investors. The following article looks at issues relevant to the listing of well-known companies with large client bases such as Myer. Having regard to the matters raised in the excerpt below it should be noted that to date the Myer share price has failed to exceed the issue price.

Myer's model behaviour no proof of value

There's something a little unsettling about the current campaign to sell Myer shares to the masses. Myer, a practised marketeer, has deliberately merged its shop-floor campaign, which fishes for an emotional response, into its share-offering campaign.

The problem is, any decision to invest in shares should not stem from emotional baiting. It should be grounded in analysis of the financial matrix underpinning the company, with prudent attention to the likely risk for the individual investor.

To be clear, nothing is *promised* in Myer's share marketing campaign; what it means to invest in its shares will not be known until the retailer releases its formal offer documents today, and no doubt that material will be packed with forecasts of sales and profits, projected returns on investment and plenty of disclaimers. The company has released detailed performance figures for 2008-09, and those results demonstrate impressive achievements in cutting costs and improving stock-delivery.

At one level, the strategy of pushing shares to Myer customers might be intended to imbue the register with a kind of stickiness; perhaps Myer figures its loyal customers will be less impulsive sellers than the ordinary punter if its share price swings the wrong way.

But the word from the Myer bunker is that the rationale is to double-up the loyalty that its customers already have for the store brand: once a customer is a shareholder (so the theory goes) then they would be more likely to spend at Myer. It's the idea, valid or otherwise, that by putting money into the till, you can take it out later in dividends.

Original source article by Leonie Wood, *The Age*

The purpose of the regulation of fundraising in the *Corporations Act* is to ensure investors are protected and that the level and accuracy of disclosure presents a true picture of the company's financial prospects. In *Pancontinental Mining Ltd v Goldfields*

Ltd (1995) 16 ACSR 463, the court considered that where forecasts are given they should be prominent and in a form that allows investors to focus their attention on the earning potential of the company. In that case, it was held that risks involved in a mining venture in Papua New Guinea were not sufficiently described. Investors are not only reliant on the adequate disclosure of risks but also on the accurate forecasting of profit. Poor financial planning or over-confident speculation by companies can create danger for investors, and, as the following newspaper article brings out, so can an unexpected change in market conditions.

RAMS' sudden about-face on profit forecast turns into one of the great IPO flops

In the space of two days there has been a big change of heart in the RAMS Home Loans groups. There has also been a change of heart among investors. Floated only three weeks ago at an issue price of $2.50 a share, the share price went into freefall yesterday.

RAMS directors said yesterday the current issues were being experienced as a result of the tightening in global credit markets "and not the performance of the company", noting that the underlying business continued to operate profitably.

Disgruntled subscribers to the public offer may focus on the assumptions used in setting the 2008 earnings forecast. One of those was that there would be "no material change" in liquidity in global RMBS and XCP markets. They may query whether that was a reasonable assumption. The prospectus was dated 25 June and by that time the sub-prime mortgage crisis in the US had been running for some months.

Original source article by Bryan Frith, *The Australian*

Investor confidence is vital for an active securities market, and this requires access to reliable information as to the financial standing and prospects of public companies that are in the process of raising capital. Where such information is not available ASIC can bring proceedings. The following newspaper article sets out details in relation to a prospectus that did not meet the relevant disclosure requirements in the *Corporations Act*.

Fincorp told to give money back
Prospectus omitted facts

Finance company Fincorp Investments has given an undertaking to a Federal Court that it will offer investors who placed money with the company over a seven-month period the right to redeem their funds without penalty.

The Australian Securities and Investments Commission took Fincorp to court in March alleging the group's 2004 prospectus was misleading and omitted crucial information required by the *Corporations Act*.

Fincorp consented to a court declaration that the prospectus did not adequately disclose information about the security and risks associated with loans for property developments funded by the aggressive financier to companies associated with it.

That prospectus pulled in $75 million but Fincorp estimates that only $21 million is affected by the consent orders, covering 1132

investors. It has undertaken to contact these investors to offer investment refunds.

After ASIC commenced action against Fincorp, which pitched advertisements at retirees, Fincorp issued a new prospectus which outlined the risks faced by its investors.

Fincorp's ads featured messages such as "invest with certainty" and a "strong measure of security so they [investors] can sleep soundly at night".

Fincorp finances a range of projects at various stages of development, with a significant proportion of the loans extended to related parties.

"This is a case where investors could not get a proper understanding of the security they were getting and the risks they were taking because Fincorp's prospectus wasn't up to scratch," ASIC's deputy chairman Jeremy Cooper said.

"If you are in the business of lending for property developments then your prospectus has got to say so."

Original source article by Anne Lampe, *The Sydney Morning Herald*

***Corporations Act 2001* (Cth), s 728**

Misstatement in, or omission from, disclosure document
Misleading or deceptive statements, omissions and new matters

(1) A person must not offer securities under a disclosure document if there is:
  (a) a misleading or deceptive statement in:
    (i) the disclosure document; or
    (ii) any application form that accompanies the disclosure document; or
    (iii) any document that contains the offer if the offer is not in the disclosure document or the application form; or
  (b) an omission from the disclosure document of material required by section 710, 711, 712, 713, 713C, 713D,713E, 714 or 715; or
  (c) a new circumstance that:
    (i) has arisen since the disclosure document was lodged; and
    (ii) would have been required by section 710, 711, 712, 713, 713C, 713D, 713E, 714 or 715 to be included in the disclosure document if it had arisen before the disclosure document was lodged.

Crowd-sourced funding

[14.30] Whereas regulation of traditional equity fundraising methods has been evident in the corporations legislation for a significant period of time, more recent funding methods have posed new challenges for the regulators. A particular example is crowd-sourced equity funding (CSF). This is a relatively new concept made possible by the increased use and sophistication of internet technologies. The idea behind CSF is to facilitate online fundraising by start-up and other small scale enterprises. **Pt 6D.3A** of the *Corporations Act* provides a regulatory framework for equity-based crowd-sourced funding. Protection for investors is accomplished by the need for an intermediary with

an Australian Financial Services licence to hold investors funds pending satisfactory completion of the acquisition. **Section 738Q** sets out the gatekeeper obligations of an intermediary including that prescribed checks in accordance with the CSF regulations must be conducted before the offer is published on the intermediary's platform. The CSF provisions in the *Corporations Act* enable unlisted public companies limited by shares and proprietary companies with less than $25 million in consolidated assets and annual revenue to make offers of ordinary shares to retail investors through a licensed CSF intermediary's platform, using a CSF offer document. An eligible CSF company must have at least two directors and the majority of directors must ordinarily reside in Australia (**s 738H**). Eligible companies can raise up to $5 million in any 12-month period under the CSF regime (**s 738G**).

Where proprietary companies seek to fund by way of the CSF provisions **s 113** provides that CSF shareholders are not to be counted in the shareholder limit calculation for the purposes of the section. Further, the restriction in **s 113(3)** on proprietary companies engaging in activity that would require disclosure under **Ch 6D** does not apply to a CSF offer.

The fact that a company makes a CSF offer of securities does not prevent the company from also making an offer of securities of the same class in reliance on a provision of **s 708** (see **s 738E**).

Summary—Fundraising

Public companies raise funds by offering securities to investors

Disclosure of the offer is needed (**s 706**) unless an exception applies

Example of an exception in **s 708**: sophisticated investor (at least $500,000)

Disclosure documents are set out in **s 709** and include: prospectus; short form prospectus; profile statement; offer information statement

Aim of the legislation is to provide prospective investor with adequate information: **s 710**

Advertising of the offer is restricted

There are penalties for misleading disclosures: **s 728**

The *Corporations Act* regulates CSF to facilitate online fundraising initiatives

15
Share Capital

[15.10] The board of directors (on behalf of the company) may issue shares at its discretion. Generally shareholder approval is not required unless, for example, the issue results in a variation of class rights (**s 246B**).

Even though directors have the power to issue shares certain restrictions exist, such as:

- **Section 113(3)** sets out that a proprietary company must not engage in any activity (such as issuing shares or debentures) that would require disclosure under **Ch 6D** unless it is an offer of shares to existing shareholders, or employees of the company or its subsidiary, or a CSF offer.
- A proprietary company may have a pre-emption clause in its constitution requiring that new shares be offered to existing shareholders on a proportionate basis prior to being offered to outsiders. **Section 254D** is a replaceable rule to this effect.

Maintenance and reduction of share capital

[15.20] Shareholders have rights via the *Corporations Act 2001* (Cth) (including the replaceable rules). A share is an item of personal property. It does not entitle the holder to ownership of company assets but rather gives various rights such as the right to vote and the right to a dividend. In the same way as other forms of property, shares can be sold, transferred by way of gift, used as security or held on trust.

The issue of shares produces share capital. In the common law, the rule in *Trevor v Whitworth* (1887) 12 App Cas 409 stated that share capital must be maintained for the benefit of creditors. That case involved the executors of the estate of a deceased shareholder selling his shares back to the company. The company went into liquidation before the second payment was made. Of importance to the Court was that the capital of a limited company should remain available to the creditors. Accordingly, even though the ability to purchase its own shares existed in the company's constitution, to do so was a reduction of capital and the agreement to purchase the shares void. In limited liability companies, creditors are restricted as to the extent that they can pursue individuals in the company and accordingly rely on the existence of a pool of available assets. This requirement that capital be maintained is currently reflected in a number of ways. These include the manner in which **s 254T** regulates the payment of dividends; the restrictions on a company acquiring its own shares or giving financial assistance to acquire its shares; and the restrictions the *Corporations Act* puts on the reduction of capital.

A reduction of capital may be mandatory, that is, compulsory for shareholders to comply. Such situations are subject to the requirements set out in **s 256B(1)**. The reduction must:

- be fair and reasonable to the company's shareholders as a whole;
- not materially prejudice the company's ability to pay its creditors; and
- be approved by the shareholders by resolution.

Note that the *Corporations Act* distinguishes between an "equal" reduction which relates only to ordinary shares and requires an ordinary (more than 50%) resolution and a "selective" reduction that involves preference shares and requires a special (75%) resolution (**s 256C**).

Alternatively, a reduction of capital may be optional. In this regard, **Pt 2J.1** dealing with share buy-backs is relevant to the procedure to be followed.

Together with the permitted means of share capital reduction mentioned above, the *Corporations Act* regulates share capital by way of the provisions dealing with the self-acquisition of shares by the company (**s 259A**) and by setting out the guidelines for when the company may provide financial assistance to a person for the purpose of acquiring its own shares (**s 260A**). A contravention of **s 259A** does not affect the validity of the acquisition, however, a person involved in the contravention will be subject to the civil penalty provisions and if dishonesty is established an offence will be committed. Unrestricted reduction of share capital would mean that companies in financial difficulty could redistribute cash or other assets to shareholders and as a result reduce the company's ability to meet its creditors' claims.

Share buy-backs

[15.30] Share capital may be legitimately reduced by way of a buy-back. The *Corporations Act* sets out that a company may buy back its own shares provided to do so does not materially prejudice its creditors and is carried out in accordance with the procedures in **Pt 2J.1**. One reason that a company may seek to use the buy-back provisions occurs where it has accumulated excess capital that it is not able to beneficially use in the carrying on of its business enterprise. A buy-back may also increase the earnings per share, provide taxation advantages, guard against company instability by encouraging the removal of dissident shareholders, and in some cases, form part of a target company's defence tactics to resist a takeover bid.

There are five types of buy-back set out in **s 257B**:

- Equal access scheme: all ordinary shareholders participate on the same basis with the offer seeking the same percentage of shares from each shareholder.
- Selective buy-back: the buy-back offer is only made to certain shareholders and a pre-condition to this type of buy-back is that one of the following take place: either; a special resolution passed at a general meeting of the company with no votes being cast in favour of the resolution by any person whose shares are proposed

to be bought back, or a resolution at a general meeting agreed to by all ordinary shareholders (a unanimous resolution).

- On-market buy-back: involves a listed company and is conducted via the stock exchange. Shareholders participate equally and where the 10/12 rule (buy back of only 10% each 12 months) is exceeded, an ordinary resolution is required.
- Minimum holding buy-back: in this type of buy-back a listed company seeks to buy back small holdings of shares that are below what is termed a "marketable parcel".
- Employee share scheme: when shares are issued to employees, a term of issue often enables the shares to be bought back by the company. If the 10/12 rule is exceeded, an ordinary resolution is required.

Certain matters are relevant to the ability of a company to reduce its capital by way of a share buy-back. These include the following:

- The aim of the statutory provisions is to protect shareholder interests and ensure shareholders have sufficient information as to the consequences of their decision.
- In some cases, documents must be lodged with ASIC (**s 257E**).
- The company cannot deal in shares it buys back. Pursuant to **s 257H(3)**, immediately after the registration of the transfer to the company of the shares bought back, the shares are cancelled.
- ASIC must be notified of the cancellation of shares (**s 254Y**).
- Where the 10/12 rule applies, the limit for a company proposing to make a buy-back is 10% of the smallest number, at any time during the last 12 months, of votes attaching to voting shares of the company (**s 257B**).

The issue of the solvency of the company is relevant to the application of the buy-back provisions. The company's creditors must not be put at risk as a result of the buy-back. Directors must be particularly careful that by undertaking the financial obligations attached to the buy-back, the company does not become insolvent (**s 257J**).

Unlike a reduction of capital under **s 256B**, a buy-back is not mandatory and it is up to the shareholder to decide whether or not to sell their shares. The *Corporations Act* provisions are designed to enable the company's shareholders to fairly assess the buy-back offer and accordingly make an informed decision as to whether they sell or hold their shares.

Accordingly, in certain instances under the *Corporations Act*, it is possible for a company with a legitimate need to alter its capital structure to return capital to its members. In the general law, the rule in *Trevor v Whitworth* would prevent a company buying back its own shares because this would have resulted in a reduction of its capital. However, the *Corporations Act* acknowledges the commercial benefits of certain authorised reductions of capital in sections such as **s 257A** allowing a company to buy back its own shares provided the relevant procedures are followed. While the *Corporations Act* strictly controls buy-backs, there is nonetheless the opportunity for

flexibility where shareholders approve. For example, the restrictions imposed by the 10/12 rule can be overcome if, pursuant to **s 257C**, an ordinary resolution is passed at a general meeting of the company authorising the terms of the buy-back.

The following newspaper article refers to an on-market buy-back. It seems that the company was only seeking to buy-back up to 10% which would mean that the shareholders would not be required to vote on the proposal as the 10/12 rule would not be infringed. Note that although the article suggests that the company, James Hardie, believed the "asbestos compensation scandal" was no longer relevant, that prediction was wrong as the fallout (including the issues surrounding the directors' breach of duty) continued.

Cashed-up Hardie plans share buyback

James Hardie Industries yesterday wowed investors by saying it had not only resisted the fierce downturn in the US housing market to post a rise in quarterly profit, but had enough spare cash for a share buyback plan …

Hardie announced that with its asbestos compensation scandal largely behind it, it would launch an on-market buyback program to purchase up to 10 per cent of its issued capital.

Chief executive Louis Gries said there was no fixed program for buying back shares, which would be purchased "opportunistically".

"Shareholder approval of the (asbestos) compensation-funding proposal was achieved in February and, taking into consideration the company's strong cash generation and low level of debt, we believe it prudent to commence returning capital to shareholders," Mr Gries said.

Original source article by Ean Higgins, *The Australian*

Classes of shares

[15.40] Companies may issue different classes of shares. There may be several reasons why a company chooses to issue more than one class of shares such as: to confine control of the company to one class of shareholders such as a family group; or to provide differing dividend distributions. **Section 254B** sets out that a company may issue shares on the terms it sees fit including matters as to the rights and restrictions attaching to those shares. The main two, and most common, classes of shares are ordinary shares and preference shares.

Ordinary shares

[15.50]

- Shareholders have residuary rights.
- Shareholders returns are tied the company's success.
- The entitlement to a dividend arises pursuant to the constitution (**s 254U**).

Preference shares

[15.60] The company's right to issue preference shares is contained in **ss 124** and **254A**. Generally, the preference involves a priority in the payment of dividends and

a right to receive dividends at a fixed percentage of the issue price of their shares. Pursuant to **s 254A(2)**, the rights of preference shareholders are to be set out in the constitution or otherwise approved by special resolution. Note that normally where a company issues preference shares it will also have issued ordinary shares. However, it is nonetheless possible for a company, in certain circumstances, to issue preference shares solely. In *Beck v Weinstock* (2013) 251 CLR 425; [2013] HCA 15, the High Court considered whether a family company could be structured so that only preference shares were issued thereby providing benefits to members upon a winding up. The Court held the arrangement valid and that the *Corporations Act* did not require companies limited by shares to have more than one class of share.

Categories of preference shares

[15.70]

- Cumulative: the entitlement to a dividend carries forward if not able to be paid by the company in any particular period.
- Non-cumulative: the entitlement does not carry forward.
- Redeemable: this category of preference shares can be redeemed (paid out) at a fixed time or at the option of the company or shareholder (**s 254A(3)**). Redeemable preference shares receive a set rate of dividend and have characteristics similar to borrowed funds. They can be redeemed only on the terms on which they were issued, if the shares are fully paid up and out of the profits or proceeds of a new issue of shares made for the purpose of the redemption (**s 254K**). While preference shareholders will mostly receive their fixed rate of dividend in circumstances where the company has financial restrictions (although ordinary shareholders may not), matters such as the prohibitions regarding a reduction of capital in **s 256B** and the matters relevant to the payment of dividends in **s 254T**, including that the company's assets exceed its liabilities, the payment is fair and reasonable and the payment does not materially prejudice the company's ability to pay its creditors, will still be relevant.
- Participating: there is a right to additional dividends if a surplus exists in any particular period.
- Converting: a priority dividend is paid for a fixed period and then the shares convert to ordinary shares.

Variation of class rights

[15.80] There is protection for shareholders of different classes under the *Corporations Act*. Varying and cancelling class rights are dealt with in **Pt 2F.2**. Specifically, **s 246B** sets out that if a company has a constitution that includes the procedure for varying or cancelling class rights then the provisions of the constitution must be complied with. Where the company does not have a constitution, or its constitution is silent on the

issue of varying or cancelling rights, then **s 246B(2)** requires a special resolution of the company and either a special resolution of the effected class or the written consent of members of the class holding 75% of the vote. **Section 246D** allows for shareholders of a class (provided they form at least 10% of that class) who do not agree to a variation or modification of their class rights to apply to the court who may then determine to set aside the variation or modification if it would unfairly prejudice the applicants.

Class rights that can be protected include rights to dividends and rights to vote on the appointment of directors. The protection was interpreted strictly in *Greenhalgh v Arderne Cinemas Ltd* [1946] 1 All ER 512 where a member's holding was increased by subdivision effectively giving him five shares (and equivalent votes) for each share. At a later date, the company applied the same concession to all of its members. The court did not consider that this action constituted a variation of rights even though the member's commercial advantage was affected. Enforcing class rights may depend on the manner of classification. In some cases, class rights attach to the shares or perhaps arise from an intention in the constitution. In *Cumbrian Newspapers Group Ltd v Cumberland and Westmorland Herald Newspaper and Printing Co Ltd* [1987] Ch 1, it was held that shares can in fact be included in a separate class where the holder of those shares has special rights even though the rights are not attached to the particular shares.

Summary—Share capital

The issue of shares produces share capital for the company

Rights attach to shares: the right to vote, the right to notice of meetings

Types of shares: ordinary; and preference

Preference shares have benefits such as a priority of dividend payment

Rule as to maintenance of capital—*Trevor v Whitworth*

Exceptions to the rule: capital reductions **s 256B**; buy-backs **s 257B**

Reductions under **s 256B** are mandatory but must be fair and not prejudice creditors

Shareholders choose whether to participate in the buy-back, buy-backs are optional

Shares bought back are cancelled

Shareholders class rights are protected (**s 246B**)

16
Dividends

[16.10] A dividend is a payment to a shareholder; it is a return on the shareholder's investment in the financing of the company and is one of several ways the company can deal with its profit (eg, seven cents per share for the period 1 January 2020 to 30 June 2020). Dividends are treated as income by the recipient and included in assessable income. They are generally paid in cash and can be either franked (this means that the company has paid tax on the dividend) or unfranked. The imputation system of company taxation is based on the premise that shareholders receiving assessable dividends from a company are entitled to a tax offset for the amount of tax paid by the company. Any tax paid by the company on a distribution to a shareholder is allocated to that shareholder by way of an imputation credit attached to the distribution. The distribution (dividend) is then referred to as franked. It is also possible, though not common, to pay a dividend by way of the distribution of bonus shares.

Matters relevant to payment of a dividend

[16.20] Dividends are payable in accordance with **s 254T**.

> ***Corporations Act 2001* (Cth), s 254T**
>
> Circumstances in which a dividend may be paid
>
> (1) A company must not pay a dividend unless:
> (a) the company's assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend; and
> (b) the payment of the dividend is fair and reasonable to the company's shareholders as a whole; and
> (c) the payment of the dividend does not materially prejudice the company's ability to pay its creditors.

This section formulates a solvency-based test as to payment of dividends. For example, the payment of a dividend would materially prejudice the company's ability to pay its creditors if the company would become insolvent as a result of the payment. Further, the calculation of assets and liabilities for the purposes of **s 254T(1)(a)** is to be carried out in accordance with accounting standards in force at the relevant time (even if the standard does not otherwise apply to the financial year of some or all of the companies concerned). The focus on solvency as a basis of payment of a dividend has parallels to the principals governing reduction of capital under **s 256B**. This section requires that any reduction is fair and reasonable to shareholders; does not materially

prejudice the company's ability to pay its creditors; and is approved by shareholders. In circumstances where a dividend is paid that does not satisfy the requirements of **s 254T**, the payment may thereby be in breach of **s 256B** and as such an unauthorised reduction of capital. Directors authorising the payment of the dividend in breach of **s 256B** will, pursuant to **s 256D**, be subject to civil penalty orders. Where the contravention of **s 256B** involves dishonesty an offence is committed (**s 256D(4)**) the penalty being a fine and/or imprisonment for up to five years (**Sch 3**). Further, where dividend payments result in insolvency the insolvent trading provisions of **s 588G** may apply resulting in liability for the directors.

The decision to pay a dividend

[16.30] The rules regarding the payment of a dividend may be set out in a company's constitution. If this is not the case then prior to the *Company Law Review Act 1998* (Cth) the manner of payment of a dividend involved a recommendation by the directors to the general meeting of shareholders that a dividend be paid. If the shareholders by majority agreed, they would vote and declare the dividend. A company formed prior to 1998 that has retained the Table A Articles of Association would still declare dividends in this manner. However, since 1998, newly formed companies automatically take the replaceable rules. **Section 254U** now gives the overall authority to the directors to determine the amount, time and method of payment of a dividend. Note though that as **s 254U** is a replaceable rule it is up to the shareholders, who can amend or replace the section by way of a special resolution (75% majority) to determine whether they wish to rest control for the payment of dividends with the directors or not.

In certain circumstances where dividends are not paid in a profitable company, shareholders may feel their interests clash with those of the company or its directors. In this situation, it is possible for shareholders to seek relief pursuant to **s 232**. This section requires the shareholder to establish that they were oppressed, unfairly prejudiced or unfairly discriminated against. If successful a court can make orders under **s 233** (for a discussion of relevant cases see [25.50]).

***Corporations Act 2001* (Cth), s 254U**

Other provisions about paying dividends (replaceable rule—see section 135)

(1) The directors may determine that a dividend is payable and fix:
  (a) the amount; and
  (b) the time for payment; and
  (c) the method of payment.
  The methods of payment may include the payment of cash, the issue of shares, the grant of options and the transfer of assets.
(2) Interest is not payable on a dividend.

When the dividend becomes a debt

[16.40] Although a company is not necessarily required to pay a dividend, once the decision has been made certain rights fall to the shareholders. **Section 254V** sets out how the relationship between the shareholders and the company regarding dividends is to be determined.

> ***Corporations Act 2001* (Cth), s 254V**
>
> When does the company incur a debt?
>
> (1) A company does not incur a debt merely by fixing the amount or time for payment of a dividend. The debt arises only when the time fixed for payment arrives and the decision to pay the dividend may be revoked at any time before then.
> (2) However, if the company has a constitution and it provides for the declaration of dividends, the company incurs a debt when the dividend is declared.

Differences exist between companies with a constitution or those that have merely retained the replaceable rules. Without a constitution, **s 254V(1)** applies and the obligation to pay a dividend becomes a debt enforceable by the shareholder only when the time fixed for payment arrives. This means that the company does not incur a debt to shareholders merely by announcing a time for payment or by setting out an amount. By enabling the decision to pay the dividend to be revoked before the time for payment the directors can better monitor whether the company continues to be in a position to pay a dividend having regard to the obligations in **s 254T**. However pursuant to **s 254V(2)** a company with a constitution that includes a provision for the declaration of dividends becomes liable to its shareholders once the dividend is declared. As there is usually a lapse of time between the declaration (or the determination) of a dividend and its payment to the shareholder it is possible in this situation that the issue of a company's sudden insolvency may raise compliance issues with **s 254T**.

An interim dividend is a payment based on a profit that will be disclosed in the annual accounts which at that time have not been finalised. Shareholders cannot enforce payment of an interim dividend before it is actually due (*Brookton Co-operative Society Limited v FCT* (1981) 147 CLR 441, and also **s 254V**).

The move from a profits test to a balance sheet solvency test

[16.50] The assets and liabilities test relevant to **s 254T(1)(a)** is based on the accountancy standards at the relevant time. While this introduces some predictability there is nonetheless a distinction in the level of financial obligations between, for instance a small proprietary company that does not, unless required pursuant to **s 292(2)**, have to prepare financial and directors reports, and a public company that not only must prepare these reports but also requires an audit. The result of this

distinction is that the level of financial information upon which the **s 254T** assets and liabilities test will be based may not be consistent as between public and proprietary companies. Prior to the present test for payment of dividends in **s 254T**, the basic principle was that dividends must be paid out of profit. There was no definition of profit in the *Corporations Act 2001* (Cth) and its meaning as identified in the cases was illustrative rather than definitive. In *Re Spanish Prospecting Co Ltd* [1911] 1 Ch 92, it was held that the fundamental meaning of profit was the amount of gain made by a business during a fixed period, usually a year. This involved a comparison of the assets at the beginning of the period and at the end. The lack of a definitive benchmark gave rise to a number of modifications. These are no longer directly relevant to **s 254T** but are indicative of how the relationship between a company's standing and the payment of dividends developed. Previously it had been held that in certain circumstances: a trading profit in the current year could be distributed notwithstanding a previous capital loss (*Lee v Neuchatel Asphalte Co* (1889) 41 Ch D 1); a trading profit in the current year could be distributed notwithstanding a previous trading loss (*Ammonia Soda Co Ltd v Chamberlain* [1918] 1 Ch 266); profit resulting from carrying on the business (circulating capital) could be distributed notwithstanding a current year loss by way of a decline in the value of fixed capital assets; and a capital revaluation resulting in an unrealised capital profit could be distributed (*Dimbula Valley (Ceylon) Tea Co Ltd v Laurie* [1961] Ch 353; *Australasian Oil Exploration Ltd v Lachberg* (1958) 101 CLR 119).

The movement away from attempting to define and then identify profit is consistent with a stakeholder (particularly creditor) perspective of company legislation. The solvency-based test found in **s 254T** looks to ensuring a company's viability following payment of a dividend (as opposed to simply focussing on profits) and in this regard protects the interests of its creditors. These concerns have become relevant as a result of financial uncertainty and increasing corporate insolvency.

Summary—Dividends

A dividend is a return on a shareholder's investment, a share of company profit

The payment of a dividend is subject to **s 254T**

The company's solvency is relevant to the payment of a dividend

Not an absolute right—directors have a discretion as to payment: **s 254U**

If the constitution provides for declaration of a dividend, a debt to shareholders arises on declaration

If the replaceable rules are retained a debt to shareholders does not arise until payment: **s 254V**

Dividends not limited to cash—may be by way of bonus share issue

17
Debentures and Loan Capital

Debentures and the requirement for a trust deed

[17.10] A company is a separate legal entity and, just like a natural person, it can borrow funds for the purpose of carrying on its business.

Debentures are documents that either create or acknowledge an obligation by a company to repay a debt. A broad definition is found in **s 9** setting out that a debenture means a chose in action that includes an undertaking by the company to repay as a debt money deposited with or lent to it. Accordingly, debentures secure loans to a company and thereby provide capital.

Section 283BH describes the three forms of debenture:

- mortgage debenture (the company gives security over real property (land) but not in excess of 60% of its value);
- debenture (the company gives security by way of a security interest over its personal property);
- unsecured note (neither of the above, no security given).

Pursuant to **s 283BH(3)**, the term debenture will apply where the repayment of all money that has been, or may be, deposited or lent under the debentures has been secured by a security interest in favour of the trustee over the whole or any part of the tangible property of the borrower or of any of the guarantors; and that property is sufficient to meet repayment.

The most common way companies borrow is from single lenders (like banks) and the lender takes a security interest over the company's assets. However, public companies may seek to raise funds from multiple lenders who wish to invest smaller sums. As these offers of investment are made to the public, they must comply with the requirements for disclosure set out in **Ch 6D**. Further, in certain circumstances, a company raising capital by offering debentures to the public must set up a trust deed and appoint a trustee (**s 283AA**). The appointment of a trustee has the effect of protecting each of the individual debenture holder's interests and in this respect the trustee appointed will have the various duties set out in **s 283DA**. Such duties include exercising reasonable diligence to determine if the company has breached the terms of the debenture or the *Corporations Act 2001* (Cth), notifying ASIC in certain circumstances, and complying with debenture holders' directions.

Section 283AC sets out who may be trustees and these include: the Public Trustee, an Australian authorised deposit-taking institution (ADI) such as a bank, and a body corporate approved by ASIC.

The company becomes subject to various obligations if it raises funds by offering debentures to the public. For example, the company (borrower) must carry on and conduct its business in a proper and efficient manner (**s 283BB**), must inform the trustee within 21 days of the creation of any security interest over its property (**s 283BE**) and give both the trustee and ASIC quarterly reports that are to include matters such as circumstances that may result in the trust deed becoming enforceable (**s 283BF**).

A company is required by **s 171** to keep a register of debenture holders. This register is to contain the name and address of each debenture holder and the amount of the debentures held. To protect the interests of debenture holders and to provide a level of security and predictability to the process of issuing debentures to the public, the *Corporations Act* gives the court wide powers to make orders in relation to the interests of debenture holders in **s 283HB**. An application under this section can be made by the trustee or ASIC.

Security interests

[17.20] Where companies borrow and then default on their repayments or perhaps fail to repay an outstanding balance due, their creditors have the right to sue in contract. In some circumstances, the initiation of proceedings by the creditor may be time-consuming and only partially successful. Accordingly, and in order to provide the creditor a more direct pathway to recoup amounts outstanding, especially where larger sums are involved, a company may be required to give a creditor security over some or all of its assets (so that the creditor will be able to take company property if the company defaults). The manner and procedure by which companies grant security is regulated by the *Personal Property Securities Act 2009* (Cth), referred to hereafter as the *PPS Act*, and the *Corporations Act*. Prior to the *PPS Act* the terminology used was that the company "charged" assets in favour of the creditor. The secured creditor, often a bank or other financier, was referred to as the chargee (or charge-holder) and a deed of charge set out the terms of the company's indebtedness, including remedies available to the creditor. An important creditor remedy under a charge was to appoint a receiver. Charges were either fixed (specific assets) or floating (category of assets). The *PPS Act*, which commenced operation in 2012, no longer uses these descriptions. The process though, is similar. Pursuant to the *PPS Act* companies grant security interests to creditors, such as banks (security holders), the security interest document (security agreement) sets out the terms, the security can cover circulating and non-circulating assets, and receivers can be appointed where default occurs.

A "security interest" is an interest in personal property provided for by a transaction that secures payment or the performance of an obligation. The form of the transaction and the identity of the person who has title to the property do not affect whether an interest is a security interest. A "grantor", who owns or has an interest in the property which is the subject of a security interest for the purposes of the *PPS Act* may be an individual or a company.

Personal property includes both tangible and intangible property, but not real property (land). Personal property is described as "collateral" if it is (or is anticipated to be) the subject of a security interest. A security interest is enforceable against a grantor (such as a company) when it attaches to collateral. A security interest attaches to collateral when a party (such as a bank) gives value (such as advancing funds) for acquiring the security interest (or does something else to acquire it), and in return, that secured party gains rights in the collateral. A common means of enforcement of a security interest where a company is in default is by way of the appointment of a receiver.

A security interest is enforceable against third parties when it has attached to the collateral and either the secured party has possession or control of the collateral, or a security agreement, such as a loan agreement, covers the collateral.

Types of security interests

[17.30] Security interests can be classified as either non-circulating (similar to the old "fixed" charge) or circulating (similar to the old "floating charge"). A non-circulating security interest attaches to specific property of the company (such as equipment used in the business in the company's possession or control) and which is identified in the security agreement. A circulating asset will be one where the secured party has agreed to the transfer (and replacement) of the asset by the company in the ordinary course of business. In this way, the secured party has a security interest in a category of assets (eg, trading stock). This allows for the necessary replacement of particular items of collateral by the company over time and protects the creditor's rights as the replacement assets would be subject to the creditor's circulating security interest. The question of whether the company has defaulted under the circulating security interest would depend on the terms of that security agreement. Whether a company's use of the collateral is in the ordinary course of business will depend on the specific circumstances. For example, in *Reynolds Bros (Motors) Pty v Esanda Ltd* (1983) 1 ACLC 1333, it was held that even transactions that were unusual in their nature can still be in the ordinary course of the business. In that case, the transfer of certain tractors by a company dealing in agricultural products, to reduce a debt, was seen by the court as essential to the continuation of the company's business and was therefore in the ordinary course of business. Accordingly, no breach of the creditor's rights in relation to the circulating security interest (a "floating charge" in this case) occurred.

Registration and priority

[17.40] In relation to the enforcement of security interests, a security interest in collateral that is "perfected" takes priority over another competing security interest that is unperfected. A security interest is "perfected" if: it has attached to collateral; it

is enforceable against third parties; and certain extra steps have been taken to protect the interest. These steps include possession or control of the collateral, or registration on the Personal Property Securities Register. The Register is administered by the Australian Financial Security Authority (AFSA).

The PPS Register is a single point of contact register for consumers, businesses and the finance industry. Consumers and business operators can search the PPS Register when they need to know whether certain personal property has a security interest registered against it. This in turn provides protection for security interest holders who have registered. Registration will benefit finance companies that provide loans on the basis that they receive a security interest in an item of personal property, as well as business operators who sell personal property on credit, consignment, or pursuant to a retention of title arrangement. The Register can be accessed electronically seven days a week, 24 hours a day. It has replaced ASIC's Australian Register of Charges.

Where companies grant security over assets, there are two distinct enforcement issues. One is between the company and the security interest holder and is in effect about enforcing a contract. The other is between competing security interest holders. In this regard, the issue of priority is important. The secured party whose security interest has the highest priority is entitled to enforce that interest ahead of secured parties with security interests that have a lower priority. Priority is determined as follows (*PPS Act*, s 55):

- As between security interests that are unperfected the order of attachment (creation of rights) is relevant.
- A perfected security interest has priority over an unperfected interest.
- If two or more security interests are perfected, priority is the earliest of: the time of registration; perfection by control; temporary perfection under the *PPS Act*.

Retention of title clauses

[17.50] The *PPS Act* allows for a degree of certainty for suppliers in relation to arrangements where the company takes possession of goods supplied but has not yet paid, or fully paid, for them. Where goods are supplied on credit suppliers (sellers) may, to protect themselves, insert a retention of title clause in the contract of sale (called a "Romalpa" clause—*Aluminium Industries Vaassen BV v Romalpa Aluminium Ltd* [1976] 2 All ER 552). A retention of title clause provides that ownership of the goods supplied does not pass to the purchaser (such as a company) until the goods have been paid for. The *PPS Act*, and **s 51F** of the *Corporations Act*, provides for such retention of title clauses to be classified as security interests and thereby the *PPS Act* requirements regarding perfection and registration apply.

Invalidation of security interests

[17.60] The *PPS Act* includes certain provisions (in *PPS Act*, Pt 2.5) enabling a person to take collateral free from existing security interests (eg, be able to exercise certain

rights in relation to company property even though another party has a security interest in that same property). This also occurs in the *Corporations Act*, where security interests may be rendered void in certain circumstances. A basis of these sections is to encourage creditors to "perfect" their security interest without undue delay, and also to discourage creditors from taking security over the assets of a failing company in the grip of insolvency and in the immediate period before liquidation. For example, pursuant to **s 588FJ**, a circulating security interest created during the six months ending on the relation-back day is void against the company's liquidator. The relation-back day is either the day on which the application for an order that the company be wound up was filed (such as a compulsory liquidation) or the day on which the winding up is deemed to have commenced (such as in a voluntary liquidation).

A further instance of security interests becoming invalid is found in **s 588FL**. Here the *Corporations Act* focuses on the issue of registration and unless the secured party has "perfected" the interest by registration in accordance with the time period set out in **s 588FL** the security interest vests in the company and the secured party loses their right of enforcement. To avoid losing the right to enforce the security interest the secured party must have registered at least six months before winding up (liquidation) of the company, voluntary administration, or the company executing a deed of company arrangement (all included in the definition of "the critical time" in **ss 513A-513C**); or within 20 business days of the security agreement that gave rise to the security interest coming into force; or a later time as ordered under **s 588FM**. Note that pursuant to **s 588FM**, an extension of the time for registration may be sought where the failure to register the collateral was accidental, due to inadvertence or other sufficient cause and did not prejudice the position of creditors. The appointment of a liquidator (or administrator) will not necessarily prevent the court from extending the time for registration (*Hewlett Packard Australia Pty Ltd v GE Capital Finance Pty Ltd* (2003) 47 ACSR 51; [2003] FCAFC 256).

The company's capacity to grant a security interest can be misused where directors or other officers, being aware of the company's difficult circumstances, use their position to secure the grant of a security interest over the company's assets shortly before the company's collapse, thereby prejudicing the claims of the unsecured creditors. Pursuant to **s 588FP**, a security interest in favour of an officer, former officer or a person associated with either, will be void if any step is taken to enforce the security interest within six months after its creation without the leave of the court. In *Re The 21st Century Sign Co Pty Ltd* [1994] 1 Qd R 93, the Court held that the actions of a company secretary having the benefit of a floating charge (circulating security interest) in demanding payment and then appointing a receiver was in fact a step in enforcing the charge and accordingly that the charge (security interest) was void in absence of the granting of leave. **Section 588FP(3)** reinforces this position by setting out that enforcement of a security interest will occur where the secured party appoints a receiver; enters into possession; or seizes the property. It is, however, possible for an officer/secured party to be granted leave to enforce the security interest where

immediately before creation of the security interest the company was solvent and in all of the circumstances it is just and equitable to do so (**s 588FP(4)**).

Summary—Debentures and loan capital

Companies keep a register of debenture holders

Where debentures are issued to the public, a trustee is appointed: **s 283AA**

The *PPS Act* is relevant to a company borrowing and giving security over assets

Security interests can be circulating (category of assets) or non-circulating (specified)

Secured creditors rights are based on "perfecting" their security interest

Security interests can be registered on the PPS Register administered by AFSA

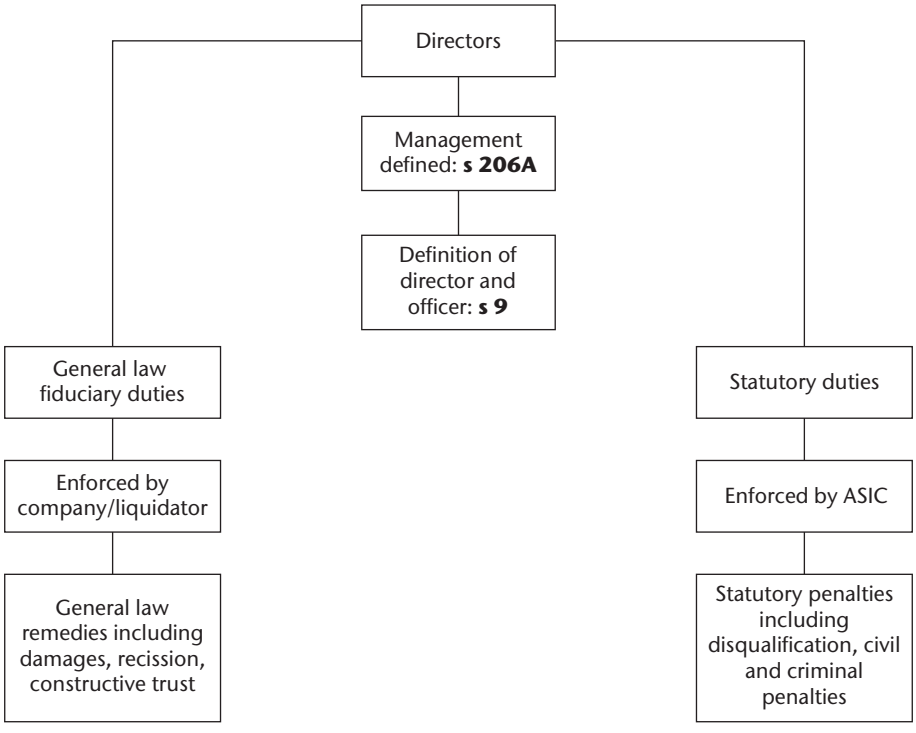
Registration on the PPS Register is a relevant step in "perfection"

Registration is relevant to priority between competing security interest holders

Security interests may be invalid if not registered (such as where liquidation occurs)

18
Directors and Management

[18.10] Shareholders elect directors to manage companies. Of primary importance to the shareholders is the directors' ability to create profit. However, directors also have an underlying responsibility to act in good faith, in the best interests of the company, and in accordance with the law.



Types of directors

[18.20] Directors control how a company functions. They are its managers. **Section 198A** sets out that "the business of a company is to be managed by or under the direction of the directors". This is a replaceable rule. In managing a company, directors must find a balance between the need to maximise profit for the company and their obligations under the *Corporations Act 2001* (Cth).

Directors are defined in **s 9**. The definition is wide and includes those who act as directors though not validly appointed, in situations where they substantially influence the management of the company or the conduct of directors. These persons are

referred to as "de facto" directors. Where directors normally follow the instructions of a particular person (or a company) and that person is not formally elected as a director that person (or company) may be referred to as a "shadow director". The issue of how close a connection is necessary before a shadow director relationship is observable was addressed in *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd* (2011) 250 FLR 42; [2011] NSWCA 109. That case involved a claim by a liquidator against a major supplier and secured creditor (Apple) of the company (Buzzle). The liquidator alleged that the creditor was a shadow director because of its substantial importance to the company and that therefore insolvent trading proceedings could be brought against the creditor. The court rejected the liquidator's argument.

Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd (2011) 250 FLR 242; [2011] NSWCA 109 (Hodgson, Young and Whealy JJA)

Extract from Judgment

Hodgson JA at [9]

Influence exercised on directors of a company by a mortgagee acting in its own interests, particularly if supported by contractual rights in its mortgage documents, would not generally constitute the mortgagee a shadow director. While in such a case the directors may on many occasions act in accordance with the instructions or wishes of the mortgagee, this will generally be so because the directors make their own decision that to do so is in the interests of the company, rather than because they defer to decision-making by the mortgagee on behalf of the company. In my opinion, the statutory formula contemplates the directors being accustomed to act in accordance with the instructions or wishes of a person, in the sense of treating those instructions or wishes as themselves being a sufficient reason so to act, rather than making their own decisions in which those instructions or wishes are merely taken into account as one factor, external to the management of the company, bearing on what is in the best interests of the company.

There are distinctions in the types of directors:

- Managing director—appointed pursuant to **s 201J** and may take all of the board's powers under **s 198C**.
- Chair of directors—exercises procedural control at meetings and signs the minutes (**s 249U**).
- Governing director—a proprietary company's constitution can be amended to give a director tenure and control of the board for life. This is not the case for public companies.
- Nominee director—represents the interests of a particular group. For example, employees may be entitled, pursuant to the company constitution, to elect a director.
- Alternate director—fills in during a director's absence.

- Executive director—full-time employee of the company. The board will often delegate important management and administrative functions to executive directors.
- Non-executive director—not involved in full-time (day-to-day) management of the company and not an employee. There are two types: an affiliated non-executive director who has, or has had, a material connection to the company, such as, an ex-manager, or a shareholder, and; an independent non-executive director who has no business or other connection that may interfere with the independent exercise of their judgement. Non-executive directors are experts who can provide specific expertise in relation to certain areas of the company's business.

Composition of the board of directors

[18.30] Most companies are small proprietary companies with small boards drawn from, and usually known by, the company's shareholders. Public companies, and especially listed public companies, are a different matter. Listed public companies can in some cases have millions of shareholders, most of which will have no contact with the board other than their vote at the AGM. The board's entrepreneurial and financial ability will be vitally important to the value of their shares. However, as the influence of large companies reaches into all spheres of society, a company's shareholders may not be its only stakeholders. Creditors, employees and the wider community will also have an interest in corporate decision making. Therefore, the individual characteristics of directors, particularly their values and outlook, have a direct relationship to investor confidence, and in a broader context are also relevant to matters that affect the community at large such as public health (consider large tobacco companies) and pollution (consider large oil companies).

A significant proportion of the directors on the boards of Australian listed public companies are non-executive directors. These directors, who are not employees but rather more like consultants, often have particular experience or expertise and bring an objective perspective to board decision making. Where a non-executive director has no connection to the company (eg, does not hold shares or have other business relationships) that director will be referred to as an independent non-executive director. A greater number of independent non-executive directors on listed companies' boards is considered beneficial to good corporate governance and has been endorsed in the ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* (4th edition), which sets out in Recommendation 2.4 that a majority of the board of a listed entity should be independent directors. It will be the responsibility of the independent non-executive directors to bring fresh perspectives to governance, to embody ethical decision-making, to support and where needed mentor the CEO, and to challenge management and hold them to account. The overall impact of the *Corporate Governance Principles and Recommendations* is to ensure listed companies appoint a diversified board, with provision for appropriate

checks and balances. This is the lesson learned from the various corporate failures of the past.

The activities and responsibilities of the boards of listed entities should include: defining the entity's purpose and setting its strategic objectives; approving the entity's statement of values and code of conduct to underpin the desired culture within the entity; appointing the chair; appointing and replacing the CEO; approving operating budgets and major capital expenditure; overseeing the integrity of the entity's accounting and corporate reporting systems, including the external audit; overseeing the entity's process for making timely and balanced disclosure of all material information concerning the entity that a reasonable person would expect to have a material effect on the price or value of the entity's securities; whenever required, challenging management and holding it to account; monitoring the effectiveness of the entity's governance practices.

One aspect of the interest in the composition of boards involves the unrepresentative number of women on the boards of listed public companies. As at June 2019, the boards of the ASX 200 companies (large listed companies) included 29.7% women (statistics from the Australian Institute of Company Directors (AICD)). This issue, of whether corporate decision making would benefit from a more diverse board, was considered by CAMAC in 2009 in its report, *Diversity on Boards of Directors*. The report addressed the need for change: "The ultimate question, in terms of the governance culture of Australian companies, is whether the environment and current practices are conducive to boards being constituted by well-qualified candidates in an effective mix" (at 29). The report's findings on diversity have influenced the *Corporate Governance Principles and Recommendations*. A company's diversity policy must ensure that selection practices at all levels are structured to consider a diverse range of candidates and not display either conscious or unconscious bias (see "Corporate social responsibility and corporate governance" in [20.100]).

Although the number of women on boards is lower in Australia than some European countries (particularly Scandinavian countries) recent improvement in diversity agendas and increased appointments have placed it in a comparable position to the statistics for industrialised nations overall. This trend, to entrench diversity outcomes, has been given impetus in the fourth edition of the *Corporate Governance Principles and Recommendations*, which require measurable objectives for achieving gender diversity in the composition of a company's board, senior executives and workforce generally. Where the company is in the S&P/ASX 300 Index, the measurable objective for gender diversity in the composition of the board is to have not less than 30% of its directors of each gender.

The adoption of measurable diversity objectives has been accompanied by a requirement of meaningful (more than simply aspirational) benchmarks to ground those objectives. For example: achieving specific numerical targets for the proportion of women on the board, in senior executive roles and in the company's workforce generally within a specified timeframe; achieving specific numerical targets for female representation in key operational roles within a specified timeframe with the view to

developing a diverse pipeline of talent that can be considered for future succession to senior executive roles.

Although diversity on boards is improving, there are, nonetheless, substantial variations even within industrialised nations, and it must be noted that although there is overall improvement the number of female directors, women occupying the role of the chair of directors remains very low. The percentage of women directors is highest in European countries (eg Norway, France) and lowest in Asian countries. Broadly, industrialised nations (developed markets) have higher rates of women on boards than emerging markets. The differences observable in female participation of boards reflect the wide range of approaches countries are taking with respect to board diversity, involving legal requirements, corporate governance guidelines, listing exchange standards, mentoring programs and other voluntary initiatives. The identifying of a measurable objective in the fourth edition of the *Corporate Governance Principles and Recommendations* is an addition to Australia's existing informal/persuasive approach to gender diversity on boards. It should be noted, that even before the introduction of measurable objective guidelines, Australia's increase in female board appointments had outstripped other comparable countries, such as the US and Canada, in relation to implementation of diversity through non-legislative approaches such as investor and media pressure, education and governance guidance. Australia's progress owes its success in part to the influence of the *Corporate Governance Principles and Recommendations* and a number of high-level mentoring programs.

***Corporations Act 2001* (Cth), s 9**

Dictionary

"director" of a company or other body means:

(a) 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) they act in the position of a director; or
    (ii) 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.

"officer" of a corporation means:

(a) a director or secretary of the corporation; or

(b) a person:
    (i) who makes, or participates in making, decisions that affect the whole, or a substantial part, of the business of the corporation; or

(ii) who has the capacity to affect significantly the corporation's financial standing; or
(iii) in accordance with whose instructions or wishes the directors of the corporation are accustomed to act (excluding advice given by the person in the proper performance of functions attaching to the person's professional capacity or their business relationship with the directors or the corporation); or

(c) a receiver, or receiver and manager, of the property of the corporation; or
(d) an administrator of the corporation; or
(e) an administrator of a deed of company arrangement executed by the corporation; or
(f) a liquidator of the corporation; or
(g) a trustee or other person administering a compromise or arrangement made between the corporation and someone else.

***Corporations Act 2001* (Cth), s 198A**

Powers of directors (replaceable rule—see section 135)

(1) The business of a company is to be managed by or under the direction of the directors.

Note: See section 198E for special rules about the powers of directors who are the single director/shareholder of proprietary companies.

(2) The directors may exercise all the powers of the company except any powers that this Act or the company's constitution (if any) requires the company to exercise in general meeting.

For example, the directors may issue shares, borrow money and issue debentures.

***Corporations Act 2001* (Cth), s 201J**

Appointment of managing directors (replaceable rule—see section 135)

The directors of a company may appoint 1 or more of themselves to the office of managing director of the company for the period, and on the terms (including as to remuneration), as the directors see fit.

***Corporations Act 2001* (Cth), s 198C**

Managing director (replaceable rule—see section 135)

(1) The directors of a company may confer on a managing director any of the powers that the directors can exercise.
(2) The directors may revoke or vary a conferral of powers on the managing director.

Appointment of directors

[18.40] When companies are formed, the directors will be those persons named in the application to register the company lodged with ASIC. Thereafter, directors are usually appointed by the shareholders in general meeting by way of an ordinary resolution (**s 201G**—note, this is a replaceable rule). However, **s 201H** also enables the directors themselves to appoint other directors provided that the appointment is confirmed by the shareholders. If the company is a proprietary company, the confirmation must be within two months, if a public company confirmation is required at the next AGM. There is no legal requirement that directors must hold shares in the company they manage, however, it is not uncommon that they will. If there is an obligation to hold shares, it will be found in the company's constitution.

In situations, where the appointment of a director turns out to be invalid because the company did not comply with its constitution or the provisions of the *Corporations Act* then **s 201M** has the effect of validating subsequent (generally procedural) acts. This section does not however affect the company's dealings with outsiders.

To be appointed as a director, a person must (pursuant to **s 201B**) be at least 18 years old, be an individual (ie, be a natural person) and not be disqualified from managing a corporation. It is also necessary that the director consent to the appointment (**s 201D**).

Remuneration

[18.50] Pursuant to **s 202A**, the shareholders, by way of resolution, determine a director's remuneration. This is a replaceable rule and should be interpreted in the context of **Ch 2E.1 Div 2**, which is headed "Exceptions to the requirement for member approval". For example, note **s 211**, which sets out that shareholder approval to reasonable remuneration, is not required in relation to directors in public companies. The *CLERP (Audit Reform and Corporate Disclosure) Act 2004* (Cth) widened the obligations regarding the disclosure of directors' and executives' remuneration and introduced increased shareholder participation. **Section 300A** requires that the annual directors' report of a listed company include details of the company's remuneration policy and practices for directors, company secretaries and senior managers (key management personnel).

The payment of termination and retirement benefits is dealt with in **Pt 2D.2** of the *Corporations Act*. **Section 200B** requires a connection between the person's retirement and the payment. In *Renshaw v Queensland Mining Corporation Ltd* (2014) 229 FCR 56, a case concerning an arranged retirement benefit, the court, in dismissing the director's appeal, affirmed that a broad approach should be taken to the nexus between the benefit concerned and the cessation of the person's relationship with the company so as to protect the rights and interests of its shareholders to know of, and approve, the expenditure of the company's money.

The area of director benefits and remuneration has important corporate governance implications and shareholders will obviously feel aggrieved, where directors' remuneration packages are excessive although company value and dividend return fall. This situation has become more common as a result of financial uncertainty and more visible because of increased media coverage. The relationship between company performance and director pay is required by **s 300A** to be included in the annual directors' report. **Section 300A(1)(b)** sets out that the report is to contain a discussion of the relationship between board policy for determining the nature and amount (or value) of remuneration of the key management personnel and company performance. Remuneration may include benefits from various sources including: cash; profit sharing; pension and superannuation benefits; and share-based payments.

The issue of executive remuneration was considered by the Productivity Commission in its report *Executive Remuneration in Australia 2010* and by CAMAC in 2011 in a report titled *Executive Remuneration*. The Productivity Commission is the Australian Government's independent research and advisory body on economic, social and environmental issues. It conducts public inquiries on key policy or regulatory issues that relate to Australia's economic performance and wellbeing. Its proposals have included insolvency reforms, barring executives from sitting on remuneration committees and strengthening shareholders input into director remuneration decisions. As a result of the Productivity Commission recommendations, the *Corporations Act* was amended by the *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act 2011* (Cth). This amendment introduced the "two strikes" procedure making it possible for shareholders in public listed companies who have serious concerns regarding the level of director remuneration to express their concerns by voting against the payment and not adopting the company's remuneration report, thereby creating the situation, where the board can be forced into a fresh election for their positions. Shareholders are entitled to vote on director remuneration packages as disclosed at the AGM. Pursuant to **s 250R(3)**, the vote is advisory only and does not bind the directors or the company. However, **s 250U** sets out that if at two consecutive AGM's at least 25% of the votes cast in relation to the company's remuneration report were against that report then, pursuant to **s 250V**, at the later of these two meetings a spill resolution, causing the directors to vacate their positions, may be put, requiring a further meeting of the company's members to be held within 90 days. It is at this meeting (the "spill meeting") that fresh elections for the board will take place.

The ability of shareholders to have their opinion heard as to executive remuneration has been increasingly used to send a message to the board that excessive director pay, and pay-outs ("golden handshakes"), may well cause shareholder discontent and signal a challenge to the existing board.

The following newspaper article refers to director remuneration issues arising from the original Productivity Commission report. It was written after the report but prior to the recommendations being adopted into the *Corporations Act*. While it does not

reject the proposals, it nonetheless provides a different perspective on the matter. It should be noted that it is not as simple, as is suggested in the article, for shareholders to vote out directors whose policies they disagree with. Removing directors requires an ordinary resolution, that is, over 50% in favour of removal. In this regard, it is relevant that not all shareholders of listed companies cast votes at AGM's and those who do cast votes (and have the largest proportion of votes that may be cast) are usually institutional investors (large investors, like super funds, with sizeable parcels of shares) who generally take a conservative approach to board replacements. This means that the status quo of boards is predictable.

Shareholders Have Say in Director Remuneration

The Productivity Commission review on executive pay was always intended as a political exercise to take the heat out of the debate, and it has duly delivered the whitewash intended. The generally positive response from the business lobby groups said it all.

The Productivity Commission delivered a well-researched, uncontroversial report that killed off some common myths on both sides of the debate, and erred more by omission than commission. The one exception was its recommendation that two consecutive 25 per cent negative remuneration report votes should result in an automatic spill of the board. If applied over the past couple of years, this would have required spills from some notables, including the likes of Babcock & Brown, Transpacific, Sonic, Suncorp, Toll and Crane Group.

But it all smacks of wanting to be seen to be doing something rather than a genuine reform from a body that is normally more rational. There is an argument pushed in the US that the entire board should be re-elected each year—in that way, most of the difficult issues around the removal of dud directors are resolved. Some argue that that practice would destroy corporate memory and continuity, but in reality the incumbents would normally be returned.

The bottom line is simply that shareholders already have the power to throw out boards of directors—it's just that most are simply too apathetic to bother, and governments should be wary of adding new powers when shareholders are not using the ones they already have.

Original source article by John Durie, *The Australian*

The inclusion of the two strikes rule in the *Corporations Act* addresses the problems that may arise if a board is able to exercise too much control over its remuneration policies, and broadly provides an opportunity for shareholders to challenge the board if its conduct or policies do not meet their expectations. The *Corporations Act* also limits a boards' ability to control its own composition, which would, if allowed without the requirement for shareholder approval set out in **s 201P**, impede the election of candidates not endorsed by the board. This benefits the implementation of more efficient governance in that by widening the field of director nominations the number of women with opportunities to sit on public company boards may increase. **Section 201P** sets out that the directors must not set a board limit unless: a resolution approving the proposal to set the limit specified in the resolution has been passed by

a general meeting of the company; the notice of the meeting set out an intention to propose the board limit resolution; and the notice was accompanied by a statement explaining the resolution.

***Corporations Act 2001* (Cth), s 202A**

Remuneration of directors (replaceable rule—see section 135)

(1) The directors of a company are to be paid the remuneration that the company determines by resolution.

Chapter 2E makes special provision for the payment of remuneration to the directors of public companies.

(2) The company may also pay the directors' travelling and other expenses that they properly incur:
  (a) in attending directors' meetings or any meetings of committees of directors; and
  (b) in attending any general meetings of the company; and
  (c) in connection with the company's business.

While not all shareholders may be interested in the remuneration paid to their directors, the *Corporations Act* enables those who are interested in access to such information. **Section 202B** sets out that a company must disclose the remuneration paid to each director of the company, or a subsidiary, if directed to by: members with at least 5% of the votes or; at least 100 members who are entitled to vote at a general meeting of the company. The section requires the disclosure of all remuneration whether paid to the director in their capacity as a director or in another capacity.

The "two strikes" rule is an important tool in how shareholders can react to unbalanced remuneration practices. In recent years, there has been a perception that some companies pay their directors too much and in some cases, regardless of company performance. Added to this is the fact that hidden or complicated remuneration arrangements are contrary to the goal of transparency in corporate management. These matters are part of the forces that have focused attention on the need to better control the area. The policies and practices of how companies determine director remuneration should appropriately reflect the different roles and responsibilities of non-executive directors compared with executive directors and other senior executives. In this regard, the ASX Corporate Governance Council in the commentary to its *Principles and Recommendations* (see [20.100]) has provided the following guidelines for listed entities, which may be useful in formulating their remuneration policies and practices. The guidelines are helpful in understanding how boards can carry out their responsibilities to the company and by extension to the shareholders. They also highlight differences in the roles of executive and non-executive directors.

Executive director remuneration guidelines: (a) should include an appropriate balance of fixed remuneration and performance-based remuneration; (b) should be reasonable and fair, taking into account the entity's obligations at law and labour market conditions, should be relative to the scale of the entity's business and reflect core performance requirements and expectations; (c) should be linked to clearly specified performance targets. These targets should be aligned to the entity's short and long-term performance objectives and should be appropriate to its circumstances, goals and risk appetite; (d) may include equity-based remuneration, including options or performance rights, but must ensure that they do not lead to short-term strategies on the part of senior executives or the taking of undue risks; (e) all aspects of any termination payments should be agreed in advance. There should be no payment for removal for misconduct.

Non-executive director remuneration guidelines: (a) may include remuneration by way of cash fees, superannuation contributions and non-cash benefits in lieu of fees (such as salary sacrifice into superannuation or equity); (b) levels of fixed remuneration should reflect the time commitment and responsibilities of the role; (c) should not include performance-based remuneration as it may lead to bias in their decision-making and compromise their objectivity; (d) it is generally acceptable for non-executive directors to receive securities as part of their remuneration, however, non-executive directors generally should not receive options with performance hurdles attached or performance rights as part of their remuneration as it may lead to bias in their decision-making and compromise their objectivity; (e) should not be provided with retirement benefits other than superannuation.

Removal and resignation

[18.60] In both proprietary and public companies, directors are removed by resolution of members. However, for proprietary companies, the relevant section (**s 203C**) is a replaceable rule, allowing for the possibility of amendment and thereby the entrenchment (non-removal) of certain directors. The types of companies that may want to give certain directors extensive powers or provide them with their role for life are small companies, particularly those conducting a family business. A director appointed in this manner is called a governing director. Public companies, on the other hand, have large numbers of shareholders, many of whom hold relatively small parcels of shares, and this fact requires both transparency and equity in relation to management. If directors could not be removed and replaced in public companies, then the holding of shares as an investment would be compromised. Accordingly in the context of the wider responsibilities placed upon public companies by the *Corporations Act*, directors of such companies can be removed by shareholder resolution regardless of anything set out in the company's constitution (**s 203D**).

Directors resign from office by giving written notice (**s 203A**). This is a replaceable rule. Note that in public companies, a director cannot be removed from office or required to vacate their office (position) by the other directors.

***Corporations Act 2001* (Cth), s 203D**

Removal by members—public companies

Resolution for removal of director

(1) A public company may by resolution remove a director from office despite anything in:
   (a) the company's constitution (if any); or
   (b) an agreement between the company and the director; or
   (c) an agreement between any or all members of the company and the director.

If the director was appointed to represent the interests of particular shareholders or debenture holders, the resolution to remove the director does not take effect until a replacement to represent their interests has been appointed …

The reasons why shareholders would seek removal of a director will vary depending on the size of the company, the balance of influence among the shareholders, and shareholders' perception of board efficiency. The following newspaper article indicates some reasons why removal of directors may be considered.

Board Renewal on Cards

As the Leighton board continues to grapple with a series of investigations it needs to think seriously about board renewal, particularly because two veteran non-executive directors stand for re-election at the May 22 board meeting.

But the mood of minority shareholders in Leighton is for more board renewal, particularly after the shenanigans that have gone on in the company for the past 18 months, which has included a botched succession plan, massive write-downs, profit downgrades, project blowouts, a big equity issue and the departure of experienced senior managers.

And while much of that is now in the past, some problems are still to be resolved. These include: an investigation by the Australian Federal Police into allegations of bribery in Iraq; inquiries by the corporate regulator into whether there was a breach of continuous disclosure rules in the timing of its announcement of cost blowouts and project delays at the $2.5 million Victorian desalination plant, the $4.2 million Brisbane Airport Link and its Middle East operations; a class action by Maurice Blackburn; and its credit rating, downgraded by Moody's and Standard & Poor's, bringing it perilously close to non-investment grade.

Original source article by Adele Ferguson, *The Sydney Morning Herald*

Note that Leightons subsequently settled the class action referred to in the above article for $70 million.

Directors are elected by ordinary resolution requiring a simple majority (more than 50%). The following newspaper article further highlights the reasons why members might consider a change in the board of directors. Note that GPG failed in its attempt to have its two candidates elected. At the members' meeting, the vote in favour of the GPG candidates was 28% which, having regard to the voting strength of SC Global Development, was not sufficient to meet the requirements of an ordinary resolution.

Board Failures Prompts Election

The Guinness Peat Group, which owns 11.8% of Jennings Ltd, requisitioned a meeting of shareholders to vote on the appointment to the board of two GPG executives. The company set a meeting date.

GPG faced an uphill task. Jennings is effectively controlled by the Singapore-based SC Global Development, which owns 42.36% of the capital, and it opposed the election of the GPG candidates.

Jennings claimed that the GPG executives would have a potential conflict of interest if they joined the board, because GPG owned 70% of the listed residential housing developer Canberra Investment Corp, which is a direct competitor of Jennings.

Jennings also claimed the existing board had sufficient skill and experience to take the company forward, and comprised highly qualified individuals with many years of experience in fields relevant to the company's business, such as property development, construction, banking and finance.

GPG said the board and management failed to deliver on forecasts and its earnings and dividends have been most disappointing.

The action moved to the shareholders' meeting.

Original source article by Bryan Frith, *The Australian*

Chair of directors

[18.70] The chair of the board generally has procedural control of company meetings. They will sign the minutes and chair shareholder meetings. At board meetings, the chair of directors will have a casting vote (**s 248G**), however, he or she may be precluded from voting if they have a conflict of interest. In listed companies, the chair may take on increased responsibilities, particularly as to matters of corporate governance, including the need to ensure the board is properly informed and that board supervision of the company is facilitated. The role of the chair of directors in relation to the voting of proxies was considered in *Whitlam v ASIC* (2003)57 NSWLR 559; [2003] NSWCA 183. In that case, the court held that Mr Whitlam, the chair of directors, had not breached a section of the *Corporations Act*, which required that the chair of the meeting vote proxies (votes by those who cannot attend) as directed by the members giving those proxies. Whitlam chaired a meeting of NRMA Ltd at which a resolution was proposed to increase directors' remuneration. He had received 3,973 proxy votes instructing him to vote against the proposal. Whitlam did not sign the poll paper as required (the vote was by way of a poll, which is where votes are counted on the basis of a vote per share) and as a result, the proxy votes were not counted in the overall tally. The NSW Court of Appeal

did not consider that there was sufficient evidence to find that Whitlam deliberately failed to sign the proxies, nor did it consider that Whitlam was acting in his capacity as a director in failing to sign the proxies, therefore, it found that he did not breach his directors' duties. The responsibility of the chair to vote proxies is now contained in **s 250BB**, which sets out that if the appointment of a proxy specifies the proxy is to vote on a particular resolution, and if the proxy is the chair, then they must vote on a poll and as directed. Breach of this requirement is an offence subject to the provisions of **s 250BB(1)**. In relation to proxies, see [26.30].

Board meetings

[18.75] The procedural rules in relation to a directors meeting are set out in the replaceable rules or the constitution (if any) or are determined by the board itself. There are also common law rules dealing with the conduct of meetings (these involve at the very basic level fairness in how the meeting is held). Courts generally require adherence to these rules because resolutions of the board may affect the legal rights of members, directors and the company. In order to be valid, board meetings require substantial compliance with the procedural rules. Informal gatherings of directors will not necessarily satisfy the requirements for a meeting. In *Poliwka v Heven Holdings Pty Ltd* (1992) 6 WAR 505, a meeting at a cafe of two persons who were the directors of a company was held not to be a meeting of directors.

Directors will determine the frequency of board meetings. However, companies generally hold board meetings at regular fixed dates. Obviously, there will be differences between board meetings in large and small companies. Public listed companies may sometimes have above 10 board members and the manner in which meetings are held and proceed will often be subject to more scrutiny than a small proprietary company. Nonetheless, the overall principles remain the same. Technology has increasingly been used by public company boards, where it is not possible for all directors to be physically present at the same time. Pursuant to **s 248D**, a directors' meeting may be called or held using any technology consented to by all directors. The consent may be a standing one. A director may only withdraw her or his consent within a reasonable period before the meeting. At such meetings, each participating director must be able to hear and be heard by every other participating director for the duration of the meeting and each must also be able to see the contents of any document that is tabled or discussed: *Gillfillan v ASIC* (2012) 92 ACSR 460; [2012] NSWCA 370. Directors may also pass a resolution without an actual meeting taking place pursuant to **s 248A** (replaceable rule) requiring all directors entitled to vote on the particular resolution to sign a statement confirming their agreement with the resolution (referred to as a circulating resolution).

Important aspects of board meetings include matters of notice (**s 248C**, a replaceable rule, provides for reasonable notice to be given to each other director individually although where the board meets regularly this may not be necessary); quorum requirements (generally 2: see **s 248F**, a replaceable rule); and the keeping of minutes. **Section 251A(1)(b)** sets out that proceedings and resolutions of directors' meetings (including meetings of a committee of directors) must be recorded in the company's

minute book. The minute book should also record circulating and other resolutions passed by directors without a meeting. The chair must sign the minutes within a reasonable time after the meeting: **s 251A(2)**. A minute that is recorded and signed is evidence of the proceeding or resolution to which it relates, unless the contrary is proved: **s 251A(6)**. This is an important principle and was confirmed and relied upon by the High Court in determining the fate of the James Hardie directors in *ASIC v Hellicar* (2012) 86 ALJR 522; [2012] HCA 17.

Boards may of course delegate their powers to a single director and appoint them as a managing director (**s 201J** and **s 198C**, both replaceable rules). However, board delegation can be much wider than this and extend to establishing various committees to deal with aspects of the business. Although this is possible in all companies, it is particularly common in large public companies. The ASX *Corporate Governance Council Principles and Recommendations 3rd edition 2014* recommend that listed companies should have an audit committee, a remuneration committee and a nomination committee. Further, **s 198D** which enables delegation by the board provides a wide scope as to who the board may choose to delegate powers to and this includes employees. Accordingly, companies may have a framework of committees dealing with strategy, ethics, environment, risk management and compliance.

Successful board meetings are an important part of good governance practices. The following factors may be relevant.

- Directors are aware of their *Corporations Act* responsibilities.
- Board members are clear on what is expected of them.
- Board meetings are well planned and agendas achievable.
- Directors value collegiate decision-making and participate in important board discussions.
- Board members are prepared and engaged.
- Diversity, whether in board make-up or in outlook on critical issues, is accommodated.
- Relevant written reports and recommendations are available prior to meetings.
- The board values and plans for director development programs and initiatives.
- Technology is effectively used to ensure board meetings are organised and run efficiently.

Company secretary

[18.80] Public companies must have at least one company secretary. However, the appointment of a company secretary in a proprietary company is optional. Company secretaries have certain administrative functions, set out in **s 188**, including the lodgement of notices and returns with ASIC. The obligation for a company to have a registered office in **s 142** is one of the functions of the secretary. Both **ss 9** and

179 include the company secretary in the definition of an "officer" thereby including company secretaries in the range of duties applying to officers, such as the duty to act in good faith and for a proper purpose in **s 181**. In *Panorama Developments (Guildford) v Fidelis Furnishing Fabrics Ltd* [1971] 2 QB 711, a company secretary rented motor vehicles using company funds but in fact used the vehicles for his own private purposes. In this matter, the court held the company liable for the hire of the vehicles. The company secretary was an officer who regularly made representations on behalf of the company in relation to its day-to-day business and was entitled to execute documents relating to the administrative side of the company's business.

***Corporations Act 2001* (Cth), s 206A**

Disqualified person not to manage corporations

(1) A person who is disqualified from managing corporations under this Part commits an offence if:
  (a) they make, or participate in making, decisions that affect the whole, or a substantial part, of the business of the corporation; or
  (b) they exercise the capacity to affect significantly the corporation's financial standing; or
  (c) they communicate instructions or wishes (other than advice given by the person in the proper performance of functions attaching to the person's professional capacity or their business relationship with the directors or the corporation) to the directors of the corporation:
    (i) knowing that the directors are accustomed to act in accordance with the person's instructions or wishes; or
    (ii) intending that the directors will act in accordance with those instructions or wishes.

Note: Under section 1274AA, ASIC is required to keep a record of persons disqualified from managing corporations.

(1A) For an offence based on subsection (1), strict liability applies to the circumstance, that the person is disqualified from managing corporations under this Part.

Note: For strict liability, see section 6.1 of the *Criminal Code*.

(1B) It is a defence to a contravention of subsection (1) if the person had permission to manage the corporation under either section 206GAB or 206G and their conduct was within the terms of that permission.

Note: A defendant bears an evidential burden in relation to the matters in subsection (1B), see subsection 13.3(3) of the *Criminal Code*.

(2) A person ceases to be a director, alternate director or a secretary of a company if:
  (a) the person becomes disqualified from managing corporations under this Part; and
  (b) they are not given permission to manage the corporation under section 206GAB or 206G.

If a person ceases to be a director, alternate director or a secretary under subsection (2) the company must notify ASIC (see subsection 205B(5)).

Disqualification from management

[18.90] **Part 2D.6** of the *Corporations Act* sets out the various ways, directors will be disqualified from management. The provisions do not simply target disqualification from being elected as, or acting as, a director. Rather, the ambit of the disqualification is wider and involves prohibiting the exercise of control (management) however it arises. Management includes making or participating in decisions affecting the business of the company; affecting the company's financial affairs; and even having an ongoing influence on the directors (**s 206A**).

The three main categories of disqualification are discussed at [18.100]-[18.120].

Automatic disqualification

[18.100] **Section 206B**—if convicted of an offence in the terms of the section, the period of disqualification will be five years (this may be extended by the court for up to 15 additional years pursuant to **s 206BA**). The type of offences that will result in a disqualification under **s 206B** are where there is a contravention of the *Corporations Act* punishable by imprisonment for a period greater than 12 months; and where a person has been convicted under any statute of an offence involving dishonesty punishable by imprisonment for a period greater than three months. Disqualification will also be automatic if the person is an undischarged bankrupt or has executed a deed of arrangement under Pt X of the *Bankruptcy Act 1966* (Cth) and has not complied with its terms. The principle upon which **s 206B** is based is that there are certain persons who because of their poor character or lack of financial ability should not be entitled to manage companies. A company is artificial, if it cannot meet its commitments because of its directors' poor judgement, or suspect motives, an outsider's ability to recoup their loss may be restricted by the company's lack of assets and the corporate veil may limit the transfer of responsibilities to management. Automatic disqualification is one way to address these problems.

An example of the application of **s 206B** is found in ASIC Media Release 09-210AD "Melbourne man convicted of managing a corporation while disqualified". The defendant was sentenced to imprisonment for four years (with a non-parole period of three years) as a result of previous contraventions of the Corporations Law and the *Crimes Act 1958* (Vic). As a result, he was automatically disqualified under **s 206B(2)** from managing a corporation for five years from the date of his release. However, in breach of the section, the defendant was found to have managed companies for a period of approximately one year while disqualified. The sentence imposed by the Melbourne Magistrates Court was the performance of 150 hours unpaid community work.

Disqualification by the court

[18.110] **Section 206C**—ASIC may apply to the court to disqualify a person from management for a period that the court considers appropriate if the person has breached a civil penalty provision (see **s 1317E**). Several of the sections concerning

the duties of directors are civil penalty sections (such as the **s 181** duty to act in good faith and for a proper purpose) and actions by ASIC against directors often result in disqualifications under **s 206C**. For example, in *ASIC v Adler* (2002) 41 ACSR 72; [2002] NSWSC 171, Mr Adler, a director of a large insurance company, HIH Insurance Ltd, was held to have breached several civil penalty sections and disqualified under **s 206C** from managing corporations for 20 years. In his judgment, Santow J sets out matters relevant to determining the length of court-imposed disqualifications. These include: the need to protect against present and future misuse of the corporate structure by deterring the defendant specifically, and others generally, from engaging in like conduct; appropriately punishing breaches of a serious nature particularly where dishonesty is present; the amount of loss suffered by the company; whether the defendant held a position of trust and misused that position. In a broad sense: the character of the directors; the nature of the breaches; the structure of the company; and the nature of its business will be relevant. As well the interests of shareholders, creditors and employees, the risks to outsiders from the continuation of the conduct, and the honesty and competence of the directors, will be determinative factors. *ASIC v Adler* involved multiple breaches of the *Corporations Act*. This was also the situation in *ASIC v Sydney Investment House Equities Pty Ltd* (2009) 69 ACSR 648 and in that case the court considered the following matters relevant to the imposition of disqualification under **s 206C**: serious breaches; significant losses; the defendant's responsibilities in the company made the potential for damage resulting from contravention of the relevant directors' duties sections high; the contraventions extended over several years; contrition in relation to the contraventions was not shown by the director; a short period of disqualification was unlikely to stem the behaviour.

Section 206D—ASIC may apply to the court to disqualify a person from management for up to 20 years if, within the last seven years, the person has been an officer of two or more companies that have failed and the court is satisfied that the manner in which the company was managed played a part in that failure. The concept of company "failure" includes liquidation, voluntary administration and the company ceasing to carry on business leaving creditors unpaid. In determining whether a disqualification is justified, the court may take into consideration the person's conduct in relation to the management of the company.

Section 206E—ASIC may apply to the court to disqualify a person from management in circumstances where that person, or a company in which they were an officer, has contravened (at least twice) the *Corporations Act*. Where ASIC seeks to disqualify a person in circumstances where it is the body corporate itself that has contravened the *Corporations Act* then **s 206E(1)(a)(i)** requires ASIC to establish that on each of the occasions the contravention took place the person failed to take reasonable steps to prevent the contravention. The period of disqualification pursuant to **s 206E** is, as in **s 206C**, whatever period the court considers appropriate.

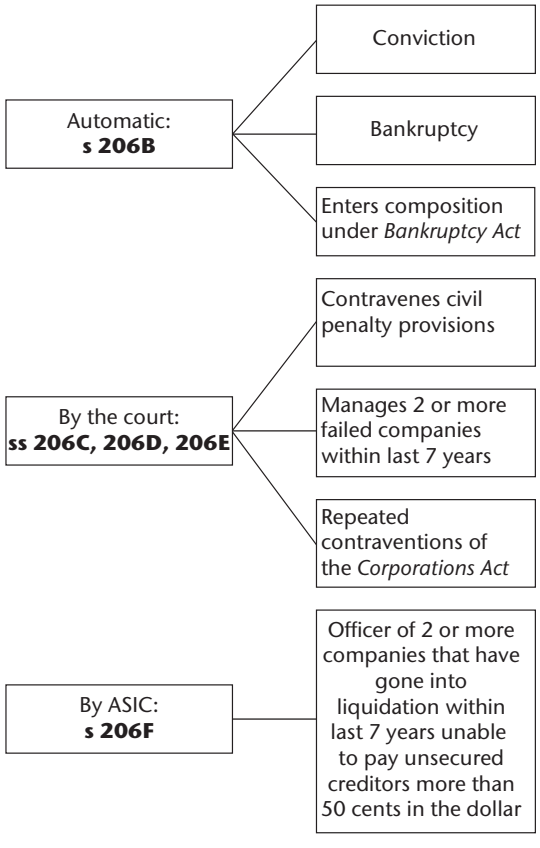
Pursuant to **s 206E(2)**, the court may have regard to the person's conduct in relation to the management, business or property of any corporation. An example of disqualification under this section is found in *ASIC v Australian Investors Forum Pty Ltd (No 3)* (2005) 56 ACSR 204. In that case, the directors were disqualified for 25 years for particularly serious conduct including: dishonesty; personal benefits gained as the result of breaches of the *Corporations Act*; deliberate misappropriation of investors' funds; lack of remorse or contrition; and the continuing risk to the public if they remained directors. The Court considered that it was clear from the terms of **s 206E(2)** that in arriving at the applicable penalty, it was not restricted to a consideration of the contraventions of the Act relevant only to the current proceedings. The primary object of **s 206E** is the protection of the public, and thereby the defendant's fitness to manage the affairs of a corporation is in issue. Accordingly, the ambit of enquiry may be broad and the court may have regard to the defendant's conduct not only in relation to the management of the corporation of which he was an officer at the time of the contraventions in issue in the proceedings but it may have regard to the defendant's conduct in relation to the management, business or property of any corporation.

Disqualification by ASIC

[18.120] **Section 206F**—if a person has been an officer of two or more companies that have been wound up (placed into liquidation) in the last seven years and, on each of those occasions, the liquidator has lodged a report with ASIC pursuant to **s 533** that the company has not been able to pay more than 50 cents in the dollar to its unsecured creditors then ASIC may disqualify that person from management for up to five years. The reality for ordinary unsecured creditors in a winding up is that they rarely receive any significant return on their debt. ASIC's insolvency statistics (based on liquidators, receivers and administrators reports) reveal that in around 97% of cases, the dividend estimate to unsecured creditors was less than 11 cents in the dollar. Accordingly, the number of times a liquidator would find it necessary to lodge an **s 533** report is very high and the possibility of external administrations returning more than 50 cents in the dollar to the unsecured creditors is very low. Before it formally disqualifies a person from management, ASIC must serve that person with a notice requiring them to demonstrate why they should not be disqualified ("show cause") and allow that person an opportunity to be heard on the issue. In determining whether a disqualification is justified, ASIC may take into consideration matters including the person's conduct in relation to the management of the company and the public interest.

Disqualification: section summary

[18.130]



Summary—Directors and Management

Definition of director **s 9** includes "de facto" directors

Types of directors include: managing director; chair of directors

Directors can be executive (full-time) or non-executive (consultant)

Directors elected by members—at least 18 years of age and natural persons

Directors are removed pursuant to **s 203C** and **s 203D**

Public companies cannot restrict members' right of removal of directors

Directors can be disqualified from management in the following ways:

- automatic disqualification for criminal offences and bankruptcy (**s 206B**);
- by the court for civil penalty breaches and poor management (**ss 206C, 206D, 206E**);
- by ASIC for managing two liquidated companies in seven years (**s 206F**).

19
Directors' Fiduciary Duties

The obligations of directors

[19.10] As companies are artificial entities, those who are elected to manage them are their directing mind and will. An outsider contracts with a company but it is the directors who negotiate the contract and who make representations on behalf of the company. Clearly, then it is important for the overall integrity of the *Corporations Act 2001* (Cth), and corporate standards in general, that those who manage companies (directors) be subject to appropriate duties and responsibilities.

Directors' duties arise from three main sources: first the general law, that is common law and equity (the fiduciary duties have developed from equitable principles); second from the company's constitution and replaceable rules; third, and perhaps most importantly today, under the *Corporations Act*.

Classification of fiduciary duties

[19.20] Directors owe their fiduciary duties to the company. Equitable principles underpin the fiduciary obligations (based on loyalty and honesty). In isolated and special circumstances, such as *Brunninghausen v Glavanics* (1999) 46 NSWLR 538, the fiduciary duty may be owed to an individual shareholder. In that matter, one of two directors/shareholders in a company sold his share to the other without a true understanding of the company's position. The Court held that the director was at a clear disadvantage and that the other director owed a duty to disclose.

The fiduciary duties may be classified as:

- the duty to act in good faith and in the best interests of the company;
- the duty to act for a proper purpose; and
- the duty to avoid a conflict of interest.

The courts have tested these duties against various fact situations over time. To act in good faith means the director must genuinely believe that they are acting for, and in the interests of, the company. Some cases have viewed the duty to act in good faith as subjective in nature, and others as objective (see [20.20] for further discussion). Where directors make decisions affecting their company's interests their own view of their conduct is only one of the various factors relevant to a courts consideration of whether they have acted in good faith. In these circumstances, it is important that the assessment of whether the duty has been satisfied takes on an objective element and this means that directors will not necessarily comply with their duty merely because

they have an honest belief that they are acting in the company's best interests. In *Advance Bank Australia Ltd* (1987) 9 NSWLR 464, directors used company funds to campaign for the election of certain candidates for election to the board of directors. Although the directors honestly believed that they were acting in the company's best interests, the fact that their conduct prejudiced an informed decision-making process by the shareholders, meant that their conduct was held to be in breach of their duty. Note that where directors face a civil penalty action under the *Corporations Act*, the issue of honesty is specifically relevant (**ss 1317S** and **1318**).

The question of where the company's interests lay is relevant for the purposes of the application of the duty and to determining breach. Generally, where a company is solvent, the interests of the company are the interests of its shareholders. However, where a company is insolvent or nearing insolvency, its best interests may correspond to the interests of its creditors rather than its shareholders (*Walker v Wimborne* (1976) 137 CLR 1). Accordingly, directors must take creditors of an insolvent company into account if they are to avoid breaching their duties. In *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 NSWLR 722, the directors of a family company (ie, the directors and shareholders were related) arranged for the company, which was in financial difficulty, to transfer its business and the lease on its premises to them on favourable terms. The company went into liquidation and the liquidator was successful in an action for breach of duty by the directors (see under "The issue of ratification of director's breach of duty" at [19.60] for more details of the case).

To determine whether a director acts for a proper purpose involves a consideration of the extent of the director's powers. For example, the power to issue shares is an expected part of the functions of a director, particularly where there is a need to raise capital. However, where the director's purpose is to maintain control of the company or dilute or extinguish voting power of certain shareholder groups, a breach of duty may occur.

The duty to avoid a conflict of interest includes a situation of a substantial possibility of conflict. Where directors place themselves in a situation where their own interests are preferred to the interests of the company, it is likely a conflict of interest will arise. Examples of when a conflict may occur include when a director takes a corporate opportunity, where a director profits personally from a transaction, or where company funds are misused.

A breach of the fiduciary duties is enforced by the company, or in some cases when the company has been wound up, the liquidator. Note that in some circumstances, pursuant to the *ASIC Act 2001* (Cth), ASIC can bring an action for breach of fiduciary duties on behalf of the company. Section 50 of the *ASIC Act* sets out that where as the result of an investigation or from a record of an examination it appears that it is in the public interest for ASIC to begin and carry on proceedings for the recovery of damages, in negligence, for breach of duty, or recovery of property, then it may cause such proceedings to be commenced in the name of the relevant person or company.

Remedies available to a company where a director is found to have breached the general law fiduciary duties include damages (what the company has lost), an account

of profits (what the director has gained), rescission of a contract, and injunction. It is also possible for the court to impose a constructive trust arrangement which has the effect of maintaining for the company (beneficiary) the benefit gained (trust fund) by the directors (trustee) as a result of the breach of duty (eg, see *Paul A Davies (Aust) Pty Ltd v Davies* (1983) 1 ACLC 1091 under "Enforcing directors' general law duties" in [21.10]).

Examples of cases dealing with the fiduciary duty

Duty to exercise power for proper purpose

[19.30] In *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821, two major shareholders controlled 55% of the shares between them. They made a takeover bid for the company. This bid was frustrated when the directors of the company issued new shares to a rival bidder reducing the 55% majority held by the two shareholders to a minority interest. Although the issue of shares was within the bounds of a director's power, the court held that in this case, by having the effect of destroying an existing majority, it was an improper use of power and accordingly a breach of duty.

In *Westpac Banking Corporation v Bell Group Ltd (in liq) (No 3)* (2012) 44 WAR 1; [2012] WASCA 157, Drummond AJA (at [2023]) set out certain important matters arising out of *Howard Smith Ltd v Ampol Petroleum Ltd*.

> First, it unequivocally turned on whether a fiduciary power vested in directors was exercised for a proper purpose, not whether it was exercised bona fide for the benefit of the company. Second, it rejected the proposition that the answer depends on whether the directors in exercising the power honestly believed they were advancing the company's interests. Third, it shows that the purpose for which a power is conferred is not governed only by the proper construction of the article conferring the power: "a wider investigation may have to be made". Fourth, the proper exercise of a particular fiduciary power confided to directors is not governed by any absolute rule eg, that the power to issue new shares can only be exercised to raise capital for the company, but by all the relevant circumstances of the case, including whether a particular exercise of power is intra vires the article conferring the power, the nature of the company and its business, the commercial setting in which the exercise of the power occurred, the motivations of the directors for the exercise of power and whether the exercise of the power involved a decision on matters of management and if so, the extent to which the court should defer to the business judgment of the directors.

Duty to avoid a conflict of interest

[19.40] In *Furs Ltd v Tomkies* (1936) 54 CLR 583, the managing director (Tomkies) of a fur processing company (Furs Ltd) had particular knowledge of its operations including certain confidential information. The business was put up for sale and the managing

director negotiated a price with the purchaser. Included in the sale price sought by Furs Ltd was an amount representing the value of its confidential information. During negotiations between the companies, the managing director arranged to commence employment with the purchaser company at completion of the sale. His arrangement with the purchaser company included that a payment was to be made to him in addition to his salary. Although the Chairman of Furs Ltd knew of the possibility of the managing director being employed by the purchaser, the fact of any extra payment was unknown. The amount of this extra payment was approximately equal to that part of the sale price relating to the confidential information. Accordingly, the sale was completed on a basis favourable to the purchaser company in that the total price negotiated excluded any amount for the confidential information. This was because the managing director of Furs Ltd had agreed to reveal it in return for payment to him personally. The seller company was successful in an action against the managing director for a breach of his duty to avoid a conflict of interest.

Furs Limited v Tomkies (1936) 54 CLR 583 (Latham CJ, Rich, Starke, Dixon, Evatt and McTiernan JJ)

Extract from Judgment

At 586 to 589, 590 to 592, 597, 598

Latham CJ

The plaintiff company was carrying on in Sydney the business of manufacturing furs for coats and ladies' stoles, and of tanning, dyeing, and dressing skins. In 1929 the chairman of directors was Mr F W Cropley and the defendant Mr G W Tomkies was the managing director of the company; he was also the manager of the tanning, dyeing and dressing branch of the business. He had special knowledge of the tanning, dyeing and dressing branch of the business which had been developed under his management. He had been sent abroad at the cost of the company and was in possession of formulae and of knowledge of processes of manufacture which were regarded as of very considerable value.

Early in 1929 this branch of the business was seen to be unsuccessful and Tomkies suggested to his co-directors that, for trade reasons, it should be conducted by a separate company or that it should be sold. This matter was discussed at meetings of the board of directors. About June Mr Lionel Lumb, who represented a New Zealand company, visited the factory and later a letter was received from New Zealand inquiring whether the plaintiff was prepared to sell this branch of its business. After discussion between the directors, on 25th June 1929, the defendant Tomkies (hereinafter referred to as the defendant) wrote a letter as managing director referring to the proposed sale and stating that the complete plant including certain machinery and chemicals "would be worth approximately £8,500, but the matter which would need most consideration would be the value of working formulas, and compensation for the amount of work we have put into this end of the business in bringing it to perfection".

On 18th July the defendant wrote another letter addressed to the (purchaser) emphasizing the value and importance of the working formulae, declining to give particulars of them at that stage of the negotiations, and stating that in addition to the £8,500 already mentioned the plaintiff company "would want £5,500 for the formulas and the business as a going concern".

Lumb (for the purchaser) came to Sydney in August 1929 and the proposal for sale was discussed in the first instance between the defendant and Lumb. The defendant and Lumb arrived at an arrangement under which the defendant would become an employee of the purchaser (or of a company to be formed by it) for a period of three years, the defendant binding himself by a restrictive covenant for a period of five years after the determination of the agreement, and the purchaser agreeing to pay a salary of £20 per week and a further sum of £5,000, to be satisfied partly by shares in the new company and partly by guaranteed promissory notes.

After making this arrangement with Lumb the defendant went to the chairman of directors and discussed the proposals for the sale of the business by the company. He then again saw Lumb, and a day or two later Lumb told him that £8,500 was as much as he would give for the plant and the formulae.

On 29th August the board of directors met, and, after the matter had been discussed, agreed to make an offer to sell the business plant and formulae for £8,500. This offer was accepted by Lumb. On 19th September a meeting of the shareholders was held and the shareholders were informed that the sale had been effected for a sum of £8,500. Neither the directors nor the shareholders were told that the defendant was receiving a sum of £5,000, and the defendant took pains to prevent this becoming known.

The defendant was in a position where his interest conflicted with his duty. As director of the company entrusted with negotiations for the sale of assets of the company, it was his duty to do his best for the company by obtaining the best price it was possible to obtain upon the sale of the business, including the plant and the formulae.

From the point of view of his own personal interests, he would naturally wish to make the best possible agreement for himself in the new employment which had become available to him. It was very important for him to arrange for his own future employment, because the sale of the branch of the plaintiff's business with which he was particularly associated would deprive him of the position which he then held.

There was thus a plain conflict of duty and interest. In such circumstances it was his duty to put the company first. The statement of the chairman of directors (or even the statement of the whole board of directors) that he could do his best for himself was an intimation that, so far as the company was concerned, he was at liberty to accept the position offered to him on the best terms he could get. But in the first place, in my opinion, it is not a fair interpretation of that intimation to say that he was thereby authorized to subordinate the interests of the company to his own. Further, if the directors did purport to give him such an authority, their action would be ineffectual. It would involve a breach of their duty to the company, and the defendant himself would be a party to that breach of duty. The directors were not at liberty to determine, in favour of any of their own body, that the rights of the company should be disregarded (*Cook v Deeks*).

> At the time when the matters to which I have referred took place the defendant was still managing director of the plaintiff company and he did not resign his position as director until 30th October 1929.
>
> In my opinion, the defendant was guilty of a breach of fiduciary obligation by which he has profited at the expense of the company. In my opinion, the defendant is bound to account for the paid up shares and the promissory notes or the proceeds thereof because they were an undisclosed profit received by him in the course of a transaction in which he occupied a fiduciary relationship to the company and by reason of his breach of the obligation upon which the rules of equity insist in such a case.
>
> **Rich, Dixon and Evatt JJ**
>
> The fact was that he occupied an exceptional situation. He was manager of the section of the business under offer and armed with all the knowledge used in conducting it, whether knowledge forming part of the stock he was entitled to carry away from the appellant company's employment or secret information to which that company alone was entitled. He was the director to whom the negotiation of the sale had been largely entrusted. No doubt, too, his influence with his board was not negligible. When he demanded £5,000, it is not surprising that the purchasers thought good reason existed for paying it to him. They did not stop to analyse the ingredients in the situation which enabled him to ask for a lump sum. They expressed the payment one way in their preliminary letter, probably without any particular design. The solicitor expressed it in another way in the service agreement he drew up, probably seeking the most plausible and respectable basis on which the payment could be justified. When, later on, they required a consideration to support an issue of shares, the purchasers described it in a third way. There was some ground for each of the complexions given to the payment. It wore more than one aspect. But the fact of paramount legal significance is that the payment was obtained by the respondent in course of a transaction which he was carrying out on behalf of the company in execution of his office of managing director. It was only because it fell to his lot to negotiate the sale on behalf of his company that he was able to demand and obtain the sum. His fiduciary character was alike the occasion and the means of securing the profit for himself.
>
> To our minds it is quite plain that, by doing so, he greatly diminished the price obtainable by the company. He himself admitted on his cross-examination that his entering into the service agreement decidedly depreciated the formulas as an asset for sale and that no value would be left in them. The respondent had a plain duty with which he brought his private interest into conflict and that is enough.

In *Furs v Tomkies*, the Court accepted evidence that the purchaser was only willing to pay £8,500, that is, the final offer did not include the amount for the confidential information ("formulas"). The defendant took this to the chairman of the seller company, who, the Court accepted, agreed to the sale at the lower price. Accordingly, the advantage taken by the defendant managing director (the £5,000 in addition to salary) may never have materialised as a part of the sale price. Even in this situation,

the defendant breached his duty, and this illustrates the important role of directors as fiduciaries. Without the existence of the defendant's arrangement, the seller company may have been in a better position to negotiate a higher sale price. Accordingly, breach of the duty not only incorporates diverting a company gain, but also nullifying the possibility of gain.

The relationship of disclosure to a breach of duty—corporate opportunities

[19.50] In *Queensland Mines Ltd v Hudson* (1978) 52 ALJR 399, a company claimed that its managing director had breached the fiduciary duty to avoid a conflict of interest when he acquired certain mining exploration licences and subsequently profited from them. The facts disclosed that at the time the managing director took up the mining licences, the company was in a poor financial position and not able to take the opportunity for itself. The managing director had fully disclosed the transaction. Here, disclosure to the board was sufficient as all shareholders were represented on the board. Generally, a board will be unable to ratify a breach of duty as the power of ratification is the shareholder's prerogative. In *Queensland Mines Ltd*, the managing director had resigned his position and had borne the risks and all related expenses concerning the licences. Having regard to the facts, the court held that there was no breach of duty. In this matter, the Privy Council set out that the obligation owed by a managing director of a company to the company is twofold. He or she should not make a profit or take a benefit through their position as fiduciary without the informed consent of their principal, and if they do so they must account to the company for such profit or benefit. In addition, they should not act in a way in which there is a real, sensible possibility of conflict between their own interest and that of the company.

Although disclosure may relieve a director of a breach of the duty owed to the company, this will only occur where the disclosure is full and frank. An example of when disclosure was held not to be sufficient can be found in *Southern Cross Mine Management Pty Ltd v Ensham Resources Pty Ltd* [2005] QSC 233. In this case, the company Ensham Resources was involved in a joint venture arrangement with its shareholders whereby it operated and managed a coal mine. The CEO of Ensham, Foots, undertook certain steps that resulted in his profiting from a lease agreement between a company that he had separately formed, Southern Cross Mine Management and Ensham. Southern Cross had acquired machinery for use in coal mining and leased it to Ensham. The importance of the machinery to Ensham and the opportunity to acquire it had arisen in the course of the carrying out of Foots role as CEO. Foots led Ensham to believe that the leasing arrangement was the most profitable manner of securing the machinery and did not disclose the large profit Southern Cross was making from the lease. It was held that because Foots was Ensham's CEO, he owed it a fiduciary duty in relation to dealings with the machinery and that it was his duty to acquire it for Ensham. Although Foots disclosed his interest in Southern Cross, he failed to disclose all relevant information, particularly that Ensham could have purchased the machinery itself and that this would be more cost-effective than leasing. The court held that Southern Cross

had participated in Foots breach and treated both the company and Foots as one (in effect lifting the corporate veil). A declaration was made that Southern Cross held the machinery on trust for Ensham (a constructive trust).

In *Coope v LCM Litigation Fund Pty Ltd* [2016] NSWCA 37, the facts involved an allegation that the appellant (Coope) had engaged in serious misconduct on two separate occasions, each of which justified the termination of his employment. The appellant cross-claimed against the respondent, seeking damages for the alleged wrongful termination of his employment contract. The New South Wales Court of Appeal affirmed the decision of the trial judge that attempts made by the appellant (the former joint managing director of LCM Management Fund Pty Ltd), to divert funds for his own personal use, amounted to a breach of duty. In addition, it was found that the director had pursued certain business opportunities as if these opportunities belonged to him and that these should have been disclosed and amounted to a conflict of interest. Payne JA, on behalf of the Court of Appeal, confirmed the obligation of the relevant director to seek approval from the company before undertaking an opportunity which arose from his directorship of the company.

The issue of ratification of director's breach of duty

[19.60] As the fiduciary duties are owed to the company, the law has permitted the company (via its shareholders at a general meeting) to ratify (approve or forgive) directors' conduct amounting to breach of these duties. Note though that shareholders cannot ratify a director's breach of the statutory duties in the *Corporations Act* (see under "Relationship of the general law to the Corporations Act" at [20.10]). Whereas ratification is available for general law breaches, its operation is limited. If the company is insolvent, the creditors are at risk and the shareholders cannot ratify conduct in breach. *Kinsela v Russell Kinsela Pty Ltd* was a case in which the directors' conduct (of transferring company assets to themselves) was held by the court to be incapable of ratification by the shareholders upon the ground of the company's insolvency at the time of the transaction. Several members of the Kinsela family were engaged in the business of funeral directors. Russell Kinsela Pty Ltd was incorporated in 1953. The company commenced to offer contributory insurance against the future cost of clients' funerals. Both directly through this participation, and indirectly through responsibility for the contributory insurance undertaken by certain related companies, the company built up a substantial commitment for the future provision of funeral services. However, the company did not make adequate provision for rising costs and inflation. The company's perilous position was compounded by the commencement of legislation in 1979 that introduced control, regulation and protection of the interests of contributors in relation to pre-arranged funeral funds such as those conducted by the company and the three related companies. The directors' response to the company's deteriorating financial circumstances was to arrange for the grant of a lease of the company's business premises in their favour. The company's financial position at the time was hopeless and it was wound up in insolvency in 1981.

Kinsela v Russell Kinsela Pty Ltd (1986) 4 NSWLR 722 (Street CJ, Hope and McHugh JJA)

Extract from Judgment

Street CJ at 729, 732 and 733

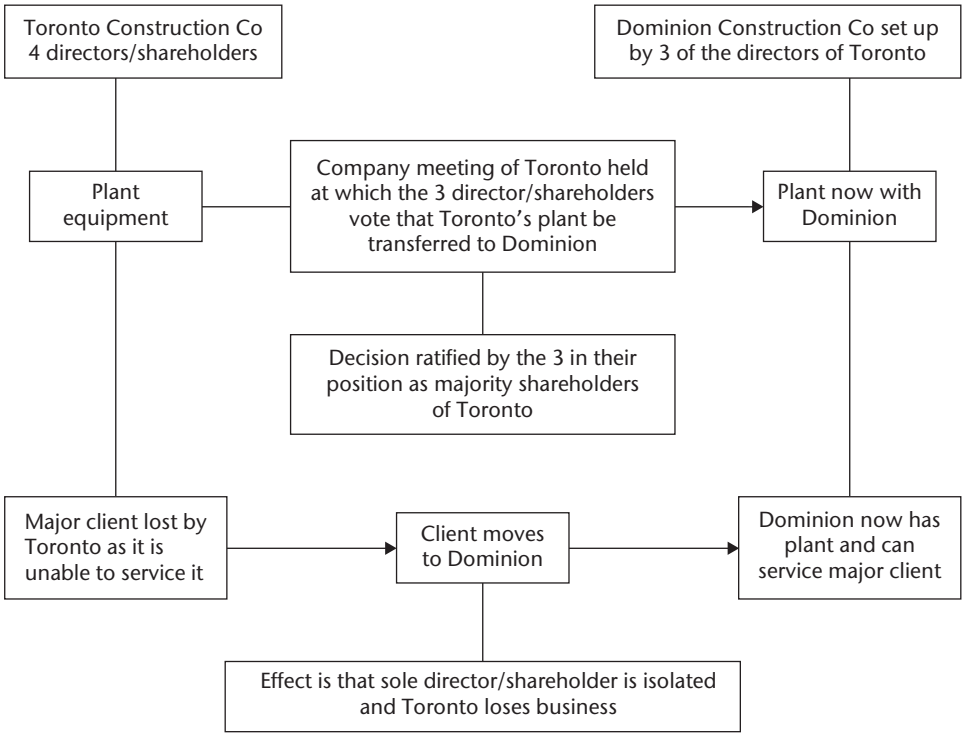
The essential elements can be stated succinctly: this insolvent company, in a state of imminent and foreseen collapse, entered into a transaction which plainly had the effect, and was intended to have the effect, of placing its assets beyond the immediate reach of its creditors; it did this by means of a lease of its business premises entered into with the intention that two of its directors, as lessees, would use those premises for the purpose of continuing to conduct a business of the nature of that which the family of the directors and all of the shareholders had carried on for many years; the lease was executed on behalf of the company by the two directors who were to be lessees with the unanimous approval of all the shareholders of the company; it may be added, for what it is worth, that the terms of the lease were, to say the least, commercially questionable.

It is, to my mind, legally and logically acceptable to recognise that, where directors are involved in a breach of their duty to the company affecting the interests of shareholders, then shareholders can either authorise that breach in prospect or ratify it in retrospect. Where, however, the interests at risk are those of creditors I see no reason in law or in logic to recognise that the shareholders can authorise the breach. Once it is accepted, as in my view it must be, that the directors' duty to a company as a whole extends in an insolvency context to not prejudicing the interests of creditors the shareholders do not have the power or authority to absolve the directors from that breach.

It needs to be borne in mind that to some extent the degree of financial instability and the degree of risk to the creditors are inter-related. Courts have traditionally and properly been cautious indeed in entering boardrooms and pronouncing upon the commercial justification of particular executive decisions. Wholly differing value considerations might enter into an adjudication upon the justification for a particular decision by a speculative mining company of doubtful stability on the one hand, and, on the other hand, by a company engaged in a more conservative business in a state of comparable financial instability. Moreover, the plainer it is that it is the creditors' money that is at risk, the lower may be the risk to which the directors, regardless of the unanimous support of all of the shareholders, can justifiably expose the company.

The case presents an unusually straightforward factual pattern. The company was plainly insolvent at the date of the lease and its collapse on that ground was imminent; thus, no occasion arises to analyse the degree of financial instability which may be necessary to impose upon directors the obligation to consider the position of creditors. Secondly the prejudice to the creditors was the direct and calculated result of the lease; its purpose was to place the company's assets beyond the reach of the creditors; there is thus no occasion to examine on a value basis the commercial wisdom or unwisdom of the decision of the directors.

A further exception to the shareholders' ability to ratify a breach of directors' fiduciary duties can be found in *Cook v Deeks* [1916] 1 AC 554. In this case, a company, Toronto Construction Co, was formed to carry out railway construction for the Canadian Pacific Railway. Toronto had four directors who were also its shareholders. A disagreement arose between three of the directors' and the fourth (Cook). These three formed a new company and then passed a resolution, as the majority shareholders in Toronto, approving the sale of Toronto's plant (needed to carry out its obligations under the contract with Canadian Pacific) to the company that the three had recently formed, Dominion Construction Co. The court held that the three directors had breached their duties in that they acted with a conflict of interest and exercised their powers improperly. The result was that they took a corporate opportunity belonging to Toronto. Further, the purported ratification of the sale by the three as majority shareholders was of no effect as it constituted a fraud on the remaining (minority) shareholder. The court considered that Toronto was entitled to the equity in the contract and that a constructive trust existed in favour of Toronto. Lord Buckmaster LC held (at 565) that those who "assume the complete control of a company's business must remember that they are not at liberty to sacrifice the interests they are bound to protect, and, while ostensibly acting for the company, divert in their own favour business which should properly belong to the company they represent … in the circumstances the defendant directors were guilty of a distinct breach of duty in the course they took to secure the contract, and they cannot retain the benefit of such contract for themselves, but must be regarded as holding it on behalf of the company (Toronto)".



Summary—Fiduciary duties

Directors' roles result in a special (fiduciary) duty to the company

The duty includes good faith, proper purpose and no conflict of interest

Breach of fiduciary duty is enforced by the company

Examples of breach: *Howard Smith v Ampol*; *Cook v Deeks*

Shareholders can in some cases forgive (ratify) a fiduciary breach

Ratification is not possible if the company is insolvent

Example of a case concerning ratification: *Kinsela v Russell Kinsela*

Remedies for breach include: damages; rescission; constructive trust

Example of a case concerning a constructive trust: *Paul A Davies Pty Ltd v Davies*

20
Directors' Statutory Duties

Relationship of the general law to the Corporations Act

[20.10] The *Corporations Act 2001* (Cth) is the main source of corporate regulation in Australia and this includes regulation of the role and responsibilities of directors and other officers. However, the duties of directors also arise from the general (non-statute) law and these general law duties are also relevant to how directors perform their roles and discharge their responsibilities. **Section 185** specifically sets this out. Pursuant to **s 185**, the general law applies in addition to the duties set out in **ss 180-184**. Accordingly, remedies exist for the company, where directors fail to adhere to the standards developed in the general law. It is the company, or sometimes the liquidator or ASIC on behalf of the company, that will bring the action. Where a director's conduct contravenes a provision of the *Corporations Act*, it will be ASIC, in its role as corporate regulator, that will investigate the contravention, commence proceedings and seek appropriate penalties. The relationship between the general law duties and the statutory duties of directors is as follows:

General law duty	Corporations Act
Care and diligence	**ss 180** and **588G**
Use power for proper purpose	**ss 181** and **184**
Good faith and best interests of the company	**ss 181** and **184**
Avoid conflict of interest	**ss 182, 183, 191** and **195**

The main provisions in the *Corporations Act* dealing with directors' duties can be divided into four groups: those dealing with meeting peer standards of management (**ss 180** and **588G**); those dealing with inappropriate conduct having regard to the special position of directors (**ss 181, 182** and **183**); those dealing with dishonest or reckless conduct (**s 184**) and those dealing with obligations of disclosure (**ss 191** and **192**).

Although in some instances a breach of a director's general law (fiduciary) duty may be ratified by the general meeting of shareholders, it should be noted that where directors breach their statutory duties ratification by the shareholders is not available. In *Angas Law Services Pty Ltd (in liq) v Carabelas* (2005) 226 CLR 507; [2005] HCA 23, the High Court considered a situation, where Mr and Mrs Carabelas were the only two shareholders and directors in a company called Angas Law Services Pty Ltd. The company obtained several loans and the loan funds were paid to Mr Carabelas with part of the funds being used to pay back some debts owed by the company. The money

paid by Mr Carabelas was treated by the company as being money loaned to him and then "on lent" to the company, with the result that proceeds from future asset sales by Angas Law Services would be paid to Mr Carabelas. The company became insolvent and actions were brought on behalf of the company against Mr and Mrs Carabelas in respect of their use of the loan funds alleging that they breached their duties owed to the company by not using their positions for proper purposes. Mr and Mrs Carabelas argued that they could not be sued by the company for these alleged breaches because the company (controlled by them) had approved of the transactions. This argument was rejected. Unlike the duties owed to the company, the *Corporations Act* is federal law enforced by ASIC. Accordingly, it should not be within shareholders prerogative to release directors from their statutory duties.

Although the various duties set out in **Pt 2D.1** are generally referred to as the "directors" duties', it must be noted that certain sections (predominately **ss 180-184**) prohibit conduct not only by directors but also by officers of the company and in some cases employees. **Section 179** sets out the coverage of **Pt 2D.1** and specifically includes, in the definition of an officer, not only directors and company secretaries but also others who may manage a corporation such as receivers and liquidators. The definition of an "officer" in **s 9** is also relevant. The importance of widening the scope of the definition of an officer is to enable the legislation to regulate management however it arises, because it is the manner and effect of how a company is managed that will be relevant to creditors and other outsiders.

ASIC plays an important role in providing information and advice to persons intending to become directors of companies. One means of this is through information sheets like the one below. The Information Sheets are periodically updated and redrafted.

ASIC Information Sheet—Your Company and the Law

Your company and the law

If you are a director or secretary of a small company, you need to follow the requirements set out in the *Corporations Act 2001*. ASIC is the company law watchdog. We've put together this guide to let you know about the most important things the law requires directors and secretaries of small companies to do. The law imposes a number of legal obligations on company directors and secretaries. Obviously we can't explain every responsibility or cover every situation here. At times you may need professional legal advice. Please note that even if you appoint an agent to look after the company's affairs, you—not the agent—may still be held responsible for those legal obligations.

1 What does the law expect of you personally?

As a director, you must: be honest and careful in your dealings at all times, know what your company is doing, take extra care if your company is operating a business because you may be handling other people's money, make sure that

your company can pay its debts on time, see that your company keeps proper financial records, act in the company's best interests, even if this may not be in your own interests, and even though you may have set up the company just for personal or taxation reasons, and use any information you get through your position properly and in the best interests of the company. Using that information to gain, directly or indirectly, an advantage for yourself or for any other person, or to harm the company may be a crime or may expose you to other claims. This information need not be confidential; if you use it the wrong way and dishonestly, it may still be a crime.

If you have personal interests that might conflict with your duty as a director, you must generally disclose these at a directors' meeting. This rule does not apply if you are the only director of a proprietary company.

2 What work must a director do?

You and any other directors will control the company's business. Your company's constitution (if any) or rules may set out the directors' powers and functions. You must be fully up-to-date on what your company is doing. Find out and assess for yourself how any proposed action will affect your company's business performance

Only be a company director or a company secretary if you are willing, able and have enough time to put in the effort. Avoid any company where someone offers to make you a director or secretary on the promise that "you won't have to do anything" and "just sign here". You could be exposing yourself to many legal liabilities.

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Statutory duties of good faith and loyalty

Section 181

[20.20] This section mirrors the general law (fiduciary) duty to act in good faith, in the best interests of the company and for a proper purpose. An example of the application of **s 181** (and of certain other sections dealing with directors' duties) can be found in *ASIC v Adler* (2002) 41 ACSR 72; [2002] NSWSC 171 (largely affirmed on appeal in *Adler v ASIC* (2003) 46 ACSR 504; [2003] NSWCA 131).

In *ASIC v Adler*, Mr Adler was a director of HIH Insurance Limited (HIH), a large insurance company. Adler Corporation Ltd (controlled by Adler) was a substantial shareholder in HIH. Funds, amounting to $10 million, advanced by a subsidiary of HIH (HIH Casualty and General Insurance Co Ltd (HIHC)) to a company controlled by Adler called Pacific Eagle Equity Pty Ltd (PEE) were misapplied in a variety of ways. PEE was the trustee of Australian Equities Unit Trust (AEUT), which was controlled by Adler Corporation Ltd. Units in AEUT where issued to HIHC at a price of $10 million (ie, the amount of the advance by HIHC). Accordingly, the $10 million had effectively

come under the control of Adler. Normal protective measures in place at HIH regarding the outgoing from its subsidiary were not applied to the loan. It was undocumented and unsecured. PEE then used the $10 million as follows. Approximately $4 million of the loan was used to purchase shares in HIH, giving a false impression as to its viability and particularly giving the impression that Adler was personally supporting HIH's falling share price by investing. In three months, these shares were sold at a loss of over $2 million. A further sum of approximately $4 million was used to purchase virtually worthless shares owned by Adler Corporation. All of this investment was lost. The third transaction entered into from the original $10 million "loan", involved PEE advancing approximately $2 million by way of unsecured and undocumented loans to companies associated with Adler and Adler Corporation Ltd.

The court held that Adler breached his duty under **s 181** (and **ss 180, 182** and **183**). Matters that played a part in establishing the breaches included: the advantage gained by Adler, the perilous financial position of HIH, the lack of safeguards in place regarding the advance of funds, the risk involved, the false impression to the market and the conflicts of interest. Among the various issues considered by the court were the matters set out in **s 260A** regarding the ability of a company to give financial assistance in relation to the acquisition of its own shares. Financial assistance is not permitted if the acquisition materially prejudices the interests of the company's creditors or shareholders. Clearly, this was the case in the HIH matter, where a subsidiary (HIHC) gave financial assistance to facilitate the acquisition of shares in its holding company (HIH). Adler was held to be an "officer" of HIHC even though he had not been appointed as a director. This is an example of the width of the definition of "officer" in **ss 9** and **179**.

As a result of the breach of his duties, Adler was disqualified from managing corporations for 20 years (**s 206C**), ordered (with Williams, the HIH CEO, and Adler Corporation Ltd) to pay almost $8 million compensation (**s 1317H**) and fined $450,000 (plus the same for Adler Corporation Ltd) under **s 1317G**.

***Corporations Act 2001* (Cth), s 181**

Good faith—civil obligations

Good faith—directors and other officers

(1) A director or other officer of a corporation must exercise their powers and discharge their duties:
   (a) in good faith in the best interests of the corporation; and
   (b) for a proper purpose.

Note 1: This subsection is a civil penalty provision (see section 1317E).
Note 2: Section 187 deals with the situation of directors of wholly-owned subsidiaries.

(2) A person who is involved in a contravention of subsection (1) contravenes this subsection.

Note 1: Section 79 defines involved.
Note 2: This subsection is a civil penalty provision (see section 1317E).

A consideration of the character of the duty to act in good faith in **s 181** is co-extensive with the manner in which the duty is applied in the general law. When considering a breach by a director of the duty to act in good faith, and for a proper purpose, there is a need to identify how the duty is to be applied. If it is a subjective duty, the director's belief as to the relevant conduct may be important. However, if the duty is objective in character, the director's conduct needs to be weighed by a peer standard. In *Bell Group Ltd (in liq) v Westpac Banking Corp (No 9)* (2008) 20 ACSR 1; [2008] WASC 239 and in the appeal of that matter *Westpac Banking Corporation v Bell Group Ltd (in liq) (No 3)* (2012) 89 ACSR 1; [2012] WASCA 157, there was support for an objective approach. The brief facts of the case are that in the early 1990s, the Bell Group of companies were in severe financial difficulty and as a result collapsed, eventually being placed into liquidation. Prior to collapse, companies in the Bell Group transferred property to certain banks. These banks then became secured creditors and their position improved as against other creditors and in fact materially prejudiced the interests of these other creditors. Proceedings were commenced by the liquidators contending that the directors of the Bell Group of companies had breached their duties, and that the banks had knowingly participated in those breaches and that the assets seized by the banks under the securities should be returned to the Bell Group of companies for the benefit of all creditors.

The WA Court of Appeal held that the directors had breached their fiduciary duties. An appeal to the High Court followed but the matter settled before the hearing of the appeal. An extract from the judgment in the Western Australia Supreme Court of Appeal focusing on the nature of a fiduciary duty follows:

Westpac Banking Corporation v Bell Group Ltd (in liq) (No 3) 89 ACSR 1; [2012] WASCA 157 (Lee AJA, Drummond AJA, Carr AJA)

Extract from Judgment

Lee AJA at [849], [883]-[884]

The directors represent the organic element of an otherwise inanimate entity and are the controlling mind and will of a corporation. They exercise all powers of the company other than those reserved to the company in general meeting. Responsibility for the management of the business of a corporation is imposed on directors by statute, subject to any qualification provided by the constitution of the company. If directors devolve management functions to employees of the company, due oversight of that management remains part of the duties of the directors. See *Australian Securities and Investments Commission ["ASIC"] v Vines* [2005] NSWSC 1349; *Corporations Act*, s 190. Specifically directors are entrusted by a company to protect and advance the interests of the corporation and, where the corporation is in a situation of insolvency, not to have the corporation prejudice the interests of creditors.

Entitlement to remedy in equity for breach of a fiduciary duty does not depend upon showing personal enrichment of the fiduciary, or of another at the hands of the fiduciary. Such relief extends to conduct of the fiduciary that causes loss

> and detriment by reason of the breach of an essential obligation of the fiduciary relationship. In other words, where there has been a breach in a fundamental respect of the pledge by the fiduciary (in a fiduciary relationship) to act in the best interests of another that occasions loss or detriment, equitable compensation should follow. Thus, where exercise of care and diligence in management of the affairs of a corporation has been pledged by a director and relied on by a corporation, it would be consonant with principle for a breach of that obligation (by unreasonable conduct by a director that amounts to gross or culpable negligence and loss or detriment has resulted to a corporation), to be treated as a breach of a fiduciary duty in that fiduciary relationship.

Section 182

[20.30] This section prohibits directors improperly using their position to gain advantage. In effect, the section targets a conflict of interest. An example of where the court has found evidence of this type of breach in the general law is *Furs Ltd v Tomkies* (1936) 54 CLR 583, where a director disclosed a secret formula known to him because of his position and received a benefit in return. In *ASIC v Adler* (2002) 41 ACSR 72; [2002] NSWSC 171, Mr Adler used loan funds to gain an advantage for a company he controlled. The loan funds were used to purchase worthless shares from Adler Corporation Ltd for almost $4 million. The court held that the conduct amounted to a breach of **s 182**.

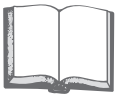
Section 182 was considered by the NSW Court of Appeal in *Gunasegaram v Blue Visions Management Pty Ltd* [2018] NSWCA 179. In this case, a project management contract being carried out by the appellant Blue Visions, for the development of Perth Children's Hospital was novated (a party substituted) in favour of a third party, Aspire Corp Pty Ltd. Aspire was established by two former senior employees of Blue Visions, being Sam Chidiac and Arun Gunasegaram. Prior to leaving Blue Visions, Chidiac had, in response to an inquiry by the hospital, indicated his willingness to continue with the project when he left Blue Visions. At a later date, when the initial contract came up for renewal Aspire, and not Blue Visions, was successful.

Blue Visions claimed damages and an account of profits resulting from the novated portion of its contract. It invoked both breach of fiduciary duties owed by its senior employees to the company and improper use of position by each, in breach of **s 182(1)**. The section includes directors, other officers, and employees.

It was held that the discussions between Chidiac and the hospital that took place while he was still employed by Blue Visions did not amount to a definite opportunity. These discussions did not show Chidiac to be pursuing any opportunity which could give rise to a real or substantial possibility of conflict (Meagher JA at [72]). As Chidiac had no role in the surrender of the relevant contract, Meagher JA distinguished *Cook v Deeks* at [19.60], a case where directors initiated, and benefitted from, a transfer of company property. Further, for a breach of **s 182**, the Court of Appeal considered that some impropriety must accompany the conduct complained of, and this must

be considered by reference to the duties, powers and authority of the director, officer, or employee at the time and in the circumstances in which it occurred (Meagher JA at [79]).

Directors' conflicts of interest can arise in many different forms, and in some cases, their duties under the *Corporations Act* to act in good faith, or to avoid using their position for gain, intersect with, sometimes general or sometimes specific, obligations under other legislation. For instance, politicians in some cases may pursue corporate interests through directorships outside of, or following, their parliamentary role. The *Foreign Influence Transparency Scheme Act 2018* (Cth) specifically targets the relationship of influence, and possible conflict, that may arise where, individuals, including directors, have obligations towards "foreign principals" and also have, or have had, parliamentary responsibilities. The following extract considers this issue.



[John Garrick, "Agents of foreign influence: with China it's a blurry line between corporate and state interests", *The Conversation*, 27 February 2019.]

Former Victorian premier John Brumby says he has quit as a director of Chinese tech giant Huawei in Australia because he has too much else to do. Former federal foreign minister and ex-NSW premier Bob Carr has quit his job as director of the Australia-China Relations Institute.

It might be just a coincidence that these decisions have come just days before new foreign influence transparency laws come into effect on March 1. The new laws are supposed to make visible the "nature, level and extent of foreign influence on Australia's government and political process". There is more than enough evidence that greater transparency is needed.

Federal parliament passed the *Foreign Influence Transparency Scheme Act* (FITS) in December. The Act obliges individuals to register if they act on behalf of "foreign principals" – be they governments, government-related entities, political organisations or government-related individuals. Failing to apply for (or renew) registration, providing false and misleading information or destroying records may lead to a prison term of up to six years for individuals and fines of A$88,200 for companies. Registrable activities include: parliamentary and political lobbying on behalf of a foreign principal; communications activities for the purpose of political or government influence; employment or activities of former cabinet ministers.

Section 183

[20.40] This section prohibits directors misusing their information to gain advantage. In *Grove v Flavel* (1986) 43 SASR 410; 4 ACLC 654, one company within a corporate group was near insolvency. To protect himself (and other companies in the group) from the negative effect of that company's possible liquidation, a director rearranged the group structure to isolate the failing company. This conduct was held to be an improper use of the information gained as a result of his role as a director.

When directors become aware that their company is insolvent, or is nearing insolvency, and creditors begin to threaten action if not paid, the directors sometimes take steps to save the business of the company but not the company itself. This is achieved by transferring the business and assets of the company to either a newly formed company or to an existing related company. This new entity is often referred to as a "phoenix" company (it rises from the ashes of the old company). The old company, which has the liability to the creditors, is left as a shell with no assets. Often, because the new company has a similar name and even the same address, creditors mistake it for the old company and fail to recognise that the company that is trading (the new company) is not the company that owes them their debts. It may be some time until this is realised by the creditor and by this time their true debtor (the old company) is completely worthless. In some instances, the directors will be adjudged as beaching their duty. First, to the old company, as fiduciaries, because the insolvency of the company meant their duties involved the creditor's interests, and second, as in *Grove v Flavel*, because they misuse their position or information and thereby breach **s 182** or **s 183**.

The problems associated with phoenix activity have been addressed by the federal government. The *Corporations Amendment (Phoenixing and Other Measures) Act 2012* (Cth) amended the *Corporations Act* to enable ASIC to wind up a company in a number of circumstances pursuant to **s 489EA**, including if it has reason to believe that the company is not carrying on a business and provided the company is given at least 20 business days' notice of ASIC's intention. Where a company is wound up under **s 489EA**, the liquidator appointed may investigate and report on any director misconduct.

It should be noted that while the position of the company's creditors in situations of insolvency is important to how the obligations of directors will be viewed, directors do not owe an independent duty to creditors, which is enforceable by creditors. Creditors have indirect rights and cannot themselves commence civil proceedings against directors to recover losses (*Spies v The Queen* (2000) 201 CLR 603; [2000] HCA 43).

In relation to the prohibitions in **ss 182** and **183**, and having regard to a director's general law duties, it is sometimes open to companies to claim that a corporate opportunity has been taken by a director to the detriment of the company. In terms of the two sections, this could encompass a director misusing either position or information for advantage. If the opportunity comes to the director while carrying out company business, a conflict of interest will arise if the director uses the opportunity for personal advantage. Note though cases like *Queensland Mines v Hudson* (1978) 52 ALJR 399 (see [19.50]) and *Peso Silver Mines v Cropper* (1966) 58 DLR (2d) 1 that provide instances where, by matters such as disclosure, the directors may avoid a breach of duty.

Where a person has aided, abetted, counselled or procured another to contravene the *Corporations Act*, or has induced or conspired with others giving rise to a contravention, then pursuant to **s 79** that person is deemed to be involved in such contravention. In *ASIC v Somerville* (2009) 77 NSWLR 110; [2009] NSWSC 934, Windeyer AJ in the Supreme Court of NSW held that a solicitor who had recommended and prepared

documents for the directors of an insolvent company, which had the effect of restricting the company's creditors' rights to recoup debts, was "involved", in the terms of **s 79**, in the contraventions by the directors of that company under **ss 181**, **182** and **183**. All of the directors and the solicitor were disqualified from managing corporations pursuant to **s 206C**. Below is ASIC's report of the case.

ASIC Media Release

09-174AD Legal adviser and company directors found liable in relation to "phoenix" activity

The New South Wales Supreme Court has found eight directors of unrelated companies to have acted in breach of the *Corporations Act* by engaging in what ASIC regards as illegal "phoenix" activity and that their legal adviser also contravened the *Corporations Act* by being involved in the directors' breaches.

Each of the directors had sought advice from their solicitor in circumstances where his company was insolvent or nearing insolvency. The transactions entered into by the directors as a result of that advice were found by the court to have the effect of taking assets out of their companies and out of the reach of creditors, and that by causing the companies to enter the transactions, the directors failed in their duty to act both in the interest of the company and its creditors.

This is the first time ASIC has successfully taken action against an adviser for involvement in facilitating illegal phoenix activity. The findings made by the Court against the solicitor mark out the line across which legal and other professional advisers should not step. It was found that the transactions would not have taken place but for the solicitors involvement. By his advice and conduct, he had facilitated his clients breaching their directors' duties and as a consequence he was found to have aided and abetted their breaches.

In this case, Acting Justice Windeyer was satisfied that the solicitor had devised a series of transactions, with the appearance of legitimacy, to bring about asset stripping and disadvantage to creditors.

"Not only does this case reinforce the role and responsibilities of directors in insolvency situations, but it brings home to advisers the need to ensure that they do not get themselves in a position where their involvement amounts to advice, as in this case, to carry out an improper activity. Advisers who go beyond the normal giving of advice which cause their clients to breach the director duties provisions of the *Corporations Act* run the risk of themselves breaching those provisions by being involved in their clients' contraventions", ASIC Commissioner Michael Dwyer said.

Declarations of breaches of their duties, under sections 181(1), 182(1) and 183(1) of the *Corporations Act*, were made against each of the eight directors. Declarations for breaches of these provisions were also made against the solicitor as it was found, pursuant to section 79 of the *Act* that he aided and abetted the directors in their breaches.

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Section 184

[20.50] Where directors or other officers act in a manner prohibited in **ss 181**, **182** or **183**, that is, they do not exercise good faith or act for a proper purpose, or they misuse their position or their information for gain, and in doing so they are reckless or dishonest, they will be in breach of **s 184**. **Section 184(1)** sets out that a director or other officer commits an offence if they are reckless or dishonest and do not exercise their powers and duties in good faith in the company's best interests, or for a proper purpose. **Section 184(2)** creates an offence, where a director, other officer or employee uses their position dishonestly with the intention of gaining an advantage for themselves or others, or causing detriment to the company, or is reckless as to whether this outcome will occur. **Section 184(3)** creates an offence, where a person who is, or has been, a director, other officer or employee obtains information because of their position and uses that information dishonestly with the intention of gaining an advantage for themselves or others, or causing detriment to the company, or is reckless as to whether this outcome will occur. It should be noted that the *Act* specifically sets out in **s 184(2A)** and **(4)** that no defence will exist for breaches of **s 184(2)** and **(3)** even if the corporation benefits from the conduct, or benefit to the corporation was intended, if the conduct in breach was, nonetheless, dishonest. This section targets criminal liability and pursuant to **Sch 3** of the *Corporations Act* breach results in 15 years imprisonment. In the matter of *Kwok v The Queen* (2007) 175 NSWLR 278, a director who deliberately failed to disclose a conflict of interest in relation to a lease transaction with associated companies was held to have acted dishonestly and thereby breached **s 184**. The director was sentenced to periodic detention.

The following ASIC Media Release concerns the collapse of property investment company Fincorp Investments Ltd and the involvement of other Fincorp group companies. Investors' funds were used to buy land and fund property development in NSW, Queensland and Victoria. Issues raised by ASIC concerned the duties of directors in relation to insolvent trading and the situation, where directors use company funds for their own personal purposes while company indebtedness increases. Proceedings commenced in the District Court of NSW resulted in a finding that the chairman had breached **s 184**. Pursuant to **Sch 3**, a prison sentence was handed down together with a pecuniary penalty and resultant disqualification.

ASIC Media Release

> ***11-78AD Fincorp director imprisoned for dishonesty offences***
>
> The former Chairman and CEO of Fincorp Investments Ltd was sentenced today in the Parramatta District Court in relation to three offences against s 184(2)(a) of the *Corporations Act*. The offences relate to the dishonest use of his position as a company director with the intention of gaining an advantage for himself and others.

District Court Judge Woodburne sentenced the director to imprisonment for three years and six months with a requirement he serve eight months before being eligible for parole. The director will also be disqualified from managing a corporation in Australia, including acting as director of a company, for five years from the date of his release from prison, pursuant to section 206B of the *Corporations Act*. He was convicted of the three offences in February 2016. A District Court jury found that he dishonestly signed three company cheques for $900,000, $825,000 and $1,980,000 to pay for services that were never provided and personally received most of the proceeds from those cheques.

The matter was prosecuted by the Commonwealth Director of Public Prosecutions.

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***Corporations Act 2001* (Cth), s 182**

Use of position—civil obligations

Use of position—directors, other officers and employees

(1) A director, secretary, other officer or employee of a corporation must not improperly use their position to:
   (a) gain an advantage for themselves or someone else; or
   (b) cause detriment to the corporation.

This subsection is a civil penalty provision (see section 1317E).

(2) A person who is involved in a contravention of subsection (1) contravenes this subsection.

Note 1: Section 79 defines involved.

Note 2: This subsection is a civil penalty provision (see section 1317E).

***Corporations Act 2001* (Cth), s 183**

Use of information—civil obligations

Use of information—directors, other officers and employees

(1) A person who obtains information because they are, or have been, a director or other officer or employee of a corporation must not improperly use the information to:
   (a) gain an advantage for themselves or someone else; or
   (b) cause detriment to the corporation.

Note 1: This duty continues after the person stops being an officer or employee of the corporation.

Note 2: This subsection is a civil penalty provision (see section 1317E).

(2) A person who is involved in a contravention of subsection (1) contravenes this subsection.

Note 1: Section 79 defines involved.

Note 2: This subsection is a civil penalty provision (see section 1317E).

***Corporations Act 2001* (Cth), s 184**

Good faith, use of position and use of information—criminal offences

Good faith—directors and other officers

(1) A director or other officer of a corporation commits an offence if they:
  (a) are reckless; or
  (b) are dishonest;
  and fail to exercise their powers and discharge their duties:
  (c) in good faith in the best interests of the corporation; or
  (d) for a proper purpose.

Note: Section 187 deals with the situation of directors of wholly-owned subsidiaries.

Use of position—directors, other officers and employees

(2) A director, other officer or employee of a corporation commits an offence if they use their position dishonestly:
  (a) with the intention of directly or indirectly gaining an advantage for themselves, or someone else, or causing detriment to the corporation; or
  (b) recklessly as to whether the use may result in themselves or someone else directly or indirectly gaining an advantage, or in causing detriment to the corporation.

(2A) To avoid doubt, it is not a defence in a proceeding for an offence against subsection (2) that the director, other officer or employee of the corporation uses their position dishonestly:
  (a) with the intention of directly or indirectly gaining an advantage for the corporation; or
  (b) with the result that the corporation directly or indirectly gained an advantage.

Use of information—directors, other officers and employees

(3) A person who obtains information because they are, or have been, a director or other officer or employee of a corporation commits an offence if they use the information dishonestly:
  (a) with the intention of directly or indirectly gaining an advantage for themselves, or someone else, or causing detriment to the corporation; or
  (b) recklessly as to whether the use may result in themselves or someone else directly or indirectly gaining an advantage, or in causing detriment to the corporation.

(4) To avoid doubt, it is not a defence in a proceeding for an offence against subsection (3) that the person uses the information dishonestly:
  (a) with the intention of directly or indirectly gaining an advantage for the corporation; or
  (b) with the result that the corporation directly or indirectly gained an advantage.

***Corporations Act 2001* (Cth), s 185**

Interaction of sections 180 to 184 with other laws etc.
Sections 180 to 184:

(a) have effect in addition to, and not in derogation of, any rule of law relating to the duty or liability of a person because of their office or employment in relation to a corporation; and
(b) do not prevent the commencement of civil proceedings for a breach of a duty or in respect of a liability referred to in paragraph (a).

The duty of care and diligence

[20.60] Whether a director had breached the duty of care and diligence in the general law has, in the past, depended on a largely subjective assessment of that director's own skills and knowledge. For example, in *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407, Romer J considered directors did not need to exhibit a greater degree of skill than may reasonably be expected from a person of their particular knowledge and experience. However, as the commercial environment increased in complexity during the later part of the 20th century, accountability and objectivity altered the application of the standard. Accordingly, the standard applied to a director's duty of care in *Re City Equitable* is no longer relevant. Today, as established in *Daniels v Anderson* (1995) 37 NSWLR 438, an objective standard applies.

Shareholders, as well as other stakeholders in corporate decision-making, will have expectations in relation to the conduct and skill of directors. The outcome of these expectations was considered in *Daniels v Anderson*, where the court examined the duty of auditors and, importantly, the application of an objective standard to test whether directors had breached their duty of care and diligence. During the late 1980s, AWA Ltd entered into investment in foreign exchange. It had initially seemed that the foreign exchange trading was profitable, however, this was due to the deception of one of its middle managers who, without adequate supervision, concealed losses of almost $50 million. During the time that these losses were accumulating two audits were conducted and even though the audit partner in charge (Daniels) raised some concerns as to AWA's internal controls (although these did not reach the board), the true position was not made clear in either of the audits. The NSW Court of Appeal found that the auditors were primarily responsible for the loss but that nonetheless the company's directors had a duty to take reasonable steps to monitor management and be familiar with the company's financial position. The Court of Appeal found the chair of directors (executive director) to have been negligent and this was attributed to the company. Accordingly, the liability of the auditors was reduced as the result of this contributory negligence.

Daniels v Anderson (1995) 13 ACLC 614;
37 NSWLR 438 (Clarke JA, and Sheller JA and Powell JA)

Extract from Judgment

Clarke and Sheller JJA at 444, 500 and 505

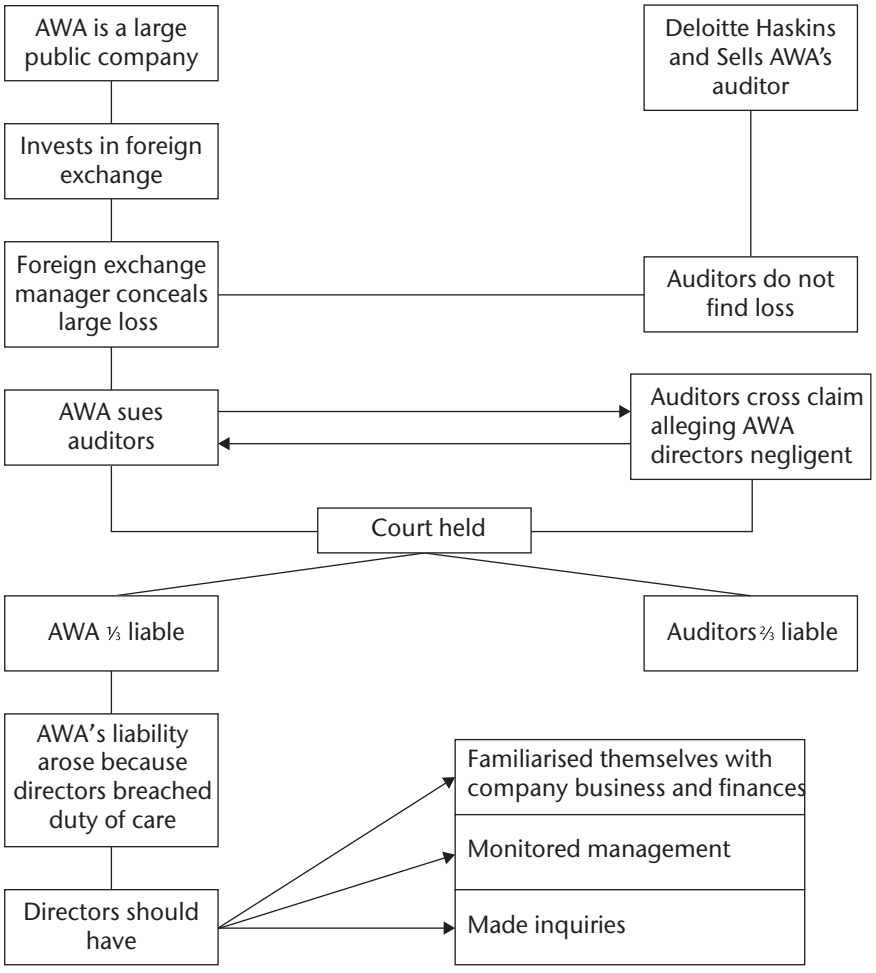
AWA Ltd (AWA) is a long established company. In 1986 and the first half of 1987 Deloitte Haskins & Sells, a well-known firm of chartered accountants, were the auditors. The directors were experienced businessmen who had served or were serving on the boards of prominent and successful companies as chairmen or directors. One of AWA's major activities was the manufacture, import and export of electronic and electrical products. AWA imported large quantities of components from Japan and other countries. To hedge against foreign currency fluctuations in late 1985 AWA began to make forward purchases of foreign currency against contracts in place or anticipated for imported goods. In December 1985, Andrew Koval was appointed foreign exchange manager of AWA. He appeared to be brilliantly successful. AWA seemed to be making huge profits on foreign exchange dealings. However, AWA claimed that by early July 1987 Koval had, undetected, lost $49.8 million as a result of Deloitte Haskins & Sells' repeated failure, as auditors, to report gross deficiencies in the company's records and internal controls.

On 28 October 1988, AWA brought proceedings against Deloitte Haskins & Sells to recover damages for breach of contract and negligence. In their defence Deloitte Haskins & Sells alleged that AWA's loss was caused or materially contributed to by its own fault and in addition cross-claimed to recover indemnity or contribution collectively and severally against four of the directors.

Negligence of directors

There is no doubt reason for establishing a board which enjoys the varied wisdom of persons drawn from different commercial backgrounds. Even so a director, whatever his or her background, has a duty greater than that of simply representing a particular field of experience. That duty involves becoming familiar with the business of the company and how it is run and ensuring that the board has available means to audit the management of the company so that it can satisfy itself that the company is being properly run.

A person who accepts the office of director of a particular company undertakes the responsibility of ensuring that he or she understands the nature of the duty a director is called upon to perform. That duty will vary according to the size and business of the particular company and the experience or skills that the director held himself or herself out to have in support of appointment to the office. None of this is novel. It turns upon the natural expectations and reliance placed by shareholders on the experience and skill of a particular director. The duty is a common law duty to take reasonable care owed severally by persons who are fiduciary agents bound not to exercise the powers conferred upon them for private purpose or for any purpose foreign to the power. The duty includes that of acting collectively to manage the company. Breach of the duty will found an action for negligence at the suit of the company.



Section 180

[20.70] This section reflects the progression of the law from a subjective approach to the determination of directors' responsibilities of care and diligence to an objective, peer-focused approach. **Section 180** sets the appropriate standard by that of a reasonable person subject to the same circumstances in which the decision is being made and with the same responsibilities as the director in question.

Directors must be pro-active in their approach to management. This can be achieved by:

- keeping themselves informed about company matters;
- regular attendance at meetings;
- making their own inquiries and not merely relying on the information of others; and
- participating in the decision-making processes.

Note that the business judgment rule in **s 180(2)** sets out criteria that, if established, enable a director to satisfy the care and diligence obligations in **s 180(1)**. Compliance with the business judgment rule requires directors to: make their decisions in good faith for a proper purpose; avoid a material personal interest in the subject matter of the business judgment; inform themselves about the subject matter to the extent they reasonably believe to be appropriate; and rationally believe the judgment is in the company's best interests. The business judgment rule provides some certainty for honest and diligent directors and as such underpins entrepreneurial risk-taking. Shareholders of public companies generally rate creation of profit as the most important characteristic of directors, and in this regard, some level of risk-taking is sometimes necessary and likely to be an important part of a director's role as an effective corporate manager. The protection afforded by **s 180(2)** is only available in relation to the care and diligence obligations set out in **s 180(1)**.

In *ASIC v Adler* (2002) 41 ACSR 72; [2002] NSWSC 171, Adler sought to rely on the business judgment rule as a defence to the actions brought by ASIC for breach of duty of care under **s 180(1)**. However, the court rejected Adler's defence upon the basis that the decision to invest the $10 million received from HIHC in Pacific Eagle Equity Pty Ltd amounted to a clear conflict of interest (ie, Adler had a material personal interest in the subject matter of the business judgment in breach of **s 180(2)(b)**).

Another example of a case concerning **s 180** is *Vines v ASIC* (2007) 62 ASCR 1. In that case, AMP Insurance (a subsidiary of AMP Limited) made a takeover offer for all of the shares in GIO Australia Holdings Ltd. Both were very large companies whose major business was based in insurance. GIO was the holding company for several subsidiaries including GIO Insurance Ltd whose business included reinsurance through a company called GIO Re. The takeover proceeded in the normal manner with the bidder (AMP) disclosing various relevant matters in relation to its bid. In response to the AMP offer, the board of GIO issued its target's statement. Largely as the result of a profit forecast relating to GIO's reinsurance business (provided by Vines), the GIO directors recommended that their shareholders reject the AMP offer as too low relative to the strength of GIO. This advice influenced small-holding shareholders who held on to their shares, however larger institutional investors decided to accept the offer, and as a result, the bid was successful. The shareholders who did not accept became subject to a scheme of arrangement which in effect converted them into AMP shareholders but which valued their shares at less than the takeover price.

An important issue in this matter involved the purpose of Vines's conduct and whether it influenced the manner in which the duty of care was to be assessed. Vines was responsible for providing advice in the form of written and oral statements he made to the company's due diligence committee and the board. This information would eventually be available to target shareholders when the company's profit forecasts were released to the market. In the environment of a hostile takeover bid, reliance was a key component of the duty. However, it must be noted that failure to exercise reasonable care and diligence may not be established unless it was reasonably foreseeable at the time of the director's conduct that such conduct might prejudice the

company's interests. The benefit of hindsight is not relevant to that assessment. The New South Wales Court of Appeal held that Vines had contravened the *Corporations Act* (although not on all of the initial grounds found at first instance—*ASIC v Vines* (2005) 55 ACSR 617; [2005] NSWSC 738). The Court of Appeal held that a breach of **s 180** arose on the basis that the profit forecast was unlikely to be achieved and that Vines knew or ought to have known this and was therefore under a duty to advise the company's due diligence committee.

Section 180 concerns decisions made in a business context and the defences in **s 180(2)** only become relevant if a "business judgment" can be shown to have been actually made. In *Gold Ribbon (Accountants) P/L v Sheers* (2005) 23 ACLC 1,288, a defence based on **s 180(2)** was rejected on the ground that the (non-executive) director, in making the decision, did not consider or "turn his mind" to the matter of whether his decision was in the best interests of the company and therefore had not made a "judgment" for the purposes of the section. The director appealed in this matter and although the findings that he failed to adequately administer his company's business and had breached his duty were not disturbed, the Queensland Court of Appeal overturned the earlier decision on the ground that the director's conduct did not cause the company's losses (*Gold Ribbon (Accountants) Pty Ltd v Sheers* [2006] QCA 335).

Executive (full-time) and non-executive (consultant) directors perform different roles in companies; however, both are subject to the obligation to act with care and diligence. The appropriate standard is that of a reasonable person with the same responsibilities and in that corporation's circumstances. However, the evidence with which breach will be tested may differ. A "reasonable" executive director may not have the same responsibilities as a "reasonable" non-executive. In *ASIC v Macdonald (No 11)* (2009) 71 ACSR 368; [2009] NSWSC 287, ASIC brought proceedings against all of the directors of James Hardie Industries Ltd. Of those 10 directors, three were executives and seven were non-executives (see discussion of this matter under "Corporate social responsibility and corporate governance" at [20.80]).

In the article from which the following extract is drawn the argument is put that **s 180** has been used to impose liability on directors in excess of the original formulations of their duties.



[Pearce M, "Company directors as 'super-fiduciaries' " (2013) 87 *Australian Law Journal* 464 at 480, 481.]

There is no doubt the law of directors' liability had to evolve beyond its early formulations by the Chancery judges. The vast expansion since those times of the role of companies in the modern economy and in modern life generally has made that inevitable. A standard of care for company directors based on gross negligence could not last. Nevertheless the equitable, and specifically fiduciary, origins of the director's liability to the company provide an important frame of reference even today. In addition, it remains unrealistic to impose a high standard of care on directors, given the risk taking expected of them.

It was not reasonable either to expect that Parliament would remain aloof from the development of the law of directors' duties. The pressure on legislators to cure all society's ills has inevitably led to legislative intervention in setting standards for company directors. Nor can those evolving standards be criticised except perhaps for the uncoupling of the duty of care and diligence from the duty of honesty and then the abandonment of the latter duty. This may have had the unconscious effect of putting further out of mind the equitable and fiduciary foundations of the director's duties.

The real difficulties have emerged in recent years in the courts' applications of the duty of care and diligence now found in s 180(1) of the *Corporations Act*. The courts' response has been influenced by the following factors:

- The prevalence of applications for consent judgments, whereby directors, many unrepresented, have agreed with ASIC to accept liability for contravention of s 180(1) to avoid the trouble and expense of a trial and declarations of contraventions are made without countervailing argument.
- ASIC's preference, however understandable, for civil actions even in respect of conduct that is clearly criminal.
- The limitations of the accessorial liability provisions such as s 79 of the *Corporations Act* and of the common law rules of accessorial liability.
- The fact that the misleading or deceptive conduct provisions like s 1041H are not civil penalty provisions so that even serious misleading conduct like in the James Hardie litigation would not, without more, result in a disqualification order.
- The fact that s 206E permits disqualification of directors of companies which contravene the *Corporations Act* only after two such contraventions.
- Highly charged litigation such as the *AWB* and *James Hardie* cases where there was an understandable desire to hold to account the people responsible for serious public scandals.

In response to these factors the law has now developed so that s 180(1) has become "catch all" provision for penalising directors when things go wrong with their companies. It covers a spectrum from criminal misappropriation of funds from third parties to merely permitting the company itself to break the law. This liability might also be imposed when the company has not even broken the law but only acted immorally and thereby suffered damage to its reputation. The liability can arise even if the director believed he or she was acting in the company's best interests and there was no suggestion that the director has preferred his or her personal interests to those of the company. The early requirement for weighing the jeopardy to the company against the advantages sought to be achieved seems to have been abandoned.

This not only undermines the will of Parliament, it also threatens the coherence of the law. It is turning company directors into a kind of "super-fiduciary" liable not only to the company in the traditional fiduciary sense but also to the world at large for the wrongs of the company even when the company has not broken the law but only acted immorally and even if the director thought he or she was acting in the company's best interests and did not stand to gain personally. This has happened without any real public debate and with minimal consideration by the courts. The High Court's emerging concern about defending the coherence of the law might justify an examination and reconsideration by it of this case law.

The roles of directors in all companies will differ in varying degrees. In large public companies, non-executive roles are generally substantially different to those of the executives. The non-executives carry out a consultative role and may rely to an extent on the information put before them by the executives. On the other hand, the executive directors play an integral part in the ongoing business of the company. All directors rely on financial data provided by a number of sources. **Section 295(4)** requires that in the financial report for a financial year a director's declaration must be prepared affirming that the company is able to pay its debts as and when they become due and payable; that where applicable, compliance with international financial reporting requirements have been met; and that the financial statement is in accordance with **s 296** regarding compliance with accounting standards and **s 297** requiring the statement to present a true and fair view of the company's financial position. **Section 295A** focuses on listed entities and sets out that each person who performs the chief executive function (CEO) or the chief financial officer function (CFO) must complete a written declaration that, in their opinion, the financial records have been properly maintained in accordance with **s 286**, that the financial statements comply with the accounting standards, and that they give a true and fair view. The role of the directors in relation to financial aspects of company disclosure was examined when ASIC brought proceedings against both the executive and non-executive directors of companies within the Centro Properties Group for failures to disclose the true extent of the company's debt in 2007. The Federal Court found that the non-executive directors of the Centro group had breached their directors' duties in failing to identify errors in the classification of liabilities and the failure to disclose post-balance date guarantees in company accounts. The proceedings covered issues in relation to both **s 180** and **s 295A**. An issue that is increasingly relevant to directors' duty of care and diligence is the level of scrutiny required as concerns financial information presented to the board by (non-board) management and independent auditors. An extract from the case follows:

ASIC v Healey (2011) 196 FCR 291; [2011] FCA 717 (Middleton J)

Background

This case primarily concerned the liability of the non-executive directors of a group of substantial, publicly-listed companies for approving accounts which failed to disclose significant matters known to the directors, or which should have been well-known to them. Specifically, those matters related to the existence of short-term liabilities (which were incorrectly classified as non-current liabilities) and guarantees given after the balance date in relation to same, both of which affected the assessment of the company's solvency and liquidity. The plaintiff claimed that the directors' actions amounted to contraventions of ss 180(1), 344(1) and 601FD(3) of the *Corporations Act 2001* (Cth) (the *Act*). The directors argued however that they were entitled to place reliance on the assurances and specialist advice provided by management and auditors in connection with the accuracy of financial reports, and that the failure of

those professionals to detect the errors in question led to the result that the directors themselves had not breached the Act.

The legislative scheme provided that a company's annual financial report and directors' report was to be prepared by the entity itself, and accompanied by a declaration by the relevant executives that, in their opinion, the financial records had been properly maintained, complied with the accounting standards and gave a true and fair view (ss 292 and 295A of the *Act* respectively). However, the directors had to pass a resolution to approve the accounts and reports and to declare that, in their opinion, the financial statements complied with the accounting standards and gave a true and fair view (s 295(4)(d)), and there were reasonable grounds to believe that the entity would be able to pay its debts as and when they became due and payable (s 295(4)(c)). Section 344 of the *Act* then required each director to take "all reasonable steps" to comply or secure compliance with those financial reporting requirements, while s 180(1) more generally required a director to exercise his or her powers and discharge his or her duties with the degree of care and diligence that a reasonable person would exercise in the circumstances. Section 601FD of the *Act*, which was engaged because two of the companies in the group were the responsible entities of managed investment schemes, also provided that duties corresponding with those detailed above were required of officers of a responsible entity of a registered scheme.

The 2007 annual reports of Centro Properties Group ("CNP") and Centro Retail Group ("CER") failed to disclose significant matters. In the case of CNP, the report failed to disclose some $1.5 million of short-term liabilities by classifying them as non-current liabilities, and failed to disclose guarantees of short-term liabilities of an associated company of about US$1.75 million that had been given after the balance date. In the case of CER, the 2007 annual reports failed to disclose some $500 million of short-term liabilities that had been classified as non-current.

Extract from Reasons for Judgment

At [10]-[23], [125] and [182]

This proceeding is not about a mere technical oversight. The information not disclosed was a matter of significance to the assessment of the risks facing CNP and CER. Giving that information to shareholders and, for a listed company, the market, is one of the fundamental purposes of the requirements of the Act that financial statements and reports must be prepared and published. The importance of the financial statements is one of the fundamental reasons why the directors are required to approve them and resolve that they give a true and fair view.

The significant matters not disclosed were well-known to the directors, or if not well-known to them, were matters that should have been well-known to them.

In the light of the significance of the matters that they knew, they could not have, nor should they have, certified the truth and fairness of the financial statements, and published the annual reports in the absence of the disclosure of those significant matters. If they had understood and applied their minds to the financial statements and recognised the importance of their task, each director would have questioned each of the matters not disclosed. Each director, in reviewing financial statements, needed to inquire further into the matters revealed by those statements.

The central question in the proceeding has been whether directors of substantial publicly listed entities are required to apply their own minds to, and carry out a careful review of, the proposed financial statements and the proposed directors' report, to determine that the information they contain is consistent with the directors' knowledge of the company's affairs, and that they do not omit material matters known to them or material matters that should be known to them.

A director is an essential component of corporate governance. Each director is placed at the apex of the structure of direction and management of a company. The higher the office that is held by a person, the greater the responsibility that falls upon him or her. The role of a director is significant as their actions may have a profound effect on the community, and not just shareholders, employees and creditors.

This proceeding involves taking responsibility for documents effectively signed-off by, approved, or adopted by the directors. What is required is that such documents, before they are adopted by the directors, be read, understood and focused upon by each director with the knowledge each director has or should have by virtue of his or her position as a director. I do not consider this requirement overburdens a director, or as argued before me, would cause the boardrooms of Australia to empty overnight. Directors are generally well remunerated and hold positions of prestige, and the office of director will continue to attract competent, diligence and intelligent people.

The case law indicates that there is a core, irreducible requirement of directors to be involved in the management of the company and to take all reasonable steps to be in a position to guide and monitor. There is a responsibility to read, understand and focus upon the contents of those reports which the law imposes a responsibility upon each director to approve or adopt.

All directors must carefully read and understand financial statements before they form the opinions which are to be expressed in the declaration required by s 295(4). Such a reading and understanding would require the director to consider whether the financial statements were consistent with his or her own knowledge of the company's financial position. This accumulated knowledge arises from a number of responsibilities a director has in carrying out the role and function of a director. These include the following: a director should acquire at least a rudimentary understanding of the business of the corporation and become familiar with the fundamentals of the business in which the corporation is engaged; a director should keep informed about the activities of the corporation; whilst not required to have a detailed awareness of day-to-day activities, a director should monitor the corporate affairs and policies; a director should maintain familiarity with the financial status of the corporation by a regular review and understanding of financial statements; a director, whilst not an auditor, should still have a questioning mind.

A board should be established which enjoys the varied wisdom, experience and expertise of persons drawn from different commercial backgrounds. Evenso, a director, whatever his or her background, has a duty greater than that of simply representing a particular field of experience or expertise. A director is not relieved of the duty to pay attention to the company's affairs which might reasonably be expected to attract inquiry, even outside the area of the director's expertise.

The words of Pollock J in the case of *Francis v United Jersey Bank* (1981) 432 A (2d) 814, quoted with approval by Clarke and Sheller JJA in *Daniels v Anderson* (1995) 37 NSWLR 438, make it clear that more than a mere "going through the paces" is required for directors. As Pollock J noted, a director is not an ornament, but an essential component of corporate governance.

Nothing I decide in this case should indicate that directors are required to have infinite knowledge or ability. Directors are entitled to delegate to others the preparation of books and accounts and the carrying on of the day-to-day affairs of the company. What each director is expected to do is to take a diligent and intelligent interest in the information available to him or her, to understand that information, and apply an inquiring mind to the responsibilities placed upon him or her. Such a responsibility arises in this proceeding in adopting and approving the financial statements. Because of their nature and importance, the directors must understand and focus upon the content of financial statements, and if necessary, make further inquiries if matters revealed in these financial statements call for such inquiries.

No less is required by the objective duty of skill, competence and diligence in the understanding of the financial statements that are to be disclosed to the public as adopted and approved by the directors.

No-one suggests that a director should not personally read and consider the financial statements before that director approves or adopts such financial statements. A reading of the financial statements by the directors is not merely undertaken for the purposes of correcting typographical or grammatical errors or even immaterial errors of arithmetic. The reading of financial statements by a director is for a higher and more important purpose: to ensure, as far as possible and reasonable, that the information included therein is accurate. The scrutiny by the directors of the financial statements involves understanding their content. The director should then bring the information known or available to him or her in the normal discharge of the director's responsibilities to the task of focusing upon the financial statements. These are the minimal steps a person in the position of any director would and should take before participating in the approval or adoption of the financial statements and their own directors' reports.

The omissions in the financial statements the subject of this proceeding were matters that could have been seen as apparent without difficulty upon a focusing by each director, and upon a careful and diligent consideration of the financial statements. As I have said, the directors were intelligent and experienced men in the corporate world. Despite the efforts of the legal representatives for the directors in contending otherwise, the basic concepts and financial literacy required by the directors to be in a position to properly question the apparent errors in the financial statements were not complicated.

In my view, the objective duty of competence requires that the directors have the ability to read and understand the financial statements, including the understanding that financial statements classify assets and liabilities as current and non-current, and what those concepts mean. This classification is relevant to the assessment of solvency and liquidity. Equally, a director should have an understanding of the need to disclose certain events post balance sheet date. It would not be possible for a

director to form the opinion required by s 295(4)(d) without such an understanding. It is not suggested that a director could vote in favour of a resolution in support of the required directors' statements when he did not hold the opinions referred to at all.

The Act explicitly requires that the declaration required by s 295(4) and the annual directors' report must be made in accordance with a resolution of the directors. In that manner the Act imposes ultimate responsibility for those matters upon the directors in a way that they cannot delegate. They must themselves determine to adopt the required resolution.

The determination of what constitutes due care and skill in any particular field of endeavour, and the assessment of whether it has been breached in a particular case, does not occur in a vacuum. A court assessing those questions, whether they arise in the context of directors' standards of due care and diligence under s 180 of the *Act*, or in the context of negligence by a medical professional, typically receives evidence from others engaged in that field of endeavour. For instance, acceptable practice is relevant in determining the standard of care, but not decisive.

Extract from Decision

Held:

(1) Company directors have a non-delegable, primary responsibility for the company's financial report and the directors' report. As such, each director is required to take a diligent interest in and have the ability to understand the financial statements, and to inquire about any potential deficiency in the accounts that they observe (or should reasonably have observed). A knowledge of conventional accounting practice and the accounting standards relevant to the matter/s being approved is needed to form the opinion required by s 295(4)(d) of the *Act* and to ensure that "all reasonable steps" are taken to secure compliance as required by s 344.

(2) Section 180(1) of the *Act* requires the directors of a company to take reasonable steps to place themselves in a position to guide and monitor the management of the company, including remaining informed as to its financial position. The circumstances of the particular company and accepted practice in the relevant field are relevant in determining the applicable standard of care. Although they are entitled to rely upon the advice of the management and auditors in this regard, such reliance cannot be a substitute for their own non-delegable responsibilities, such as to be diligent and careful in their consideration of the resolution to approve financial statements.

(3) The directors failed in their duties to exercise the degree of care and diligence required of them by law. Specifically, they failed to: properly read and understand the financial statements; apply the knowledge they had or should have acquired to perform that task; make appropriate inquiries; and have apparent errors corrected. They are therefore in breach of ss 180(1), 344(1) and 601FD(3) of the *Act*.

(4) The management representation letter did not satisfy the declaration requirements of s 295A of the *Act*, such that the directors should not have gone on to approve the accounts.

ASIC Media Release

11-125MR Decision in Centro civil penalty case

ASIC Chairman Mr Greg Medcraft today welcomed the Federal Court's decision in its case against eight directors and former executives of Centro Properties Group, citing it as a landmark decision in Australian corporate governance. Mr Medcraft said Justice Middleton's judgment on the legal duties of directors and management sent a clear message to boardrooms across the country about corporate accountability. "The central question in the proceeding was whether the directors were required to apply their own minds to, and carry out a careful review of, the proposed financial statements and the proposed directors report, to determine that the information they contained was consistent with the director's knowledge of the company's affairs, and that they did not omit material matters known to them or material matters that should have been known to them."

The Chairman said the case also highlighted the danger of boards uncritically relying on management, or the auditors. "Each member of the board must bring and apply their own skills and knowledge when declaring financial statements are true and fair." Further "this is not a responsibility company boards can delegate or merely rubber stamp. It's not good enough for directors to just be present."

Mr Medcraft said there was a minimum standard of boardroom participation that directors must meet. This means the key elements of a company's financial position are something directors should understand and be able to communicate accurately to the market. "Directors are an important gatekeeper for our markets. The community expects them to take their responsibilities seriously, and discharge their duties carefully," Mr Medcraft said. This case makes clear directors' responsibilities to apply their skills and knowledge to the financial statements of the company.

"We will continue to take on the big and difficult cases, when we think it's in the public interest. The public would expect nothing less," he said.

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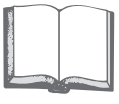


[Crutchfield P and Button C, "Men over board: The burden of directors' duties in the wake of the Centro case" (2012) 30 *Company and Securities Law Journal* 83 at 98, 99.]

The central proposition of the Centro case is that s 295(4)(d) requires that all directors of all companies read, understand and focus upon the contents of financial statements. As explored above, on the facts of the Centro case (where the necessary information as to debt and a summary of the accounting standard were before the

board in a comprehensible form), the permissible scope for reliance did not extend much beyond the discharge of mechanical tasks. In other cases, the issues may well be substantially more complex. Even so, and while the debate on reliance certainly will continue to occur, the Centro decision sounds a caution against regarding accounting as a specialised field, the discharge of which can be wholly delegated to competent experts. One thing that can be said with some certainty is that, as things stand, and notwithstanding s 344, it is not enough for directors to ensure that appropriate systems and expertise are in place.

The upside of the Centro case ought not to be overlooked. The decision unquestionably arms non-executive directors with a strong basis upon which to make demands of management. Those demands may relate, eg, to the form and nature of management's reports to the board. Non-executive directors may also be emboldened in the questions they ask of management, including chief executive officers.

***Corporations Act 2001* (Cth), s 180**

Care and diligence—civil obligation only

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.

Note: This subsection is a civil penalty provision (see section 1317E).

Business judgment rule

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

The director's or officer's belief that the judgment 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.

Note: This subsection only operates in relation to duties under this section and their equivalent duties at common law or in equity (including the duty of care that arises under the common law principles governing liability for negligence)—it does not operate in relation to duties under any other provision of this Act or under any other laws.

(3) In this section:
"business judgment" means any decision to take or not take action in respect of a matter relevant to the business operations of the corporation.

***Corporations Act 2001* (Cth), s 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:

(a) the constitution of the subsidiary expressly authorises the director to act in the best interests of the holding company; and
(b) the director acts in good faith in the best interests of the holding company; and
(c) the subsidiary is not insolvent at the time the director acts and does not become insolvent because of the director's act.

***Corporations Act 2001* (Cth), s 189**

Reliance on information or advice provided by others

If:

(a) a director relies on information, or professional or expert advice, given or prepared by:
    (i) an employee of the corporation whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned; or
    (ii) a professional adviser or expert in relation to matters that the director believes on reasonable grounds to be within the person's professional or expert competence; or
    (iii) another director or officer in relation to matters within the director's or officer's authority; or
    (iv) a committee of directors on which the director did not serve in relation to matters within the committee's authority; and
(b) the reliance was made:
    (i) in good faith; and
    (ii) 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; and
(c) the reasonableness of the director's reliance on the information or advice arises in proceedings brought to determine whether a director has performed a duty under this Part or an equivalent general law duty;

the director's reliance on the information or advice is taken to be reasonable unless the contrary is proved.

The regulation of directors' duty of care and diligence seeks to find a balance between risk and profit. The standards to be applied are continually being refined by the courts. In *ASIC v Mariner Corporation Ltd* (2015) 241 FCR 502, ASIC brought proceedings against the directors of Mariner Corporation, which included claims that the directors engaged in misleading and deceptive conduct (**s 1041H**) in relation to a takeover bid by Mariner for all of the issued capital of Austock Group Ltd. ASIC also alleged contraventions of **s 180(1)** in that each of the directors made a decision that Mariner would announce a takeover bid for Austock thereby: causing Mariner to make a public proposal that contravened **s 631(2)(b)**; causing Mariner to make an announcement to the ASX, which contravened **s 1041H**; stating that Mariner would make a bid at 10.5 cents per share, which it could not lawfully do; and failing to take into account regulatory constraints on the ability of Mariner to acquire more than various percentages of shares in Austock. Beach J did not find that ASIC had made out its claims. He found that the benefits to the company outweighed the risks, and accordingly dismissed the application. In the course of his judgment, he commented at [447]-[452] on the nature of **s 180**.

ASIC v Mariner Corporation Ltd (2015) 241 FCR 502 (Beach J)

Extract from Judgment

It is wrong to assert that if a director causes a company to contravene a provision of the Act, then necessarily the director has contravened s 180. No contravention of s 180 would flow from such circumstances unless there was actual damage caused to the *company* by reason of that other contravention or it was reasonably foreseeable that the relevant conduct might harm the interests of the company, its shareholders and its creditors (if the company was in a precarious financial position). In order for an act or omission of the director to be capable of constituting a contravention of s 180 there must be reasonably foreseeable harm to the interests of the company caused thereby.

Not only must the Court consider the nature and magnitude of the foreseeable risk of harm and degree of probability of its occurrence, along with the expense, difficulty and inconvenience of taking alleviating action, but the Court must balance the foreseeable risk of harm against the potential benefits that could reasonably be expected to accrue from the conduct in question.

After all, one expects management including the directors to take *calculated* risks. The very nature of commercial activity necessarily involves uncertainty and risk taking. The pursuit of an activity that might entail a foreseeable risk of harm does not of itself establish a contravention of s 180. Moreover, a failed activity pursued by the directors which causes loss to the company does not of itself establish a contravention of s 180.

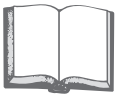
In *ASIC v Cassimatis (No 8)* [2016] FCA 1023, the fact that directors must give consideration to matters beyond the financial consequences of a particular action was seen as relevant to the manner in which the duty of care and diligence was approached. The case concerned an investment company (Storm Financial Limited) offering

unusual investment opportunities, which resulted in failure and investor losses. Its directors were its only shareholders. Edelman J considered that **s 180** did not confine the duties owed by directors solely to those imposed upon them by the company, and raised the prospect of the duties imposed by the law generally. However, the case only concerned the discharge of the duty of care and diligence by the directors as directors of the relevant company and is not authority for expanding the assessment of the duty of care and diligence to any broader body of stakeholders. It affirmed that such duty is defined by the elements of the section, being a reasonable person in the same circumstances and with the same responsibilities as the relevant director. The case confirmed that shareholders cannot ratify a breach of the *Corporations Act*.

Corporate social responsibility and corporate governance

[20.80] As a general proposition, companies are formed to carry on business activity for the benefit of their participants and investors. This would suggest that shareholders' interests should guide corporate governance behaviour. However, it is obvious that broader social, political and economic factors impact on corporate policy and goals. The decisions of boards, and the actions of companies, affect not only their own shareholders, but creditors, employees and other groups within the community that come into contact with the company or its products and services. Accordingly, corporate governance must, today, be viewed from a wider perspective. As more companies fail, and corporate management is put under the microscope as ASIC targets directors for breaches of the *Corporations Act*, the issue of how to regulate management and ensure good business practice becomes increasingly significant. As an overall principle, good corporate governance should lead to corporate social responsibility. Factors in good corporate governance include ethical and responsible decision making, integrity in financial reporting, timely disclosure and recognition of the interests of stakeholders in the company. It is this last characteristic that is at the core of the expanding need for socially responsible decision making. Whereas directors must of course consider the interests of their shareholders, this in itself is not the entire picture. As corporations grow in size, their reach and influence affect more than merely their shareholders.

The issue of corporate ethics and its relationship to corporate culture has become of vital importance to both legislative oversight of, and public confidence in, board decision-making. The following article extract highlights the public interest factor in weighing corporate accountability.

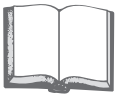


[Julia Shaw JA and Hillary Shaw HJ, "Business education, aesthetics and the rule of law: Cultivating the moral manager" (2010) 6 *Social Responsibility Journal* 469 at 471.]

Ethical corporate behaviour has tended to be discussed by senior managers only in retrospect, when a company has been accused of wrongdoing; therefore meaningful

> discussion about the role of ethics in a business context has been rather perfunctory. However, the very fact that much modern corporate rhetoric demonstrates acceptance of social and moral obligations beyond merely satisfying the demands of their shareholders, even if this compliance is only to silence popular disgruntlement, legitimises the requirement for corporate accountability. It follows that a key prerequisite of ethical behaviour in business is that, whilst not directly promoting, it seeks compatibility with the public interest. Protection of the public interest lies in a firm commitment to the ideological conception of the rule of law complimented by international human rights standards in order to address corporate corruption, or worse, corporate indifference.

The provisions regulating directors' conduct in the *Corporations Act* provide an overarching benefit from within which groups with diverse interests are able to isolate particular protections that meet their needs and ends. While the *Corporations Act* may not always deter prohibited conduct, it nonetheless sets a framework for directors. The test for the legislation is whether it will be sufficiently adaptive to future demands for an equitable, informed and secure market.



[Harris J, Hargovan A and Austin J, "Shareholder primacy revisited: Does the public interest have any role in statutory duties?" (2008) 26 C&SLJ 355 at 376.]

> With reference to the *Corporations Act 2001* (Cth), the statutory duties serve a public purpose through enforcement by ASIC, through different penalties and sanctions, and through alternative enforcement mechanisms (such as the statutory derivative action). These factors suggest that there are substantial public interest factors at work and that the purpose of statutory duties is not merely to provide for ASIC to protect and enforce the shareholder's rights. ASIC is not charged solely with protecting the company's current shareholders. The statutory duties provide a set of minimum norms of corporate managerial behaviour and thereby serve the interests of the community at large. As Kirby J observed in *Rich v Australian Securities and Investments Commission* (2004) 220 CLR 129 at 105, being a director "[is a] privilege to be earned each day [which] … may be withdrawn for misconduct but also for incompetent, improper or lax activities in the functions of corporate management".

The term "corporate governance" cannot be precisely defined. It is made up of many things and has been considered by many committees and many interest groups since the early 1990s. Justice Owen considered the concept in the Report of the Royal Commission set up to investigate the collapse of HIH Insurance Ltd (https://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id:%22library/prspub/XZ896%22):

> At its broadest, the governance of corporate entities comprehends the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations. It includes the practices by which that exercise and control of authority is in fact effected. [Part 3 at 6.1]

There have been several reports on the issue of corporate governance. An early report from the United Kingdom, the Cadbury Report (1992), focused on openness, integrity and accountability. In Australia, the Hilmer Report (1993) raised the interests of shareholders and stakeholders, and emphasised the monitoring of director performance to ensure a company's long-term viability. The Bosch Report (1995) was one of the earliest reports to target board structure and composition. It also considered remuneration issues and management of risks and internal controls. In 2001, the Ramsey Report examined legislative controls on external auditors. The most definitive of the guidelines concerning corporate governance in Australia is the *ASX Corporate Governance Council Principles and Recommendations*. These were introduced in 2003. A second edition was released in 2007 and revised in 2010 adding the important principles of board diversity. In 2014, the third edition was released. The fourth, and current, edition of the *ASX Corporate Governance Council Principles and Recommendations* was released in 2019. It takes effect for an entity's first full financial year commencing on or after 1 January 2020. Listed companies are not required to comply with the ASX Corporate Governance Council Principles but if they do not comply they must explain their actions in their annual report to the ASX pursuant to ASX Listing Rule 4.10. The ASX Listing Rules are enforceable pursuant to **s 793C** of the *Corporations Act*. This approach to ensuring better governance is termed the "if not, why not?" approach. This means that there is an onus on listed companies to either fall into line with the *Principles and Recommendations* or explain why they have not.

The *Principles and Recommendations* are specifically directed at, and only intended to apply to, ASX listed entities. However, as they reflect a contemporary view of appropriate corporate governance standards, other bodies may find them helpful in formulating their governance rules or practices.

The ASX Corporate Governance Council Principles and Recommendations

Principle 1—Lay solid foundations for management and oversight
A listed entity should clearly delineate the respective roles and responsibilities of its board and management and regularly review their performance.

Recommendation 1.1: A listed entity should have and disclose a board charter setting out:

(a) the respective roles and responsibilities of its board and management; and

(b) those matters expressly reserved to the board and those delegated to management.

Recommendation 1.2: A listed entity should:

(a) undertake appropriate checks before appointing a director or senior executive or putting someone forward for election as a director; and

(b) provide security holders with all material information in its possession relevant to a decision on whether or not to elect or re-elect a director.

Recommendation 1.3: A listed entity should have a written agreement with each director and senior executive setting out the terms of their appointment.

Recommendation 1.4: The company secretary of a listed entity should be accountable directly to the board, through the chair, on all matters to do with the proper functioning of the board.

Recommendation 1.5: A listed entity should:

(a) have and disclose a diversity policy;

(b) through its board or a committee of the board set measurable objectives for achieving gender diversity in the composition of its board, senior executives and workforce generally; and

(c) disclose as at the end of each reporting period:

(1) the measurable objectives set for that period to achieve gender diversity;

(2) the entity's progress towards achieving those objectives; and

(3) either:

(A) the respective proportions of men and women on the board, in senior executive positions and across the whole workforce (including how the entity has defined "senior executive" for these purposes); or

(B) if the entity is a "relevant employer" under the Workplace Gender Equality Act, the entity's most recent "Gender Equality Indicators", as defined in and published under that Act.

If the entity was in the S&P/ASX 300 Index at the commencement of the reporting period, the measurable objective for achieving gender diversity in the composition of its board should be to have not less than 30% of its directors of each gender within a specified period.

Recommendation 1.6: A listed entity should:

(a) have and disclose a process for periodically evaluating the performance of the board, its committees and individual directors; and

(b) disclose, for each reporting period whether a performance evaluation has been undertaken in accordance with that process during or in respect of that period.

Recommendation 1.7: A listed entity should:

(a) have and disclose a process for evaluating the performance of its senior executives at least once every reporting period; and

(b) disclose, for each reporting period whether a performance evaluation has been undertaken in accordance with that process during or in respect of that period.

Principle 2—Structure the board to add value

The board of a listed entity should be of an appropriate size and collectively have the skills, commitment and knowledge of the entity and the industry in which it operates, to enable it to discharge its duties effectively and to add value.

Recommendation 2.1: The board of a listed entity should:

(a) have a nomination committee which:

(1) has at least three members, a majority of whom are independent directors; and

(2) is chaired by an independent director,

and disclose:

(3) the charter of the committee;

(4) the members of the committee; and

(5) as at the end of each reporting period, the number of times the committee met throughout the period and the individual attendances of the members at those meetings; or

(b) if it does not have a nomination committee, disclose that fact and the processes it employs to address board succession issues and to ensure that the board has the appropriate balance of skills, knowledge, experience, independence and diversity to enable it to discharge its duties and responsibilities effectively.

Recommendation 2.2: A listed entity should have and disclose a board skills matrix setting out the mix of skills and diversity that the board currently has or is looking to achieve in its membership.

Recommendation 2.3: A listed entity should disclose:

(a) the names of the directors considered by the board to be independent directors;

(b) if a director has an interest, position, association or relationship of the type described in Box 2.3 (Factors relevant to assessing the independence of a director) but the board is of the opinion that it does not compromise the independence of the director, the nature of the interest, position, or relationship in question and an explanation of why the board is of that opinion; and

(c) the length of service of each director.

Recommendation 2.4: A majority of the board of a listed entity should be independent directors.

Recommendation 2.5: The chair of the board of a listed entity should be an independent director and, in particular, should not be the same person as the CEO of the entity.

Recommendation 2.6: A listed entity should have a program for inducting new directors and for periodically reviewing whether there is a need for existing directors to undertake professional development to maintain the skills and knowledge needed to perform their role as directors effectively.

Principle 3—Act ethically and responsibly

A listed entity should instil and continually reinforce a culture across the organisation of acting lawfully, ethically and responsibly.

Recommendation 3.1: A listed entity should articulate and disclose its values.

Recommendation 3.2: A listed entity should:

(a) have and disclose a code of conduct for its directors, senior executives and employees; and

(b) ensure that the board or a committee of the board is informed of any material breaches of that code.

Recommendation 3.3: A listed entity should:

(a) have and disclose a whistleblower policy; and

(b) ensure that the board or a committee of the board is informed of any material incidents reported under that policy.

Recommendation 3.4: A listed entity should:

(a) have and disclose an anti-bribery and corruption policy; and

(b) ensure that the board or a committee of the board is informed of any material breaches of that policy.

Principle 4—Safeguard integrity in financial reporting

A listed entity should have appropriate processes to verify the integrity of its corporate reports.

Recommendation 4.1: The board of a listed entity should:

(a) have an audit committee which:

(1) has at least three members, all of whom are non-executive directors and a majority of whom are independent directors; and

(2) is chaired by an independent director, who is not the chair of the board,

and disclose:

(3) the charter of the committee;

(4) the relevant qualifications and experience of the members of the committee; and

(5) in relation to each reporting period, the number of times the committee met throughout the period and the individual attendances of the members at those meetings; or

(b) if it does not have an audit committee, disclose that fact and the processes it employs that independently verify and safeguard the integrity of its corporate reporting, including the processes for the appointment and removal of the external auditor and the rotation of the audit engagement partner.

Recommendation 4.2: The board of a listed entity should, before it approves the entity's financial statements for a financial period, receive from its CEO and CFO a declaration that, in their opinion, the financial records of the entity have been properly maintained and that the financial statements comply with the appropriate accounting standards and give a true and fair view of the financial position and performance of the entity and that the opinion has been formed on the basis of a sound system of risk management and internal control which is operating effectively.

Recommendation 4.3: A listed entity should disclose its process to verify the integrity of any periodic corporate report it releases to the market that is not audited or reviewed by an external auditor.

Principle 5—Make timely and balanced disclosure

A listed entity should make timely and balanced disclosure of all matters concerning it that a reasonable person would expect to have a material effect on the price or value of its securities.

Recommendation 5.1: A listed entity should have and disclose a written policy for complying with its continuous disclosure obligations under listing rule 3.1.

Recommendation 5.2: A listed entity should ensure that its board receives copies of all material market announcements promptly after they have been made.

Recommendation 5.3: A listed entity that gives a new and substantive investor or analyst presentation should release a copy of the presentation materials on the ASX Market Announcements Platform ahead of the presentation.

Principle 6—Respect the rights of security holders

A listed entity should provide its security holders with appropriate information and facilities to allow them to exercise their rights as security holders effectively.

Recommendation 6.1: A listed entity should provide information about itself and its governance to investors via its website.

Recommendation 6.2: A listed entity should have an investor relations program that facilitates effective two-way communication with investors.

Recommendation 6.3: A listed entity should disclose how it facilitates and encourages participation at meetings of security holders.

Recommendation 6.4: A listed entity should ensure that all substantive resolutions at a meeting of security holders are decided by a poll rather than by a show of hands.

Recommendation 6.5: A listed entity should give security holders the option to receive communications from, and send communications to, the entity and its security registry electronically.

Principle 7—Recognise and manage risk

A listed entity should establish a sound risk management framework and periodically review the effectiveness of that framework.

Recommendation 7.1: The board of a listed entity should:

(a) have a committee or committees to oversee risk, each of which:

(1) has at least three members, a majority of whom are independent directors; and

(2) is chaired by an independent director,

and disclose:

(3) the charter of the committee;

(4) the members of the committee; and

(5) as at the end of each reporting period, the number of times the committee met throughout the period and the individual attendances of the members at those meetings; or

(b) if it does not have a risk committee or committees that satisfy (a) above, disclose that fact and the processes it employs for overseeing the entity's risk management framework.

Recommendation 7.2: The board or a committee of the board should:

(a) review the entity's risk management framework at least annually to satisfy itself that it continues to be sound and that the entity is operating with due regard to the risk appetite set by the board; and

(b) disclose, in relation to each reporting period, whether such a review has taken place.

Recommendation 7.3: A listed entity should disclose:

(a) if it has an internal audit function, how the function is structured and what role it performs; or

(b) if it does not have an internal audit function, that fact and the processes it employs for evaluating and continually improving the effectiveness of its governance, risk management and internal control processes.

Recommendation 7.4: A listed entity should disclose whether it has any material exposure to environmental or social risks and, if it does, how it manages or intends to manage those risks.

Principle 8—Remunerate fairly and responsibly

A listed entity should pay director remuneration sufficient to attract and retain high quality directors and design its executive remuneration to attract, retain and motivate high quality senior executives and to align their interests with the creation of value for security holders and with the entity's values and risk appetite.

Recommendation 8.1: The board of a listed entity should:

(a) have a remuneration committee which:

(1) has at least three members, a majority of whom are independent directors; and

(2) is chaired by an independent director,

and disclose:

(3) the charter of the committee;

(4) the members of the committee; and

(5) as at the end of each reporting period, the number of times the committee met throughout the period and the individual attendances of the members at those meetings; or

(b) if it does not have a remuneration committee, disclose that fact and the processes it employs for setting the level and composition of remuneration for directors and senior executives and ensuring that such remuneration is appropriate and not excessive.

Recommendation 8.2: A listed entity should separately disclose its policies and practices regarding the remuneration of non-executive directors and the remuneration of executive directors and other senior executives.

Recommendation 8.3: A listed entity which has an equity-based remuneration scheme should:

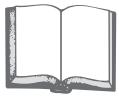
(a) have a policy on whether participants are permitted to enter into transactions (whether through the use of derivatives or otherwise) which limit the economic risk of participating in the scheme; and

(b) disclose that policy or a summary of it.

In addition to the eight *Principles and Recommendations* above, the ASX has added further Recommendations that only apply in certain situations. These are: that a listed entity where directors do not speak the language in which board meetings are held has processes in place to enable those directors to understand and discharge their obligations (9.1); that a listed entity established outside Australia hold meetings at a reasonable time and place (9.2); and that a listed entity established outside Australia ensure its external auditor is present at its AGM (9.3).

Recommendation 1.5 focuses on the issue of board diversity. These principles are a good example of how the area of corporate governance grows and expands as it reacts to new challenges and altered community perceptions. Matters concerning the proportion of women on boards were canvassed in Ch 18. Given that good corporate governance adds value to a company's performance, it is important that the law plays its part in the processes of change. Importantly, the fourth edition of the *Principles and Recommendations* provides for the first time specific guidance on diversity. Recommendation 1.5 sets out that for entities in the S&P/ASX300 Index, the measurable objective for achieving gender diversity in board composition is to have not less than 30% of its directors of each gender.

In Australia, corporate governance is approached at a number of levels. First, the regulation and prohibitions in the *Corporations Act* (and in some cases, other legislation) influence both directly and indirectly how companies are governed. These may be referred to as "hard law". Second, and at the other end of the spectrum, are the purely voluntary codes and guidelines, such as reports and literature on governance. These provide "best practice" advice and may be referred to as "soft law". Between these lie guidelines that do not have the capacity to penalise like a statute, but include persuasive mechanisms nonetheless. The best example of these "hybrid" laws is the *ASX Corporate Governance Council Principles and Recommendations*, which, as a result of its "if not, why not?" approach, allows companies to arrange their governance issues to suit themselves, however, requires justifications for departures from its core principles.



[Nagarajan V, "Regulating for women on corporate boards: Poly-centric governance in Australia" (2011) 39 *Federal Law Review* 255 at 255, 257.]

Tackling the gender gap on the boards of publicly listed companies provides us with an accessible and fascinating site to reconsider the effectiveness of the variety of regulatory tools and to reflect on the role of the various participants in the regulatory

game in Australia. Whereas a small number of governments have elected to rely on hard laws to action this systemic shift, many other nations, including Australia, have outsourced this task to non-state regulators who have relied on soft laws to do the job. Often a hard law, once made, gives rise to the development of a range of soft laws that support and enforce it. Sometimes soft laws can solidify into hard laws, for example by being codified into legislation. At other times soft laws can set firmer, for example moving from a standard to become a listing rule. In any of these cases, epistemic communities have developed and many participants have been enrolled to undertake the continuous and laborious tasks of publishing, influencing, training, facilitating, coordinating and assessing progress. The participants are primarily non-state actors, consisting of both for-profit and not-for-profit organisations, while most government bodies remain in the background.

There are four main reasons that are advanced in support of increasing the number of women on corporate boards: moving the corporate board to a more democratic representation of society's diversity; improved decision-making by increasing the range of views, values and experiences represented; better corporate profitability; and finally an enhanced corporate image for shareholders, employees and consumers.

The regulation of the directors' duty of care and diligence is closely linked to the goal of good corporate governance. An example of this relationship is observable in the issues that arose in relation to James Hardie Industries Limited (JHIL) and the setting up of a fund to meet claims by victims of asbestos-related conditions. The company was the parent/holding company of the James Hardie group of companies. Two wholly-owned subsidiaries within the group had substantial current and future claims by a large number of people affected by their exposure to asbestos products manufactured and supplied by these wholly-owned subsidiaries. The company's conduct was examined during the Special Commission of Inquiry set up to report on the Medical Research and Compensation Foundation (MRCF), an entity claimed by the public relations arm of the James Hardie group to have sufficient funds to meet anticipated compensation claims against the company. The extent of the inquiry into the matters relating to the funding of compensation claims widened substantially and resulted in the commencement of civil proceedings by ASIC against the companies involved and particularly against the JHIL board at the time of the funding arrangements.

In the JHL matter, *ASIC v Macdonald (No 11)* (2009) 71 ACSR 368; [2009] NSWSC 287 and *ASIC v Macdonald (No 12)* (2009) 73 ACSR 638; [2009] NSWSC 714, all seven non-executive directors were defendants together with three former executives. There were various actions against JHIL relating to misleading or deceptive conduct. Other than an action against one of the executive directors (Macdonald) under **s 181(1)** for failing to exercise powers and discharge duties in good faith and for a proper purpose, all of the actions against the directors focused on breaches of directors' duties of care and diligence as set out in **s 180**. Issues raised by these care and diligence actions included the overriding dichotomy faced by directors when they must make decisions affecting a range of diverse stakeholders. The decisions made by the JHIL board in relation to

the setting up of the MRCF in 2001 were strongly weighted to dampen inquiry into the compensation arrangements. ASIC alleged they were misleading, and that the non-executive directors should have inquired further and sought independent assessments, particularly as to the adequacy of the funding. The focus of the matter involved the release of an announcement regarding the funding at a meeting on February 2001. The directors denied they had approved the company releasing the announcement. In the matter at first instance (before a single judge), several of the defendants raised (unsuccessfully) the issue of the discretion available to the court pursuant to **ss 1317S** and **1318**, whereby it may consider, in relation to civil penalty proceedings, the issue of whether a person has acted honestly. However, Gzell J held that all of the directors had breached their duty of care and diligence under **s 180** and imposed fines and disqualifications. In delivering his judgment, Gzell J considered the public policy value of **s 180**. He found that the benefit of **s 180** was to ensure that the boards of companies comprised directors with skills to monitor the actions of management and to perform any special tasks particular to their appointment. The specific penalties imposed by Gzell J on the directors included disqualification from managing a corporation under **s 206C** (Macdonald was disqualified for 15 years, another director for seven years and the remaining eight, including the seven non-executives, for five years). All directors also received pecuniary penalties under **s 1317G**.

Appeals to the Supreme Court of NSW Court of Appeal were lodged by all directors except Macdonald. In this appeal, *Morley v ASIC* (2010) 247 FLR 140; [2010] NSWCA 331, the Court of Appeal upheld the decisions at first instance in relation to the breach of **s 180** by the CFO Morley and company secretary and legal counsel Shafron. However, the non-executive directors' appeals were successful. An important issue in the outcome regarding the non-executive directors concerned whether ASIC failed to adduce direct evidence that the board actually approved the misleading ASX announcement. The issue revolved around the fact that ASIC had failed to call one of the company's main legal advisers, David Robb, a former partner of Allens Arthur Robinson. The Court of Appeal found that this witness would have been able to testify about whether the directors signed off on the misleading statement about the company's ability to fund asbestos claims. Although the non-executive directors' appeals were allowed, the Court of Appeal indicated that if satisfactory evidence existed that the directors had voted in favour of the ASX announcement, a breach of **s 180** would be found.

ASIC appealed to the High Court against the decision of the Court of Appeal. This appeal, *ASIC v Hellicar* (2012) 86 ALJR 522; [2012] HCA 17, was successful and affirmed the decision of Gzell J at first instance. The High Court found no reason why the minutes of the relevant meeting in February 2001 could not be relied on as evidence of the company's approval of the release of the announcement. In relation to the conclusiveness of the minutes, the High Court (French CJ, Gummow, Hayne, Crennan, Kiefel and Bell JJ) held (at 138) that:

> the Court of Appeal treated the minutes as no more than one circumstance from which ASIC sought to have the Court draw an inference that a draft announcement

> was tabled and approved. But the minutes were more than just one of several pieces of evidence from whose united force ASIC sought to have the tribunal of fact draw an inference. The minutes were a formal and near contemporaneous record (adopted by the board as an accurate record) of the proceedings at the meeting. The minutes were evidence of what they represented. They were more than a foundation for some further inference. Absent evidence to the contrary, ASIC proved its case by tendering the minutes and, through the evidence of Mr Baxter, identifying the document referred to as the "ASX Announcement". Pointing to other ways in which events might have occurred did not, without more, falsify the minutes.

The High Court also held that ASIC's obligation to secure a fair trial was not compromised by it not calling the company's legal adviser, who in fact could have been called by either side. Further, ASIC not calling Mr Robb caused no unfairness to the respondents and neither was there any basis for concluding that Mr Robb would have given evidence adverse to ASIC's case.

The issue of the expectations placed on non-executive directors is a particularly important matter from both a regulatory and a governance perspective. The following newspaper article, written at the time of the decision at first instance, looks at this issue. Note that even though the realities of board practice may on occasion be less than perfect, the High Court's decision in *ASIC v Hellicar* did emphasis that, having regard to the facts of that matter, the meeting of February 2001 was a vitally important meeting for the company, and that this importance should have resulted in utmost care and attention to detail.

Judge raises bar for directors in Hardie case

NSW Supreme Court judge Ian Gzell has once again satisfied the court of public opinion in the James Hardie case, but the hard part will be convincing the appeal court his circumstantial case is within the law.

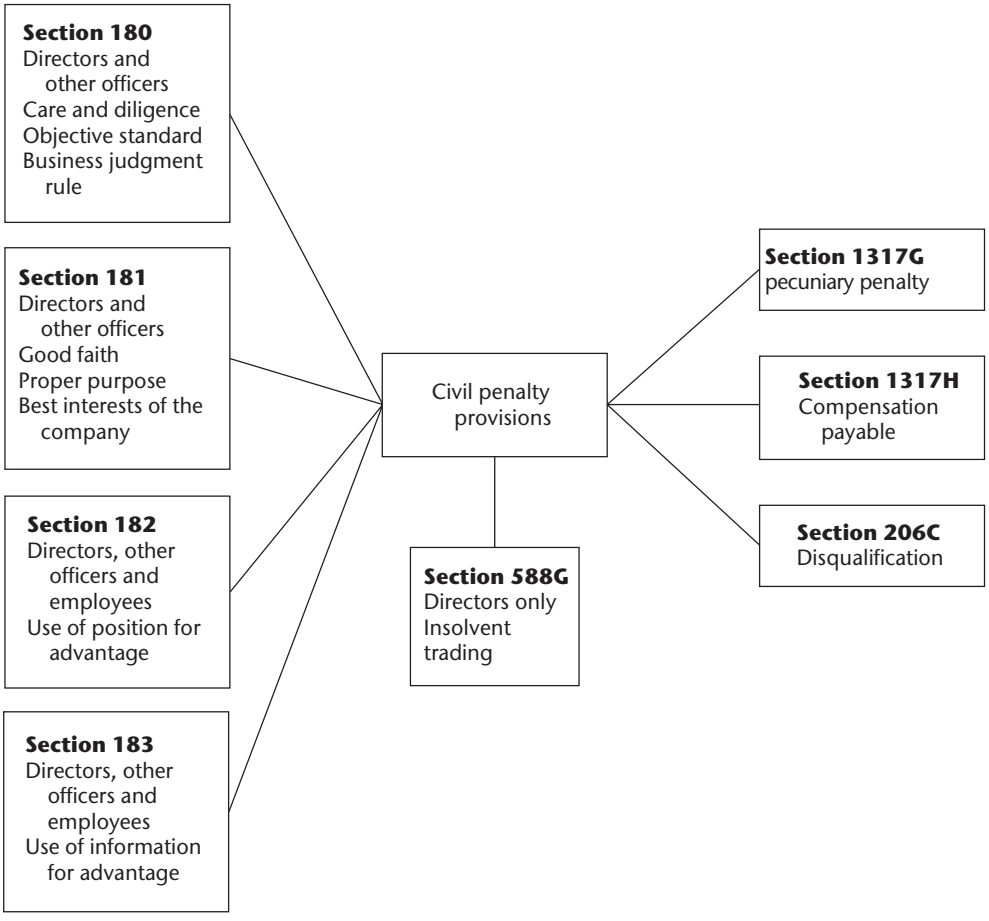
The old guard at James Hardie is hard to defend, given the apparent disregard for the people it seemingly hurt knowingly, but that is no reason to wave the rule of law goodbye and hang people just because everyone thinks they should be strung up. In the case of the Hardie board, Justice Gzell went to some lengths to explain how, as the company was plotting its change in domicile, satisfying everyone that there was enough money in the asbestos victims fund was important. It just followed that the board would want to make sure the press release on the issue was correct.

Boards of directors rarely check press releases and few directors would ever claim responsibility for them. In this case there is no direct evidence to show the Hardie board approved the press release in question.

Justice Gzell has raised the bar for directors. ASIC wanted a case to show directors how seriously they should take their duty of care, and it has satisfied this objective. ASIC has its trophy heads, but for the wrong reasons.

Original source article by John Durie, *The Australian*

Examples of directors' statutory duties and civil penalties



Insolvent trading

Section 588G

[20.90] As well as their duties to act with care and diligence and to act in good faith and for proper purposes, directors also have a duty under **s 588G** to ensure that the company does not incur debts if there are reasonable grounds to suspect that the company is insolvent. Unlike **ss 180**, **181**, **182** and **183** which apply to the broader category of company officers, **s 588G** applies only to directors. However, it should be noted that the definition of a director in **s 9** does not merely include elected directors but "de facto" directors as well. Breach of **s 588G** can result in an action against the director by ASIC seeking civil penalties (these include a fine under **s 1317G** and disqualification under **s 206C**) or compensation for the company. If the provisions of

s 588G(3) apply (involving dishonesty), the director will have committed an offence resulting in the application of criminal penalties. Note that there is further discussion of insolvent trading, including the relevant defences to insolvent trading at [33.110] and [33.120].

Summary—Statutory duties

The *Corporations Act* sets out that the general law re directors is still relevant—**s 185**

The statutory duties target directors, other officers and employees

Fiduciary duties of good faith and loyalty are repeated in **ss 181, 182** and **183**

Examples of breach: *ASIC v Adler*; *ASIC v Vizard*

Breaches of **ss 181, 182** and **183** are civil penalty breaches

Example of a civil penalty order: **s 1317G** (fine)

A civil penalty breach allows a court to disqualify a director—**s 206C**

Where breaches involve dishonesty criminal penalties (prison) apply

Directors have a duty to manage with due care and diligence—**s 180**

An objective standard applies—**s 180** is a civil penalty provision

Defences for directors exist in **s 180(2)**—the business judgment rule

Reliance on the business judgment rule includes: good faith; no material personal interest

Examples of breach: *Daniels v Anderson*; *ASIC v Adler*

Directors obliged to disclose material personal interest—**s 191**

Aim of good governance and corporate social responsibility

21
Remedies and Penalties for Directors' Breaches

Enforcing directors' general law duties

[21.10] The general law duties are owed to the company and are enforceable by the company. Note though that where ASIC believes it is in the public interest for a company to bring proceedings against a director (as the result of an investigation into a company or as the result of the examination of a director) and, for example, the company does not have sufficient funds for the litigation, then ASIC may bring the action in the name of the company (*ASIC Act 2001* (Cth), s 50).

If a company is in liquidation, its property vests in the liquidator and it will be the liquidator who has the power to bring actions on behalf of the company. Accordingly, in some instances where the liquidator considers funds can be recouped from a director who has breached their general law (specifically, fiduciary) duties, they may bring proceedings in the name of the company. Remedies available to the company under the general law include damages or compensation (measured by the company's loss), an account of profits (measured by the gains made by the director in breach of their duties), rescission of contract (a director may have benefited from a contract in breach of their duties), injunction (an order restraining an individual or a company from acting in a certain way, or an order requiring certain action) and the finding of a constructive trust.

An example of the use of a constructive trust as a remedy for a breach of fiduciary duty by directors can be found in *Paul A Davies (Aust) Pty Ltd v Davis* (1983) 1 ACLC 1091. In this case, directors used company funds in relation to a private purchase of real property that increased in value. The company was wound up and the liquidator claimed the land (and its increased value). The directors offered to repay the original funds (claimed to be a loan), however, the court held that as they were fiduciaries, the directors held the asset in trust for the company (the court implied a trust) and that the company as the beneficiary of the trust was now entitled to the increased value of the asset.

Enforcing directors' statutory duties

[21.20] The statutory duties are the means by which Parliament regulates the conduct of directors (and other officers) in order to achieve the aim of efficient, reliable and competent corporate management. The duties in the *Corporations Act 2001* (Cth) are enforced by ASIC. Section 13 of the *ASIC Act* gives ASIC the power to investigate corporate conduct. Section 49 enables it to commence prosecutions for offences and s 50 allows it to begin civil proceedings. Directors' duties are found throughout the *Corporations Act*, but particularly in **Pt 2D.1** (**ss 179-197**) and include both civil

and criminal penalties. The most common penalty (civil or criminal) is a pecuniary (monetary) penalty. Civil penalty breaches can also attract disqualification from management, compensation orders, relinquishment orders and refund orders. Criminal penalties can also include imprisonment. There are a number of ways the monetary amounts for both civil and criminal penalties are calculated. For civil penalties, see **s 1317G** at [21.30]; for criminal penalties, see **s 1311B** and s **1311C** at [21.50] and **Sch 3**. The sections setting out monetary penalties for breach involve a comparison of different methods of calculation to arrive at the relevant monetary penalty. When a company is in breach, annual turnover is also relevant. If the breach is an offence pursuant to the *Corporations Act* the calculation of a monetary penalty may vary depending on the period of imprisonment. Factors to be considered in the calculation of a monetary penalty include the benefit derived and detriment avoided because of the breach, and the number of "penalty units" applicable to the breach.

The dollar value of a penalty unit is found in s 4AA of the *Crimes Act 1914* (Cth). Currently, a penalty unit is $210. The value of a penalty unit is periodically updated. Section 4AA sets out that as and from 1 July 2020, and on each third 1 July following that day the dollar amount allocated to a penalty unit will be indexed using a formula set out in that section.

Following from recommendations made by the ASIC Enforcement Review Taskforce, and in the light of the public interest generated by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Final report February 2019), both civil and criminal penalties under the *Corporations Act* were significantly increased in 2019. The changes were introduced by the *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Act 2019* (Cth).

Note that although directors and officers insurance is available, certain restrictions exist in the *Corporations Act*. **Sections 199A, 199B** and **199C** combine to prohibit companies paying or agreeing to pay for insurance that encompasses coverage for various matters including wilful misconduct or contravention of **s 182** (misuse position for gain) or **s 183** (misuse information for gain). In listed companies, the Director's Report, contained in the company's annual report, will contain information regarding the payment of premiums under contracts insuring the directors and officers of the company, to the extent allowed by the *Corporations Act*, against liability incurred by them in their respective capacities in successfully defending proceedings against them. This inclusion in the Directors Report is required by **s 300**.

Civil penalties

[21.30] If the section of the *Corporations Act* breached is a civil penalty provision, the following penalties are applicable to individuals:

- a pecuniary penalty of the greater of: (a) 5,000 penalty units (presently $1.05 million), and, (b) if the court can determine the benefit derived and detriment avoided because of the contravention, then that amount multiplied by three (**s 1317G**);

- an order to pay compensation (**s 1317H**) (and note **s 1317HA** regarding financial civil penalty provisions);
- a relinquishment order requiring a person to pay to the Commonwealth an amount equal to the benefit derived and detriment avoided because of the contravention (**s 1317GAB**). The court may make the order on its own initiative, or ASIC can apply for an order within six years of the contravention;
- a refund order, where an ongoing fee has been received after termination of the fee arrangement in contravention of **s 962P** (**s 1317GA**);

  and

- disqualification from managing a corporation (**s 206C**).

Section 1317G also sets out civil penalties that are applicable to contraventions by body corporates. In **s 1317G(4)**, the penalty will be the greatest of the following three calculations: (a) 50,000 penalty units, (b) if the court can determine the benefit derived and detriment avoided because of the contravention then that amount multiplied by three and (c) whichever is the lesser of 10% of annual turnover of the company or 2.5 million penalty units.

All civil penalty sections are listed in **s 1317E** and each civil penalty section (such as **s 180**) will be followed by a note stating: "This subsection is a civil penalty provision (see **s 1317E**)". Matters relevant to the extent of the civil penalty imposed by the court include the nature and effect of the contravening conduct, the amount of loss or damage caused, the impact of the conduct on the company's share price and whether any dishonesty was involved. When civil penalty proceedings are brought, the civil rules of evidence and procedure apply. Therefore, the standard of proof required for a contravention of the civil penalty provisions, such as **s 180**, is on a balance of probabilities.

Pursuant to **s 1317S** and **s 1318**, where a court is determining civil penalty breaches the issue of a director's honesty may be taken into account. In *Hall v Poolman* (2007) 65 ACSR 123; [2007] NSWSC 1330, Palmer J at [325] explained the application of the relief available:

> In my view, when considering whether a person has acted honestly for the purposes of a defence under the *Corporations Act*, s 1317S(2)(b)(i) or s 1318, the Court should be concerned only with the question whether the person has acted honestly in the ordinary meaning of that term, ie whether the person has acted without deceit or conscious impropriety, without intent to gain improper benefit or advantage for himself, herself or for another, and without carelessness or imprudence to such a degree as to demonstrate that no genuine attempt at all has been to carry out the duties and obligations of his or her office imposed by the *Corporations Act* or the general law. A failure to consider the interests of the company as a whole, or more particularly the interests of creditors, may be

of such a high degree as to demonstrate failure to act honestly in this sense. However, if failure to consider the interests of the company as a whole, including the interests of its creditors, does not rise to such a high degree but is the result of error of judgment, no finding of failure to act honestly should be made, but the failure must be taken into account as one of the circumstances of the case to which the Court must have regard under the *Corporations Act*, ss 1317S(2)(b)(ii) and 1318.

***Corporations Act 2001* (Cth), s 1317E**

Declaration of contravention of a civil penalty provision

Declaration of contravention

(1) If a Court is satisfied that a person has contravened a civil penalty provision, the Court must make a declaration of contravention.
(2) The declaration must specify the following:
    (a) the Court that made the declaration;
    (b) the civil penalty provision that was contravened;
    (c) the person who contravened the provision;
    (d) the conduct that constituted the contravention;
    (e) if the contravention is of a corporation/scheme civil penalty provision—the corporation, registered scheme or notified foreign passport fund to which the conduct related;

Civil penalty provisions

Column 1	**Column 2**
Provision	**Brief description of the provision**
subsections 180(1), 181(1) and (2), 182(1) and (2) and 183(1) and (2)	officers' duties
subsections 188(1) and (2)	responsibilities of secretaries etc. for corporate contraventions
subsection 209(2)	related parties rules
subsections 254L(2), 256D(3), 259F(2) and 260D(2)	share capital transactions
subsections 344(1) and (1A)	requirements for financial reports
subsection 588G(2)	insolvent trading
subsection 670A(4)	misstatements in, or omissions from, takeover and compulsory acquisition and buy-out documents
subsections 674(2), 674(2A), 675(2) and 675(2A)	continuous disclosure
subsection 727(6)	offering securities without a current disclosure document

Civil penalty provisions	
subsection 728(4)	misstatement in, or omission from, disclosure document
subsection 911A(5B)	need for an Australian financial services licence
subsection 911B(4)	providing financial services on behalf of a person who carries on a financial services business
subsection 1020A(5)	offers etc. relating to certain managed investment schemes not to be made in certain circumstances
subsection 1021E(8)	preparer of defective disclosure document or statement giving the document or statement (whether or not known to be defective)
subsection 1021G(3)	financial services licensee failing to ensure authorised representative gives etc. disclosure documents or statements as required
section 1041A	market manipulation
subsection 1041B(1)	false trading and market rigging—creating a false or misleading appearance of active trading etc.
subsection 1041C(1)	false trading and market rigging—artificially maintaining etc. market price
section 1041D	dissemination of information about illegal transactions
subsections 1043A(1) and (2)	insider trading

Note 1: Once a declaration has been made, ASIC can seek a pecuniary penalty order (section 1317G) or (in the case of a corporation/scheme civil penalty provision and certain other civil penalty provisions) a disqualification order (section 206C).

***Corporations Act 2001* (Cth), s 1317F**

Declaration of contravention is conclusive evidence
A declaration of contravention is conclusive evidence of the matters referred to in subsection 1317E (2).

***Corporations Act 2001* (Cth), s 1317G**

Pecuniary penalty orders

Court may order person to pay pecuniary penalty

(1) A Court may order a person to pay to the Commonwealth a pecuniary penalty in relation to the contravention of a civil penalty provision if:
   (a) a declaration of contravention of the civil penalty provision by the person has been made under section 1317E; and
   (b) if the contravention is of a corporation/scheme civil penalty provision, the contravention:

(i) materially prejudices the interests of the corporation, scheme or fund, or its members; or
(ii) materially prejudices the corporation's ability to pay its creditors; or
(iii) is serious.

The order is a ***pecuniary penalty order*** .

Maximum pecuniary penalty

(2) The pecuniary penalty must not exceed the pecuniary penalty applicable to the contravention of the civil penalty provision.

Pecuniary penalty applicable to the contravention of a civil penalty provision—by an individual

(3) The ***pecuniary penalty applicable*** to the contravention of a civil penalty provision by an individual is the greater of:
(a) 5,000 penalty units; and
(b) if the Court can determine the benefit derived and detriment avoided because of the contravention—that amount multiplied by 3.

Pecuniary penalty applicable to the contravention of a civil penalty provision—by a body corporate

(4) The ***pecuniary penalty applicable*** to the contravention of a civil penalty provision by a body corporate is the greatest of:
(a) 50,000 penalty units; and
(b) if the Court can determine the benefit derived and detriment avoided because of the contravention—that amount multiplied by 3; and
(c) either:
(i) 10% of the annual turnover of the body corporate for the 12-month period ending at the end of the month in which the body corporate contravened, or began to contravene, the civil penalty provision; or
(ii) if the amount worked out under subparagraph (i) is greater than an amount equal to 2.5 million penalty units—2.5 million penalty units.

Contrary intention in relation to pecuniary penalty applicable

(5) Subsections (3) and (4) apply in relation to a contravention of a civil penalty provision by an individual or a body corporate unless there is a contrary intention under this Act in relation to the pecuniary penalty applicable to the contravention. In that case, the ***pecuniary penalty applicable*** is the penalty specified for the civil penalty provision.

Determining pecuniary penalty

(6) In determining the pecuniary penalty, the Court must take into account all relevant matters, including:
(a) the nature and extent of the contravention; and
(b) the nature and extent of any loss or damage suffered because of the contravention; and
(c) the circumstances in which the contravention took place; and
(d) whether the person has previously been found by a court (including a court in foreign country) to have engaged in similar conduct.

***Corporations Act 2001* (Cth), s 1317H**

Compensation orders—corporation/scheme civil penalty provisions

Compensation for damage suffered

(1) A Court may order a person to compensate a corporation or registered scheme, or notified foreign passport fund for damage suffered by the corporation, scheme or fund if:
   (a) the person has contravened a corporation/scheme civil penalty provision in relation to the corporation, scheme or fund; and
   (b) the damage resulted from the contravention.

The order must specify the amount of the compensation.

An order may be made under this subsection whether or not a declaration of contravention has been made under section 1317E.

Damage includes profits

(2) In determining the damage suffered by the corporation, scheme or fund for the purposes of making a compensation order, include profits made by any person resulting from the contravention or the offence.

…

Recovery of damage

(5) A compensation order may be enforced as if it were a judgment of the Court.

Disqualification as a penalty for breach of duty

[21.40] In the matter of *Rich v ASIC* (2004) 220 CLR 129; 22 ACLC 1198, the issue of the effect of a disqualification order was considered. Rich was a director of One.Tel, a large telecommunications company that collapsed owing many millions of dollars. ASIC brought proceedings against the directors for contravention of the *Corporations Act* seeking orders for compensation and disqualification. For the purposes of the gathering of evidence, ASIC sought discovery from the directors (disclosure of documents). The directors opposed the application for discovery on the ground that it exposed them to the imposition of penalties (disqualification) under the Act. ASIC argued that the provisions regarding disqualification under the *Corporations Act* were protective in nature rather than punitive. The High Court (on appeal) held that as the effect of an order for disqualification was that the person could not hold a position affecting the management of a company, such disqualification was a penalty. Accordingly, discovery was refused.

The collapse of One.Tel in 2001 resulted in a significant amount of litigation. The most complex of the matters concerning the collapse were the proceedings brought by ASIC against One.Tel directors Jodee Rich and Mark Silbermann alleging breach of their statutory duty of care and diligence (*ASIC v Rich* (2009) 75 ACSR 1; [2009] NSWSC 1229). Certain other directors involved in the matter reached a settlement with ASIC during the course of the litigation. ASIC sought civil penalty orders, including compensation

and disqualification. In November 2009, Austin J in the Supreme Court of NSW found that ASIC failed to prove its case to the appropriate civil standard and dismissed the proceedings. It was found that ASIC had been unable to establish the true financial circumstances of the company in the period from January to April 2001. This goal had proven evidentially difficult. In this respect, the Court contrasted the litigation to the James Hardie matter (*ASIC v Macdonald (No 11)* (2009) 71 ACSR 368; [2009] NSWSC 287 and *ASIC v Macdonald (No 12)* (2009) 73 ACSR 638; [2009] NSWSC 714), where the company's position at only one particular point in time (the media release) was the focus of inquiry.

The ability of the court (**ss 206C**, **206D** and **206E**) and also ASIC (**s 206F**) to disqualify a director from management of a corporation is an important tool in ensuring that the expectations of the community as to efficient and capable management of companies is achieved. In the matter of *ASIC v Vizard* (2005) 145 FCR 57; [2005] FCA 1037, Mr Vizard, a prominent media identity and a director of Telstra, a large public company, used confidential information in relation to the investment strategies of Telstra as the basis of trading in shares on the stock market. To conceal his activities, Mr Vizard used various company and trust structures. ASIC brought an action against Vizard in relation to three breaches of the directors' duty not to make improper use of information to gain advantage (part of the cause of action arose prior to the *Corporations Act*, however, the relevant section of the legislation was identical in all respects to **s 183**). The matter was settled by way of negotiation between the parties. ASIC had been prepared to accept a disqualification of five years, however, the Federal Court increased the period and ordered that Vizard be fined $390,000 and disqualified from managing a corporation for 10 years. It is likely that the need to deter others from engaging in the type of conduct undertaken by Vizard prompted Finkelstein J of the Federal Court to increase the period of disqualification sought by ASIC. The judgment in the case, an extract of which follows, provides a good example of issues relating to the sentencing of directors who breach their statutory good faith and loyalty duties.

ASIC v Vizard (2005) 145 FCR 57; [2005] FCA 1037 (Finkelstein J)

Extract from Judgment

At [30]-[38], 40

It is appropriate now to make mention of the principles that underlie sentencing, being principles that also guide the determination of civil penalties. This is not the occasion upon which to discuss in any detail the four concepts that inform sentencing: general deterrence and personal deterrence (where punishment is imposed to avert future harm), and rehabilitation and retribution (where punishment is imposed simply because the offender deserves it). It is important, however, to make this point. For most offences (and contraventions of ss 232(5) and 183(1) are no exception) the punishment imposed by the Court is the means by which society expresses its moral condemnation of the offender. It also affirms that the particular

law is worthy of obedience. If the punishment is unduly lenient there is the risk that the Court will be perceived as endorsing the offender's conduct.

In the present case, punishment need not take into account personal deterrence or rehabilitation. The defendant admitted his wrongdoing prior to the institution of this proceeding and, through his counsel, has made a statement in open court expressing his unreserved contrition for his wrongdoing.

Nevertheless, as I have been at pains to point out, an offender such as the defendant deserves punishment for his moral culpability. The contraventions in question involved a breach of trust. I have already said that in each case the breach was serious. Shares in Sausage and Keycorp were purchased in hopes of recovering a sizeable profit. The trades were profitable. The fact that no profit was realised is beside the point. That was due to the wholly fortuitous decline in the share market.

While retribution is important as a stamp of society's disapproval of particular conduct, the governing principle of "sentencing" in cases of the kind with which we are concerned is general deterrence. The sentence must be exemplary and sufficient so that members of the business community are put on notice that if they break the trust which has been reposed in them they will receive a proper punishment. It is vital not only in the interests of the business community but in the interests of society that leaders of that community will act honestly in all their dealings. Any slip from the high standards demanded of directors can put at risk the fortunes of their company and also the fortunes (large or small) of those who invest in them. In extreme cases the misconduct can affect the economy as a whole.

It could hardly be denied that, as a rule, directors of publicly listed companies are sensitive to risk. The few that may be tempted to gain prestige, wealth and security by illegal means can be dissuaded from that course if the risk of detection and serious punishment is too great. Although the civil penalties are not substantial when compared with the possible gains from corporate crime, other penalties may act as a better deterrent.

This is where the possibility of disqualification from office can play an important function. It may be accepted that the principal object to be achieved by a disqualification order is protective: protection of the company and its shareholders against the likelihood of repetition of the offending conduct. The mistake is to treat this as the sole purpose of a disqualification order. That error has now been exposed. In *Rich v Australian Securities and Investments Commission* (2004) 78 ALJR 1354 the High Court made it clear that a disqualification order can be imposed not only to protect the company's shareholders against further abuse, but also by way of punishment and, importantly, for general deterrence. I am confident the fear of losing both their position from business life, as well as their good reputation, will be an effective deterrent in the case of many a director who is contemplating a dishonest course for gain. Few corporate crimes are spontaneous. There is always time to consider the consequences. The risk of a long period of disqualification, eg, so long that it will keep the director forever out of public corporate life, may well tip the scales.

Traditional sentencing holds that factors such as an unblemished past life, a reputation for honesty, an involvement in and a contribution towards community affairs, and so on (generally referred to by the umbrella expression "good character")

> are important factors in mitigation of sentence. I do not wish to deny the relevance of those factors, but in some cases they may result in the imposition of a very lenient sentence. At any rate there must be a limit to how far good character can be taken into account when dealing with a "white collar" offender, especially where the contravention concerns dishonesty or the abuse of a position of trust. Those convicted of such offences rarely have a criminal record. It is their good character that has enabled them to occupy the position of trust which they have ultimately breached. Indeed, it is their good character that is often used to facilitate the offence.

As litigation of legal matters, especially complex corporate matters, can be both lengthy and costly, it is always prudent for parties to consider the benefits of settlement. However, as can be seen from the court's substitution of a more severe penalty in *ASIC v Vizard*, there can sometimes be a difference of perspective between the corporate regulator and that of the court as to what penalties are appropriate. The infringement notice procedure in **Pt 9.4AA** of the *Corporations Act*, as well as ASIC's ability to negotiate enforceable undertakings from companies pursuant to either ss 93AA (company or individual) or 93A of the *ASIC Act*, are both parts of the strategy ASIC uses to deal with corporate misbehaviour, but they too have received criticism for how they may shield companies or individuals from the public scrutiny associated with litigated outcomes (see "ASIC too soft on defective disclosure" at [22.40]). In *ASIC v Ingleby* (2013) 93 ACSR 274; 275 FLR; [2013] VSCA 49, a case involving the settlement of proceedings against a director relating to the collapse of (and scandal surrounding) the Australian Wheat Board, the court highlighted that the statement of agreed facts did not properly set out the nature of the director's involvement in the matters relevant to the company's circumstances and disapproved of the penalty negotiated between the parties. In his judgment, Weinberg J at [19] referred to his earlier comments in *Australian Competition and Consumer Commission v Colgate-Palmolive Pty Ltd* [2002] FCA 619 as relevant to considering the settlement in *ASIC v Ingleby*:

> The Court may be seen, perhaps not altogether incorrectly, to act as a "rubber stamp" in simply approving a decision taken at an executive level by a body charged with investigating and prosecuting contraventions of the Act, but having no role in actually imposing particular sanctions for those contraventions. Negotiated settlements are an important vehicle for resolving complex matters such as those involved in the present case. It must be borne in mind, however, that there is a public interest in ensuring that corporations that engage in behaviour of the kind that occurred in this case are dealt with appropriately, and that proper recognition is given to the need for specific and general deterrence.

Criminal penalties

[21.50] Specific sections of the *Corporations Act* will, in each of those sections, indicate that contravention of the section is a criminal offence. An example of a section that

sets out that breach is an offence is **s 184**. In that section, a director, officer, and for **s 184(2)** and **(3)**, an employee, "commits an offence" if they contravene the section. The penalty for breach of **s 184** is listed in **Sch 3**. There are many sections in the *Corporations Act* where a person is either required to undertake, or prohibited from undertaking, a certain act or type of conduct. In these sections, an offence will be created by **s 1311**, which is a general penalty provision, but only if a penalty relating to contravention of that section is set out in **Sch 3**. So, in effect, **Sch 3** is a table indicating which sections of the *Corporations Act* result in criminal sanctions.

Section 184, which targets the type of conduct engaged in **ss 181**, **182** and **183** but with the addition of recklessness or dishonesty, is an example of a criminal offence carried out by an individual. The definition of "dishonest" for the purposes of the legislation is found in **s 9**. The section states that it means dishonest according to the standards of ordinary people. This introduces objectivity to the establishment of directors' dishonest conduct and removes the difficult task of proving a director's intention.

Criminal offences committed by individuals are penalised in the *Corporations Act* by both imprisonment and pecuniary (monetary) penalties. The level of penalty will depend on the seriousness of the breach, with some offences carrying only a monetary penalty (a fine expressed as either a specific monetary amount or as a multiple of a specific number of penalty units) and no imprisonment. Where imprisonment is imposed, the most serious offences for individuals carry a maximum of 15 years. Not every contravention of a provision in the *Corporations Act* amounts to an offence, however, the large number of sections found in **Sch 3** to which criminal penalties apply reinforces the important role of the *Corporations Act* in ensuring compliance with expected standards of corporate management.

Where an offence is committed by an individual (for instance, a director) **s 1311B** will be relevant to the penalty applicable. If the offence carries only a fine (monetary penalty), then the amount of the fine will be the penalty. Where imprisonment for less than 10 years is the only penalty, then the penalty will be either that term of imprisonment, a fine, or both. The fine is the number of penalty units worked out pursuant to a formula in **s 1311B(3)**. This is referred to as the "individual fine formula" (term of imprisonment expressed in months × 10 = number of penalty units). In more serious offences, where imprisonment of 10 years or more is the only penalty, the monetary penalty will, pursuant to **s 1311B(4)**, be the greater of (a) 4,500 penalty units and (b) if the court can determine the benefit derived and detriment avoided because of the offence then that amount multiplied by three. **Section 1311B** will apply in relation to an offence by an individual unless there is a contrary intention under the *Corporations Act*.

The *Corporations Act* distinguishes between individual, and corporate, criminal offences. The penalties where a company commits an offence are substantially higher than for an individual. Where a body corporate is convicted of an offence under the *Corporations Act*, and a fine only is imposed, the penalty will be a fine not exceeding 10 times the amount specified for an individual. Companies, of

course, being artificial legal entities, cannot be imprisoned, and this is relevant to the fact that companies will generally receive monetary penalties at a higher rate than individuals. Where an offence committed by a body corporate carries only a penalty of imprisonment and no specified monetary penalty the *Corporations Act* provides (as it also does for individuals) for a distinction in how a monetary amount will be arrived at based on the period of imprisonment noted for the offence. In circumstances where the term of imprisonment is less than 10 years, the monetary penalty will be the number of penalty units as calculated pursuant to **s 1311C(2)** and will be worked out by multiplying the "individual fine formula" by 10. However, where the maximum term of imprisonment is 10 years or more the monetary penalty for a company in contravention will, pursuant to **s 1311C(3)**, be the greatest of the following three calculations: (a) 45,000 penalty units; (b) if the court can determine the benefit derived and detriment avoided because of the offence, then that amount multiplied by three; and (c) 10% of the annual turnover of the company for the 12-month period ending at the end of the month the company committed, or began committing, the offence.

Accordingly, directors have obligations arising from the general law and also under the *Corporations Act*. Where they breach their statutory duties, ASIC may seek to enforce the civil penalty provisions. If the breach of duty involved an element of dishonesty or recklessness, the criminal penalties, including imprisonment, may apply.

The following newspaper article (from the time of the hearing in the HIH matter—see discussion of case at [20.20]) is characteristic of the media interest when large companies like HIH collapse and when company officers holding high positions are prosecuted for criminal offences. The failure of the HIH Insurance Group in 2001, owing $3.5 billion, led to several convictions of its directors and associates. Mr Williams was the highest-ranking executive in HIH. He pleaded guilty to three criminal charges, including that he was reckless and failed to properly exercise his powers and discharge his duties for a proper purpose. Mr Adler similarly pleaded guilty to charges brought by ASIC, including that he was intentionally dishonest and failed to discharge his duties in good faith in the best interests of HIH (**s 184**).

Jail terms in HIH matter

The former chief executive of the failed HIH Insurance group was given a maximum 4 1/2-year jail term with a non-parole period of two years and nine months for recklessly misleading HIH shareholders and a bank about the company's dismal financial position before its 2001 collapse.

Sentencing Williams in the NSW Supreme Court, Justice James Wood said the three offences to which Williams pleaded guilty were "objectively serious and involved a considerable abandonment of duty" on his part. Williams, he said, as the chief executive officer of HIH, was in a significant position of trust and responsibility.

Former HIH director, Rodney Adler, received the same maximum sentence but with a non-parole period of 2 1/2 years.

[Note: Both sentences have been served]

The offences for which Williams was jailed were that: In October 1998 he authorised the

issue of a prospectus for convertible notes which contained a material omission, namely that $35 million of the $155 million raised was the subject of a financial swap arrangement rather than a fund raising.

In September 1999 he authorised a statement that HIH offloaded insurance risk through a reinsurance arrangement when no risk was transferred, in what amounted to a financial arrangement which effectively understated HIH's real loss for that year by $92.4 million.

In 2000, three months before the company's collapse, he was reckless in signing a letter to noteholders which failed to reveal that a funding arrangement had been breached—a breach which could have triggered repayment to noteholders.

Justice Wood said Williams was not being blamed by the commission for the collapse of HIH, nor was he was solely responsible for the three transactions, but his actions were part of a "wider history and pattern of mismanagement which, in combination, eventually led to the collapse".

The commission's chairman, Jeffrey Lucy, welcomed the sentence and said it sent a strong message that the courts would not tolerate company directors who did not act honestly and in the best interests of shareholders.

Original source article by Anne Lampe, *The Sydney Morning Herald*

ASIC is increasingly pursuing directors who have breached their duties in circumstances where dishonesty or recklessness has been involved. The availability of criminal sanctions is hopefully a serious deterrent to those contemplating corporate mismanagement. However, the evidence needed to secure a prosecution is sometimes difficult to establish, criminal trials are often lengthy and complex, and ASIC, for all its good intentions, may find its opportunities to follow up serious breaches restricted as a result of its funding limitations.

Where criminal proceedings follow civil proceedings

[21.60] In 2002, Rodney Adler, a director of HIH, was found liable under various civil penalty provisions of the *Corporations Act* (*ASIC v Adler* (2002) 41 ACSR 72; [2002] NSWSC 171) and fined and disqualified. In *Adler v DPP* (2004) 22 ACLC 1460, he sought a stay of subsequent criminal charges on the ground that he was being punished twice for the same conduct. The court rejected Adler's argument on the basis that the earlier proceedings were civil (enforcing directors duties) as opposed to criminal (punishing conduct) and that the two forms of proceeding differed in several aspects. **Section 1317P** sets out that criminal proceedings may be commenced in relation to conduct that is substantially the same as conduct constituting a contravention of a civil penalty provision regardless of whether a declaration of contravention, a pecuniary penalty, a relinquishment order, a refund order, or a compensation order, has been made, and regardless of whether the person has been disqualified from managing a corporation. The *ASIC Act* also enables the commencement of criminal proceedings covering the same conduct as civil proceedings (s 12GBCJ).

Summary—Remedies and penalties

The company enforces the general law duties seeking remedies

Examples of general law remedies are: rescission; an account of profits

ASIC enforces the *Corporations Act* seeking penalties (civil or criminal)

A list of the civil penalty sections can be found in **s 1317E**

Examples of specific civil penalty sections: **s 180, s 181, s 588G**

Example of a civil penalty order: **s 1317G** (pecuniary penalty/fine)

A civil penalty breach allows a court to disqualify a director: **s 206C**

Where breaches involve dishonesty criminal penalties (which may include prison) apply

22
Financial and Reporting Obligations

[22.10] The financial and regulatory obligations upon a company are aimed at ensuring transparency. Regulatory control of company disclosure and reporting serves the interests of a wide group of stakeholders, particularly present and future investors. However, the complexity and cost of adhering to the obligations will vary depending on the size and type of the company. Listed public companies are larger and more accountable than proprietary companies and, accordingly, will have more financial and reporting obligations.

Reporting obligations

[22.20] There are certain fundamental reporting obligations upon a company. Pursuant to **s 286**, all companies must keep written financial records that record and explain its financial position and performance. The financial records must be kept in a manner that would enable true and fair financial statements to be prepared and audited. If the company is a large proprietary or public company (or a disclosing entity or registered scheme) **s 292** requires that a financial report and a directors' report must be prepared for each financial year and **s 301** sets out that the financial report must be audited and an auditor's report obtained. The directors' report is required to provide a review of the company's operations detailing any significant changes and set out the company's principle activities and likely developments (**s 299**). Specific information as to dividends or distributions paid to members and details of options granted to any of the directors are also required (**s 300**). If the company is listed, further information such as the company's business strategies must be included (**s 299A**). Pursuant to **s 302**, where the company is a disclosing entity, for example a listed public company, a financial report and a directors' report must be prepared, and the financial report audited, for each half-year.

The contents of the annual financial report are set out in **s 295**. These are: the financial statements for the year; the notes to the financial statements; and the directors' declaration about the statements and notes. The requirement for the directors' declaration is in **s 295(4)** and importantly specifies that that the directors must confirm compliance with **s 296** (the accounting standards) and **s 297** (that the financial statements must present a true and fair view of the company's position). This obligation was particularly relevant to the decision in *ASIC v Healey* (2011) 83 ACSR 484; [2011] FCA 717, where it was held that the duty of directors in relation to the company's financial report and the directors' report is a non-delegable, primary responsibility and that each director is required to take a diligent interest in, and have the ability to understand, the financial statements, and to inquire about any potential

deficiency in the accounts that they observe (or should reasonably have observed). Importantly, a knowledge of conventional accounting practice and the accounting standards relevant to the documents being approved was considered necessary by the Court to form the opinion required by **s 295(4)(d)** of the *Act* and to ensure that all reasonable steps are taken to secure compliance as required by **s 344**.

The reporting requirements in **ss 292** and **301** are generally considered too onerous for small proprietary companies, and in some instances for small companies limited by guarantee (defined in **s 45B**). However, in relation to such companies, members with at least 5% of the votes may require the company to prepare financial and directors' reports pursuant to **s 293** (proprietary companies) and **s 294A** (guarantee companies). These sections also allow shareholders to require that the financial report be audited. A small proprietary company's obligations to prepare reports may also stem from a direction by ASIC under **s 294**.

The outcome of the reporting and financial obligations is to ensure:

- that there is compliance with the accounting standards (**s 296**); and
- that a true and fair view of the company's financial position is presented (**s 297**).

Within two weeks of the company's review date (usually determined by the date of registration), ASIC forwards to each company an extract of its particulars (**s 346A**). This contains some or all of the company's particulars that are recorded in ASIC's registers; ASIC may also require the company to supply other particulars prescribed by the regulations (**s 346B**). The company must notify ASIC of any changes to its particulars within 28 days, otherwise it need take no action (**s 346C**).

Companies may decide where their financial records are kept. However, if the records are kept outside of the jurisdiction (ie, outside Australia) written notice of their whereabouts must be given to ASIC (**s 289**). Financial records must be kept for seven years after the transactions covered by the records are complete (**s 286(2)**) and must be available in hard copy. Records kept in electronic form must be converted (**s 288**).

Together with the general requirement under **s 286** in relation to record keeping, a company has several other obligations, including the need to nominate a registered office (**s 121**) and notify ASIC of the address (which must be an actual location and not a post office box). Pursuant to **s 251A**, a company must keep minute books in which it records (within one month) proceedings and resolutions of members meetings and directors meetings. Minute books are to be kept at the company's registered office, principal place of business or other place approved by ASIC.

Continuous disclosure

[22.30] Investors will only be able to make informed decisions as to a company's worth if all relevant information is available and current. Pursuant to **s 674**, if a reasonable person would consider information in the company's possession that is not generally available would have a material effect on the price or value of a listed

company's securities, then that information must be disclosed. Civil penalties apply to the section. The requirements to disclose material information on a continuous basis vary depending on whether the disclosing entity is listed or unlisted (for unlisted disclosing entities, see **s 675**). Where the company is a listed disclosing entity, disclosure must comply with the ASX Listing Rules. A claim under the continuous disclosure provisions was one of the claims made in the original proceedings in *Sons of Gwalia Ltd v Margaretic* (2007) 231 CLR 160; [2007] HCA 1. Although the effect of the decision has been reversed by the *Corporations Amendment (Sons of Gwalia) Act 2010* (Cth) (see Ch 13 under "Comparison of share and loan capital" at [13.20]), the circumstances are illustrative. Mr Margaretic paid $26,200 (plus brokerage and GST) to acquire 20,000 shares in Sons of Gwalia Ltd on 18 August 2004 shortly before it was placed into voluntary administration. The company was worthless at the date of the appointment of the administrators. The shareholder claimed that the company breached the provisions of **s 674** relating to the continuous disclosure obligations of companies listed on the ASX in that it failed to properly disclose the true position. The company had entered into substantial forward contracts to sell gold and had made disclosures to the market that it had sufficient reserves to meet the forward contracts. However, the disclosures were incorrect resulting in the need to purchase gold in a market where prices were increasing rapidly. The shareholder claimed that a reasonable person would expect this information to have a material effect on the price or value of the company's ordinary shares.

The continuous disclosure provisions are also designed to stop companies listed on the stock exchange from engaging in selective disclosure practices. An example of a selective disclosure practice is where a large listed company provides exclusive information to established stockbrokers but does not share this information with the market generally, so that large investors are better informed than smaller investors.

In *ASIC v Chemeq Ltd* (2006) 58 ACSR 169; [2006] FCA 936, there was a breach of the continuous disclosure provisions when the company admitted it failed to disclose cost overruns on the construction of its production plant in Western Australia and failed to disclose that a patent registered in the US had no commercial value. The Federal Court (French J) stressed the relevance of the corporate culture to the duty of disclosure, setting out that there must be an awareness of the need to consider regulatory obligations as part of day-to-day decision-making process in companies.

Because investors will be influenced by positive disclosures regarding a company's prospects, it is essential that the provisions of **s 674** are vigilantly enforced. In *ASIC v Fortescue Metals Group Ltd (No 1)* (2011) 190 FCR 364; [2011] FCFCA 19, the company provided information to the ASX in relation to certain contracts that had been allegedly entered with a number of Chinese entities for the purposes of joint arrangements, including rail and mining projects. The matter was eventually decided in favour of the company by the High Court. However, prior to this, the Federal Court of Appeal held that the disclosures were misleading or deceptive, breaching **s 1041H**, and that the contracts were not binding. Accordingly, the outcome of the Federal Court of Appeal's decision was that the company had an obligation to notify the ASX with the

correct information. **Section 674** requires that the ASX be notified of information about specified events that a reasonable person would expect to have a material effect on the value of the company's securities for the purpose of the market operator (ASX) making that information available to participants in the market. The Court of Appeal also found that that the company's CEO, Mr Forrest, breached his duty of care and diligence under **s 180** by allowing the company to contravene its continuous disclosure obligations. Mr Forrest sought to rely on the business judgment rule in relation to the relevant announcements and releases; however, the Federal Court of Appeal held that decision making of that kind related to compliance with the *Corporations Act 2001* (Cth) and could not be properly described as a business judgment. The Court of Appeal (at [197]) held: "A decision not to make accurate disclosure of the terms of a major contract is not a decision related to the 'business operations' of the corporation. Rather it is a decision related to compliance with the requirements of the Act".

Fortescue Metals and Mr Forrest appealed to the High Court (*Forrest v ASIC* [2012] HCA 39). The High Court held that the market announcements by Fortescue were not misleading or deceptive. This meant that the breach of the continuous disclosure provisions became a non-issue in the final decision. ASIC's secondary argument regarding non-disclosure, that Fortescue was obliged to disclose the terms of the agreements, was rejected by the High Court on two grounds: by the majority as not necessary as the announcements accurately conveyed the effect of the agreements, and by Heydon J on the ground that if they really were "unenforceable agreements to agree" (which was ASIC's position), then they were not of relevant significance in any case. The target or intended audience, and the special nature of the arrangement, particularly the involvement of Chinese state-owned enterprises, were important parts of the grounds for the decision.

The case raised the issue of the ability or experience of those parties dealing with a company in circumstances where inadequate disclosure is alleged. In this context, the identification of the target audience as commercially shrewd or relatively sophisticated, that is, having the ability to distinguish between intentions and legal effect, may be a relevant factor to consider in similar circumstances. The commercial realities of corporate deal-making mean that contract negotiations may ebb and flow. Overall, the precise timing of a disclosure, or even the more drastic step of a trading halt, will continue to prove a difficult decision for companies having regard to the continuous disclosure requirements.

ASX Listing Rules and continuous disclosure

[22.40] The important area of corporate disclosure to the market is regulated both in the *Corporations Act* and by ASX pursuant to its Listing Rules (3.1-3.1B). To assist listed entities to understand and comply with their continuous disclosure obligations under the Listing Rules, ASX has produced Guidance Note 8 containing a detailed explanation of the continuous disclosure regime. The Guidance Note addresses matters including disclosure of earnings surprises and post-balance date events, and investor briefings.

Clarification of when and in what circumstances disclosure was required was the basis of the updated Guidance Note. Of the issues Guidance Note 8 addresses, the following stand out: the meaning of "immediately"; the value of trading halts; a perspective on the reasonable person test in **s 674(2)(c)(ii)**.

Listing Rule 3.1 requires market-sensitive information to be disclosed immediately upon the entity becoming aware of it. A definition of the word "immediately", and one used by ASX in its Listing Rule, is found in *R v Berkshire Justices* (1879) 4 QBD 469. In that case, "immediately" is equivalent to "prompt and vigorous, without any delay". Unfortunately for investors, delay is sometimes the tactic applied to disclosing market-sensitive material as companies balance timing of disclosure with time-critical, and perhaps financially beneficial, deadlines.

The test for determining whether information is market-sensitive, thereby requiring disclosure, is set out in **s 677**. A reasonable person will expect information to have a material effect on the price or value of an entity's securities if the information would or would be likely to influence persons who commonly invest in securities in deciding whether to acquire or dispose of those securities.

To ensure companies are aware of their responsibilities, the Guidance Note sets out that ASIC may issue infringement notices for even relatively short delays in disclosure. In fact, the whole of the Guidance Note, with its practical, example-based tone, will provide companies with the sort of detailed information that should lead to more transparency in relation to the continuous disclosure regime.

There is recognition in the Guidance Note of the realities of lines of communication in companies, for instance concerning the need to verify information, or seek board approval. How such factors impact upon the concept of "prompt and without delay" is not only relevant to ASX but also to ASIC in considering its options for proceedings under **s 674**. The material in Guidance Note 8, particularly the importance of market-sensitive information being brought to the notice of directors and senior managers, is relevant to good corporate governance practice. This connection was drawn in the judgement in *ASIC v Chemeq* (2006) 58 ACSR 169; [2006] FCA 936, where the Court considered that it was necessary for corporate management to heed and apply relevant regulatory requirements as part of their ongoing decision-making processes.

The significance of trading halts is tied to timing issues, which are inherent in the need for immediate disclosure. A trading halt can be requested under Listing Rule 17.1 for a maximum period of two days (a period not exceeding the commencement of normal trading on the second trading day following the day on which it is requested). A trading halt not only may protect potential investors, but also may reduce the exposure of the listed entity if it is subsequently found to have breached its obligations. The use of a trading halt may go some way to satisfying the spirit, intention and purpose of Listing Rule 3.1 (see Listing Rule 19.2). The focus upon the use of trading halts is a positive factor and the explicit support of these in the Guidance Note is a step in removing the reticence that listed companies may feel in implementing the procedure, which may arise from the perception of negative market response regardless of eventual outcome.

The usefulness of the continuous disclosure provisions in the *Corporations Act*, and the Listing Rules, is based on not only what is required to be disclosed, but on what is not. Listing Rule 3.1A.1 is relevant in this regard and lists categories of information excluded. These include information where disclosure would be a breach of the law, information concerning incomplete negotiations, matters of supposition, or trade secrets. Listing Rule 3.1A.2 sets out that excluded information must also be confidential and Listing Rule 3.1A.3 requires that a reasonable person would not expect the information to be disclosed.

Timely and adequate disclosure is critical to the integrity and efficiency of the market. ASX Guidance Note 8 stresses context. This is particularly important for the purposes of balancing the regulatory regime with the realities of corporate practice, particularly in critical situations, where the continuous disclosure provisions may have an impact. In the High Court judgement in *Forrest v ASIC*, it was considered important to examine what the statements made by the company conveyed to their target audience. Guidance Note 8 at 4.15 sets out that wherever possible an announcement under Listing Rule 3.1 should contain sufficient detail for investors or their professional advisors to understand its ramifications and to assess its impact on the price or value of the entity's securities.

Enforcing the Listing Rules regarding continuous disclosure

[22.50] The area of disclosure, particularly continuous disclosure, has become increasingly important as a result of several factors including the growing number of investors (particularly individuals), the increasing spotlight being shone on regulatory bodies especially as corporate behaviour becomes mainstream media, the size of some listed companies making information as to their activities inaccessible to all but the most resourced investors, and having regard to the seemingly ever hovering financial crisis, the uncertainty of the market.

To police the Listing Rules, for instance Rule 3.1, ASX issues inquiries of companies where investigation into, or information as to, the company's share price indicates activity that may warrant disclosure (Aware Query or Price and Volume Query). Such inquiries can also be prompted by an announcement posted by the company on the ASX website. Listing Rule 18.7 underpins ASX's right to seek information. The ASX inquiry generally follows a format inquiring as to explanation of recent trading activity, or whether information contained in an Announcement would be of the character that a reasonable person would expect to have a material effect on the price or value of its securities, in other words, whether the company is complying with Listing Rule 3.1.

Although Rule 3.1 inquiries focus on trading patterns and market perception, the ASX queries do not generally require confirmation that the company has sufficient funds to cover its activities (ie, it can continue to trade). This would occur less frequently. Whether the ASX inquiries have stemmed from an investigation into share fluctuations in the company or whether they have stemmed from an announcement

by the company in relation to some aspect of its activities may also make a difference. Some companies make regular announcements, which, depending on market conditions, may increase the frequency of ASX inquiries. It may be wise for mining companies, for example, to keep investors updated (via announcements) about their prospects of success. The difference in share price resulting from a "find" or discovery can be substantial and the ability of investors to assess their investments is often based on quite technical information.

The following two newspaper articles give an indication of some of the issues that are faced by disclosing entities in relation to compliance with the continuous disclosure provisions.

Questions must be asked about when Flight Centre knew PEP's takeover play would fail

The ASX should make inquiries of Flight Centre to determine whether some directors knew several days before their controversial termination of the proposed joint venture with Pacific Equity Partners—and ahead of receiving a report from the independent expert—that the transaction was likely to collapse because it no longer had the support of the founding majority shareholders.

If so, that raises the question as to whether the company complied with the ASX continuous disclosure rule, which requires the immediate release of any information known to the company which a reasonable person would expect to have a material effect on the price or value of its securities.

The directors announced the termination of the agreement to put the company's businesses into a leveraged joint venture, 70 per cent owned by Flight Centre and 30 per cent by PEP, on the morning of Wednesday July 31, before the start of ASX trading, after receiving a report from the expert Ernst & Young that conveniently concluded that the proposal was not fair and reasonable.

But the expert's opinion didn't kill the transaction, nor was it killed by the advice that the amount of CGT may balloon. The deal was killed by the decision of the independent directors to make a provision of $80 million to $100 million against the possibility of the higher CGT bill.

That would have drastically reduced the amount available for distribution to Flight Centre shareholders by way of a share buy-back, and depending on the take up by other shareholders, could have meant that the founding shareholders may have been unable to receive a a distribution.

Original source article by Bryan Frith, *The Australian*

Brambles puts kybosh on potential raid by flushing out Asciano and Toll shareholdings

Brambles, in disclosing that Asciano Group, and to a lesser extent Toll Holdings, have been buying its shares, is no doubt seeking to blow any chance of them building a strategic stake as a prelude to some form of corporate play—if that is what they had in mind.

Brambles said yesterday that the shares were registered in the name of a Macquarie subsidiary. However, the notices revealed that an Asciano subsidiary, National Rail Consortium (Insurance), held 15.97 million shares, and another subsidiary, MS Corporate Services,

held a further 1.6 million shares. Together that amounted to 1.2 per cent of the capital.

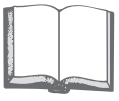
Brambles' announcement has led to debate as to whether the company was required to disclose the Asciano and Toll buying and, if so, whether the company had failed to comply with its disclosure requirements.

Companies are only required to give details of responses to tracing notices if they trigger the continuous disclosure rule, that is, the information is price sensitive and a reasonable person would expect it to have a material effect on the price or value of the company's securities. That Brambles released the information suggests it considered the information to be materially price sensitive, and yesterday's market reaction would suggest that investors would agree with that interpretation.

But the continuous disclosure rule stipulates that such information be disclosed as soon as it is known, and Asciano is at pains to "clarify" that its presence as a shareholder was first notified to Brambles on Monday July 30.

The Brambles camp rejoined that it was not a straightforward task to accurately interpret the responses to its notice, that it had had to make several requests before it could piece the picture together, and that the company did not want to make a premature announcement before it was sure of the buyer's identity.

Original source article by Bryan Frith, *The Australian*



[Bloch M, Weatherhead J and Webster J, "The development and enforcement of Australia's continuous disclosure regime" (2011) 29 *Company and Securities Law Journal* 253 at 254, 255.]

The purpose of a continuous disclosure regime is to prevent distortions in the price of securities and to promote fairness in the market, in each case by ensuring that privileged investors cannot take advantage of an uneven playing field. The latter point is critical, as the ultimate objective of Australia's continuous disclosure regime is not full disclosure of price-sensitive information, but prevention of an uneven playing field. This is inherent in the fact that there exists a carve-out to the regime, which allows companies legitimately to withhold certain information. In *Heard It on the Grapevine*, a consultation paper released in August 1999, ASIC instructed disclosing entities, in establishing written policies and procedures on information disclosure, to "focus on … equal access to information for all investors". Inevitably, there are differing views as to the appropriateness of this objective, with some arguing that the regime should aspire towards perfect disclosure. In an article published in 2007, commentator Alan Kohler referred to "the Handbook for Keeping Shareholders in the Dark, otherwise known as the exceptions to the continuous disclosure section of the ASX listing rules". Nevertheless, as the regime is currently formulated, fairness, rather than full disclosure, remains its animating purpose.

Infringement notices

[22.60] The importance of transparency in financial markets and the need to guard investors against corporate deception, intended or otherwise, has meant that the continuous disclosure provisions have become a useful tool in regulation and

as such investor protection. To enable ASIC to deal with instances of misleading, or non-existent disclosure, **s 1317DAB** sets out that the purpose of **Pt 9.4AA** of the *Corporations Act* is to enable the issue of an infringement notice to a disclosing entity for an alleged contravention of **ss 674(2)** or **675(2)** as an alternative to proceedings for civil penalties. The company is able to make submissions, but if ASIC determines to issue an infringement notice then **s 1317DAE** allows for penalties of up to $100,000. This procedure provides a swifter means to address disclosure breaches and may also lead to settlement of the matter. The following ASIC Media Release details ASIC's view of the usefulness of the process.

Media Release

12-43AD BC Iron complies with ASIC infringement notice for alleged continuous disclosure breach

BC Iron Limited (BCI) has paid a $66,000 penalty after ASIC served an infringement notice alleging the company had not complied with the continuous disclosure provisions of the *Corporations Act 2001* (the *Act*) and relevant provisions of the Australian Securities Exchange (ASX) Listing Rules.

The alleged continuous disclosure breach related to a scheme implementation agreement (SIA) BCI entered into in 2011 with Regent Pacific Group Limited (Regent), a company incorporated in the Cayman Islands and listed on the Hong Kong Stock Exchange (HKSE).

BCI paid the penalty on 1 March 2012 in compliance with the infringement notice. As provided by the Act, compliance with the notice is not an admission of guilt or liability, and BCI is not regarded as having contravened subs 674(2) of the *Act* (Obligation of an entity to provide information to market operator).

ASIC Deputy Chairman, Belinda Gibson, said the issuing of infringement notices was a timely and efficient remedy for dealing with some breaches of the continuous disclosure laws and effective in maintaining confidence in the integrity of our market.

Further information about ASIC's administration of continuous disclosure notices is contained in ASIC Regulatory Guide 73 *Continuous disclosure obligations: infringement notices* (RG 73).

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The continuous disclosure provisions in the *Corporations Act* aim to protect investors and regulate bodies whose securities are of interest to investors. Making information easier to access is essential. However, it is equally important that companies breaching **s 674** are properly accountable and that any action taken by ASIC acts as an effective deterrent to similar conduct in the future. The following newspaper article questions whether the infringement notice process (and the use of enforceable undertakings) will necessarily achieve this aim.

ASIC too soft on defective disclosure

It was something of an irony that Leighton Holdings issued a statement to the ASX at 7.50pm on Friday—almost four hours after the market had closed—informing shareholders it had settled up with the Australian Securities and Investments Commission over alleged continuous disclosure breaches last year. In the statement, Leighton agreed to pay $300,000 in penalties, said it would implement a formal review of its continuous disclosure policies and procedures and refused to admit liability.

But a statement by ASIC on Sunday paints a fuller picture of the investigation and begs questions about the trend of ASIC to use enforceable undertakings rather than test cases in the courts. While the latter is more expensive it is useful to create precedents and send a stern message to companies and directors that the regulator is tough. Light penalties and small fines are akin to fighting with a piece of wet lettuce, particularly with companies that have big balance sheets.

ASIC's statement says the infringement notice was issued because ASIC has "reasonable grounds to believe Leighton contravened subsection 674(2) of the act in the period from 18 March 2011 to 6 April 2011". The ASX listing rules require Leighton to immediately tell the ASX of anything that would have a material effect on the price. ASIC found that from March 18, Leighton should have told shareholders that its Airport Link Project was expected to make a substantial loss. Senior executives had met that day to discuss different loss scenarios ranging from $182 million to $610 million. Ditto for its desalination plant in Victoria and its Middle East business.

It is a shocking state of affairs that a listed entity the size of Leighton needs to improve its systems so that shareholders can trade in an informed market. That should be a given. But to receive a $300,000 penalty and an enforceable undertaking to hire two external consultants to help set up new disclosure systems, looks like another example of ASIC fighting companies with a feather. What about the directors in all of this?

Original source article by Adele Ferguson, *The Sydney Morning Herald*

Summary—Financial obligations

All companies must keep written financial records (**s 286**)

Larger companies have more reporting obligations

Public companies and large proprietary companies:

- must prepare financial and directors reports (**s 292**);
- are required to have the financial report audited.

The aim is to provide a true and fair view of the company's finances

Small proprietary companies generally do not have to prepare financial or directors reports, or be audited

However, pursuant to **ss 293, 294, 301**, financial information and audits of small proprietary companies may be required (by shareholders and ASIC)

Listed and unlisted companies have continuous disclosure requirements (**s 674**)

Example of a case concerning continuous disclosure: *ASIC v Chemeq Ltd*

23
Auditors

Auditor independence

[23.10] An auditor's role is to check company accounts so that any irregularities are exposed. Both outsiders and the company's shareholders rely on the information contained in an audit and the fact that the auditor remains independent is an essential aspect of this reliance. Auditors' liability arises in contract (to the company), in tort (to the company and outsiders) and under the *Corporations Act 2001* (Cth).

Section 1280 sets out the criteria to be registered as an auditor and includes completing a course of study in commercial law (including company law). ASIC must be satisfied that the applicant for registration as an auditor has satisfied the components of an auditing competency standard approved by ASIC and had relevant practical experience in auditing.

The *CLERP (Audit Reform and Corporate Disclosure) Act 2004* (Cth) was part of the ongoing changes to company law brought about by the Corporate Law Economic Reform Program initiatives and resulted in certain amendments to the *Corporations Act*, particularly with respect to audit practice. The reforms were a response to the involvement and implication of auditors in the various corporate collapses of the late 1990s and early 2000s. An important effect of the reforms on the *Corporations Act* was to improve the control and checking of audits and to foster audit independence (see **s 324CA** for general requirement for independence).

A person (or firm) contravenes the requirements for auditor independence if, at the relevant time, there is a relationship between the person (or firm) and the audited body (the company) that may entail some element of conflict, such as: the person is an officer of the audited body (not applicable to small proprietary companies); the person or firm has an asset that is an investment in the audited body; or the person or firm owes an amount to the audited body, a related body corporate or an entity that the audited body controls (unless the debt is disregarded in terms of the section). See **s 324CH** for a list of circumstances relevant to a consideration of auditor independence. An objective standard for auditor independence applies including the imposition of a mandatory waiting period of two years for partners of an audit firm that were directly involved in a company audit, that is, they were members of the audit team for the audit, before those partners can become directors or take a senior management position, in the client company (**s 324CI**).

Another important introduction to maintaining auditor independence arising from the *CLERP (Audit Reform and Corporate Disclosure) Act 2004* is the requirement in **s 324DA** of the *Corporations Act* that individuals who play a significant role in the audit

process of listed companies or listed registered schemes are rotated after a maximum of five successive years of servicing a particular audit client. With an increasingly stricter regulatory environment, resulting in part from widening corporate failure, improving audit standards and accountability will remain high on Parliament's agenda. This is reflected in the amendments to the *Corporations Act* stemming from the *Corporations Legislation Amendment (Audit Enhancement) Act 2012* (Cth). Rotation and transparency are both dealt with. **Section 324DAA** sets out that subject to certain conditions the directors of a listed company may by resolution grant an approval for an individual to play a significant role in the audit of the company for not more than two successive financial years in addition to the five successive financial years contained in **s 324DA(1)**. Pursuant to **s 324DAC**, if approval is granted, a copy of the resolution must be lodged with ASIC and given to the relevant individual within 14 days. Audit practice is further improved in **s 332A** by requiring audit firms that carry out more than 10 listed company audits during a 12-month period to complete an annual transparency report covering matters such as details of internal procedures for quality assurance and professional education. Both extensions of the period for publication of the report (**s 332C**) and exemption orders relieving the auditor from compliance (**s 332D**) are available in certain circumstances.

In Information Sheet 196 on *Audit quality: The role of directors and audit committees* (March 2014), ASIC suggested that to improve the audit environment within listed companies, directors and audit committees should consider the following: non-executive directors recommending auditor appointments and setting audit fees; assessing the commitment of the auditors to audit quality; reviewing the resources devoted to the audit, including the amount of partner time and the use of experts; accountability within the audit firm for quality; support by company management for the audit process; two-way communication with the auditor on concerns and risk areas; ensuring independence of the auditor and reviewing audit firm responses to findings from ASIC audit inspections.

Auditors' statutory duties and powers

[23.20] Auditors' statutory duties and powers are found in **ss 307-313**. To be able to obtain the necessary information to complete an audit, the auditor has a right of access to the company's books together with the ability to extract information from the company's officers (**s 310**).

The principle duties of an auditor are set out in **s 307** and following sections and comprise forming an opinion as to:

- whether the company's financial report complies with accounting standards (**s 296** or **s 304**);
- whether the company's financial report provides a true and fair view (**s 297** or **s 305**);
- whether all relevant information has been provided;

- whether the company has kept adequate financial records; and
- whether the company has kept other records and registers as required.

Audits must be conducted in accordance with auditing standards and audit working papers retained for seven years. The auditor's report must include any statements or disclosures required by the auditing standards. The auditor (in the case of an audit firm or company, the lead auditor) must give a written declaration to the directors that to the best of the auditor's knowledge and belief no contravention of the auditor independence requirements have occurred. The general standard of independence is based on avoiding a conflict of interest situation. Where there is a situation of conflict, the auditor will not be able to act impartially or objectively. The *Corporations Act* sets out an objective test in relation to whether an auditor has breached the duty to avoid a conflict of interest based on a reasonable auditor in the circumstances.

Another main statutory requirement of auditors is to notify ASIC if they have reasonable grounds to suspect a contravention of the *Corporations Act* (**s 311**). Matters relevant to the obligation of an auditor to notify ASIC include the level of penalty applicable to the contravention and the effect that the contravention would have on the company's overall financial position. The reporting obligations cover individual auditors, audit companies and lead auditors. **Section 311** reinforces the importance of an auditor's role in the efficient regulation of corporate conduct and widens the ambit of their responsibilities.

***Corporations Act 2001* (Cth), s 311**

Reporting to ASIC

Contravention by individual auditor

(1) An individual auditor conducting an audit contravenes this subsection if:
  (a) the auditor is aware of circumstances that:
    (i) the auditor has reasonable grounds to suspect amount to a contravention of this Act; or
    (ii) amount to an attempt, in relation to the audit, by any person to unduly influence, coerce, manipulate or mislead a person involved in the conduct of the audit (see subsection (6)); or
    (iii) amount to an attempt, by any person, to otherwise interfere with the proper conduct of the audit; and
  (b) if subparagraph (a)(i) applies:
    (i) the contravention is a significant one; or
    (ii) the contravention is not a significant one and the auditor believes that the contravention has not been or will not be adequately dealt with by commenting on it in the auditor's report or bringing it to the attention of the directors; and
  (c) the auditor does not notify ASIC in writing of those circumstances as soon as practicable, and in any case within 28 days, after the auditor becomes aware of those circumstances.

Liability in negligence to the company

[23.30] Auditors owe a duty of care to the company. They must exercise reasonable care and diligence in the performance of their functions. In *Pacific Acceptance Corp Ltd v Forsyth* (1970) 92 WN (NSW) 29, auditors for the lender failed to check certain security transactions involving mortgages believed to be prepared by the solicitor acting for the borrowers. The auditors claimed that they were entitled to place reliance on the proper execution and registration of the mortgages by the solicitors. The court held that in the circumstances where the borrowers' auditors had only issued a qualified audit regarding the borrower company, the auditors for the lender should have been suspicious and investigated further. The fact that the auditors employed inexperienced staff compounded their negligence.

Another case in which auditors were held to have breached their duty of care to the company was *Daniels v Anderson* (1995) 37 NSWLR 438; 13 ACLC 614. In that case, the court found that a failure to warn the company's directors in relation to deficient accounting records and ineffective internal controls (for example, that the foreign exchange trading was not integrated into the company's computerised accounting system) was a breach of the appropriate duty of care and amounted to negligence. The matters considered relevant by the court in relation to a finding of negligence on the part of the auditors in this case are summarised in the following extract.

Daniels v Anderson (1995) 37 NSWLR 438;
13 ACLC 614 (Clarke, Sheller and Powell JJA)

Extract from Judgment

Clarke and Sheller JJA at 485

In the language of the chairman of Deloitte Haskins & Sells in his letter of 16 November 1987 when speaking of the foreign exchange operations for the year ended 30 June 1987 the records of AWA were poorly maintained and not always retained, the internal controls were inadequate and the management control of foreign exchange activities was ineffective.

The various contradictory and incomplete records to which (counsel for Deloitte Haskins and Sells) referred could not be described as accounting records which correctly recorded or explained the transactions and the financial position of AWA.

In accordance with their own audit manual, the standard practices and procedures of the auditing profession and common prudence, Deloitte Haskins & Sells were under a duty to report the acknowledged absence of proper records and the weakness in internal controls to management and then, in the absence of appropriate and timely action by management, to the board. Deloitte Haskins & Sells failed in their duty in this regard and there was no acceptable excuse for their failure.

> Inquiry from a member of the (AWA) board on 22 September 1986 brought no true response about these matters. There was a deliberate concealment by Daniels of the weaknesses in records and books and the lack of internal control and a failure to explain the significance of the wrong way round position of which Daniels was aware. In our opinion AWA established that by their actions up to and on 22 September 1986 Deloitte Haskins & Sells failed in their duty as auditors in respect of the period to 30 June 1986.
>
> Thereafter Deloitte Haskins & Sells' lack of care continued. The inappropriateness of the signing of the profit statement of 9 March 1987 could not be denied. The signing occurred in the knowledge that the defective system of records and internal controls had not been improved and that the circularisation of the banks had revealed discrepancies in the accounts never satisfactorily explained.
>
> The litany of negligence continued thereafter. Deloitte Haskins & Sells though aware of the defects reported made no report of them to the board of directors. Rather when the occasion offered at the meeting of 30 March 1987, Daniels said nothing.
>
> Deloitte Haskins & Sells' negligence on 22 September 1986 was compounded and exacerbated by their continuing negligence thereafter.

Liability to outsiders

[23.40] Auditors may also be liable to outsiders (third parties) in tort (negligence). As company audits are often included in various company documents, including the annual report, it is possible that the audit will be seen by those not connected with the company, who then on the strength of the audit decide to invest in the company. If the audit turns out to be misleading or incorrect in fairly narrow situations, there will be a limited right for an outsider to sue.

In *Esanda Finance Corp Ltd v Peat Marwick Hungerfords* (1997) 188 CLR 241; 15 ACLC 483, a company, Excel Pty Ltd, guaranteed loans provided by Esanda to companies associated with Excel. Peat Marwick had prepared an unqualified audit of these associated companies upon which Excel had relied. However, the audit failed to disclose the associate companies' true position. Excel became insolvent and could not meet its commitment on the guarantees. Accordingly, Esanda sued Peat Marwick. The court held that the mere possibility that a third party (Esanda) may rely on an audit did not ground a duty of care. What was necessary to prove was much more specific, including that the auditor knew or should reasonably have known that it would be very likely that the third party would enter into such a transaction relying on the audit and as such risk economic loss. The High Court's decision was unanimous in dismissing Esanda's appeal. The judgment of the Chief Justice outlined the general principles relevant to the issue of third-party reliance on audits. These are set out below.

Esanda Finance Corp Ltd v Peat Marwick Hungerfords (1997) 188 CLR 241; 15 ACLC 483 (Brennan CJ, Gaudron, McHugh, Dawson, Toohey and Gummow JJ)

Extract from Judgment

Brennan CJ at 252

The uniform course of authority shows that mere foreseeability of the possibility that a statement made or advice given by A to B might be communicated to a class of which C is a member and that C might enter into some transaction as the result thereof and suffer financial loss in that transaction is not sufficient to impose on A a duty of care owed to C in the making of the statement or the giving of the advice. In some situations, a plaintiff who has suffered pure economic loss by entering into a transaction in reliance on a statement made or advice given by a defendant may be entitled to recover without proving that the plaintiff sought the information and advice. But, in every case, it is necessary for the plaintiff to allege and prove that the defendant knew or ought reasonably to have known that the information or advice would be communicated to the plaintiff, either individually or as a member of an identified class, that the information or advice would be so communicated for a purpose that would be very likely to lead the plaintiff to enter into a transaction of the kind that the plaintiff does enter into and that it would be very likely that the plaintiff would enter into such a transaction in reliance on the information or advice and thereby risk the incurring of economic loss if the statement should be untrue or the advice should be unsound. If any of these elements be wanting, the plaintiff fails to establish that the defendant owed the plaintiff a duty to use reasonable care in making the statement or giving the advice. The statement of claim does not plead these elements. Accordingly, the appropriate order is simply that the appeal be dismissed.

[footnotes removed]

Note that the liability of auditors is also in issue in situations where companies fail to satisfy their continuous disclosure obligations under **s 674** by way of conduct that is misleading or deceptive and a factor in a company's failure are the actions of auditors who, themselves, fail to identify errors or, moreover, engage in conduct that is in itself misleading or deceptive. Such allegations were levelled at PricewaterhouseCoopers in their role as auditors of the Centro Group in a class action brought against Centro and the auditors by investors who had suffered as a result of Centro's collapse (see [20.90] for an extract from the judgment in *ASIC v Healey*). The class action settled (see [25.70] "Class actions").

Summary—Auditors

Must be registered (**s 1280**) and remain independent (**s 324**)

Powers are found in the *Corporations Act*: for example, access to books (**s 310**)

Duties arise in contract, tort and pursuant to the *Corporations Act*

Example of statutory duty: inform ASIC if suspect breach (**s 311**)

Duties to the company involve exercising reasonable care and skill

Example of case concerning duty of care—*Pacific Acceptance Corp v Forsyth*

Duty to third parties based on reasonable reliance—*Esanda Finance*

24
ASIC Investigation

[24.10] The Australian Securities and Investments Commission (ASIC) is given its functions and powers under the *Australian Securities and Investments Commission Act 2001* (Cth) (*ASIC Act*). ASIC is an independent Australian government body enforcing and regulating company and financial services laws to protect consumers, investors and creditors. Legislation administered by ASIC includes: the *Corporations Act 2001* (Cth), the *ASIC Act* and the *Insurance Contracts Act 1984* (Cth). ASIC is also the consumer credit regulator. It licenses and regulates people and businesses engaging in consumer credit activities (including banks, credit unions, finance companies, and mortgage and finance brokers) to ensure that licensees meet the standards, including their responsibilities to consumers, that are set out in the *National Consumer Credit Protection Act 2009* (Cth).

ASIC's most important role is its responsibility for ensuring compliance with the *Corporations Act*. It is sometimes referred to as "the corporate watchdog". To enable it to carry out its role, the *ASIC Act* (Pt 3) gives ASIC wide investigatory and information gathering powers. Formal investigations may be initiated following: reports of misconduct from members of the public; referrals from other regulators; statutory reports from auditors or registered liquidators; or as the result of ASIC's own monitoring and surveillance. Issues to be considered before enforcement action is taken include: the strategic significance of the matter including the extent of loss involved; the cost-effectiveness of enforcement; the availability of evidence; and whether any alternatives to formal investigation exist.

In s 13(1) of the *ASIC Act*, ASIC is given power to make "such investigation as it thinks expedient" however must have "reason to suspect" that a contravention of the *Corporations Act* (or certain other acts) may have taken place. In various situations, including the possibility of a contravention of the *Corporations Act*, or concerning a dealing in financial products, s 14 sets out that the Minister may direct that an investigation by ASIC take place.

ASIC is given powers to investigate regarding liquidators' reports lodged pursuant to **s 533** of the *Corporations Act*. That section sets out that where a liquidator considers that an officer of a company has committed an offence, or finds that the company cannot pay unsecured creditors more than 50 cents in the dollar, the liquidator must inform ASIC.

An important power available under s 19 of the *ASIC Act* is that of examination of persons with information relevant to an investigation. ASIC can require that the person examined give it all reasonable assistance in relation to an investigation, this includes not only answering questions but may include undertaking certain actions such as signing a power of attorney (*ASC v Kutzner* (1985) 25 ACSR 723). Examinations

by ASIC are private and representation is allowed (ss 22 and 23). The person being examined is entitled to written notice of the examination, an explanation of the general nature of the matter being investigated, and notice of their right to legal representation.

Powers to inspect books and records, including company registers and financial reports, are contained in ss 28-39, and ASIC investigations can lead to criminal or civil proceedings against directors.

Following an investigation, ASIC has the power under s 49 of the *ASIC Act* to commence a prosecution relating to the commission of an offence. It may also bring civil proceedings pursuant to s 50 in the name of a company if it is in the public interest to do so. Section 50 enables ASIC to bring an action, for example against a director for a breach of fiduciary duty, in circumstances where the company does not have the financial resources. Another use of s 50 could be a class action on behalf of a group of investors. In *ASIC v Deloitte Touche Tohmatsu* (1996) 70 FCR 93, it was held that s 50 gives ASIC an extremely wide discretion to bring proceedings on behalf of the company. Where criminal proceedings are appropriate, these are usually initiated by the Director of Public Prosecutions following the completion of an investigation by ASIC.

ASIC has the power under s 51 to hold a formal hearing for the purposes of the performance or exercise of its functions and powers. Hearings cannot be held as part of an investigation into a suspected contravention of the *Corporations Act*. ASIC hearings may be public or private (s 52), and although statements made in an ASIC examination are admissible in further proceedings (s 76), there are however exceptions of criminal self-incrimination and professional privilege. Matters that will determine the type of hearing include the confidential nature of the evidence and public interest factors. Evidence at ASIC hearings may be by way of oath or affirmation. The rules of natural justice, incorporating a fair hearing and absence of bias, apply to the hearing, however ASIC is not bound by the formal rules of evidence.

[24.20] As well as its enforcement of the *Corporations Act*, ASIC also investigates contraventions of the *ASIC Act*. For example, s 12CB of the *ASIC Act* enables ASIC to target conduct in trade or commerce which relates to the supply of financial services and is unconscionable. This is a wide power and was applied in *ASIC v Skeers* [2007] FCA 1551 where a mortgage broker arranged loans for a borrower who at the time of the loan application had insufficient income to enable him to meet the required commitments.

An alternative to civil or administrative action where there has been a contravention of the *Corporations Act* is found in ASIC's power to accept enforceable undertakings pursuant to either ss 93AA (company or individual) or 93A of the *ASIC Act*. Undertakings accepted are recorded on the enforceable undertakings register and where not complied with ASIC may initiate enforcement proceedings in a relevant court.

Although ASIC has various powers in relation to its role as corporate regulator, it is nonetheless subject to review. Both the *Corporations Act* and the *ASIC Act* provide

for review by the Administrative Appeals Tribunal. Where the substance of the review relates to the process by which a decision was made rather than the merits of that decision, an application can be made to the Federal Court. Complaints regarding ASIC administrative procedures can be made to the Commonwealth Ombudsman.

[24.30] As the corporate, markets and financial services regulator, ASIC has a diversified range of responsibilities. An increasingly important role played by ASIC is to help consumers make informed decisions about financial products and services, understand their rights and responsibilities, and identify and avoid scams. It has introduced investor education initiatives to raise awareness about the proper assessment of risk in relation to retail investment products. Sections 12DG-12DL of the *ASIC Act* deal with matters such as bait advertising, referral selling, harassment and coercion, pyramid selling, and unsolicited credit and debit cards. Specifically, s 12DL sets out that a person must not send a "targeted" person a credit or debit card unless it is effectively the same as, or equivalent to, the existing card and would not place that person in a different position with respect to use of the card.

As the corporate market regulator, ASIC has a vested interest in ensuring public confidence in its role. It has raised its public profile. The effects of this include increased awareness by corporate management that ASIC is an active investigator relying on its own inquiries and on public information and complaints to identify possible breaches of the law. It polices contraventions thereby encouraging compliance with the *Corporations Act*. ASIC releases enforcement reports that reinforce its important market supervisory role and provide examples of successful investigations.

ASIC's strategic priorities are to ensure investors and financial consumers are confident and informed, markets are fair and efficient, and registration and licensing systems are efficient. Holding the "gatekeepers" of the financial system to account is an important part of how ASIC achieves its priorities. Investors and financial consumers rely on ASIC to promote sound investment practices, prevent or detect market failures and promote market integrity. ASIC outlines four principles of conduct gatekeepers must observe. They must display honesty by respecting other people's property and not using a position of trust for self-advantage; diligence by applying due care and skill to advice or decision making; competence by meeting any applicable conduct, licensing, registration and training obligations; and independence by managing conflicts of interest appropriately.

To augment its investigative efforts into corporate behavior, ASIC relies on information provided by members of the public. These informants, particularly when they are from within or connected to the relevant company, may be referred to as "whistleblowers". In this respect, legislation exists to regulate and protect those involved in this type of activity (the *Fair Work (Registered Organisations) Act 2009* (Cth) as amended, including amendments resulting from the *Fair Work (Registered Organisations) Amendment Act 2016* (Cth)).

The important role that whistleblowers play in exposing corporate malpractice was recognised in the enacting of the *Treasury Laws Amendment (Enhancing Whistleblower*

Protections) Act 2019 (Cth). This Act consolidated whistleblowing laws and amended the *Corporations Act*. **Part 9.4AAA** is headed "Protection for Whistleblowers" and **s 1317AC** specifically targets victimisation of, and threats to, whistleblowers. **Section 1317AD** provides for a person who suffers damage because of a contravention of **s 1317AC** to seek compensation. The encouragement of whistleblowing as the result of effective statutory protection, such as **Pt 9.4AAA**, can improve compliance with the law and promote a more ethical corporate culture as individuals within companies will be aware that there is a higher likelihood that misconduct will be reported.

[24.40] ASIC has played an increasingly important role in regulating the lending market. In order to improve standards in the mortgage broking sector to reduce the risks to consumers, it has taken strategic enforcement action, reviewed consumer problems, and worked with consumers and industry on codes of practice. With the introduction of the *National Consumer Credit Protection Act*, ASIC took over national responsibility for credit. The Act establishes a national licensing scheme for all credit providers, finance brokers and other intermediaries. It focuses on engagement in credit activity (s 6). A credit licence is required if a credit service is performed. This is broadly defined in s 7 and includes providing credit assistance or acting as an intermediary. Once these tests are met, the person must obtain an Australian credit licence from ASIC. The applicants must be "fit and proper" and once licensed avoid conflicts of interest. The definition is wide enough to catch direct, or indirect, assistance to a consumer.

Pursuant to the *National Consumer Credit Protection Act*, a credit licence is needed if a person is an intermediary in the "chain" between consumer and lender under a credit contract, or a lessor under a consumer lease, even if that person has no direct contact with the consumer. An intermediary's role may be wholly or partially aimed at obtaining credit or a consumer lease for the consumer. "Credit assistance" will be given if a person deals with the consumer or their agent and as little as "suggests" (not defined in the Act but similar to "propose" or "introduce" into the consumers mind) or "assists" (not defined in the Act but similar to a "go-between") the consumer in applying for a credit contract with a credit provider (see ASIC Regulatory Guide 203).

Note that both of s 8 defining "credit assistance" and s 9 defining "intermediary" target credit providers and lessors. They are not sections simply regulating any financial transaction. Merely informing the consumer that a particular credit activity can be provided, including where it can be provided and any commission payable, will not amount to a referral under the *National Consumer Credit Protection Act*.

Where a person engages in credit activity as defined, they must obtain a licence. Where they are not licensed, ASIC must enforce the *National Consumer Credit Protection Act*. Section 29 sets out the prohibitions in engaging in credit activities without a licence and includes a civil penalty of up to 5,000 penalty units and a criminal penalty of 2 years imprisonment. A penalty unit has a prescribed amount under s 4AA of the *Crimes Act 1914* (Cth) – see [21.50]

Pursuant to the *National Consumer Credit Protection Act*, ASIC can suspend or cancel a licence, or ban a person from engaging in credit activities. In 2011, responsible lending obligations were introduced into the Act requiring brokers to verify a borrower's financial position and make suggestions as to the suitability of the loan vis-à-vis the borrower's circumstances (s 128).

[24.50] ASIC has certain strategic priorities outlined in ASIC's "Corporate Plan 2018–22: Focus 2018–19". These include focusing on the following: potential harms from technology driven by the growing digital environment and structural changes in financial services and markets; poor culture and professionalism in financial services and credit; culture, governance and incentives that can harm markets; practices that target financially vulnerable consumers; and misalignment of retail product design and distribution with consumer needs.

Following the decisions of the Royal Commission into the banking and finance industry, ASIC has embarked on a program of proactive enforcement planning. This approach is complimented by the significant increases in the penalties ASIC can seek under statutes it administers such as the *Corporations Act* and the *National Consumer Credit Protection Act*. As a result, ASIC has developed an enforcement culture with a focus on the question, "why not litigate?". Following the Final Report of the Royal Commission, the Government's Response and ASIC's Internal Enforcement Review, an Office of Enforcement has been established within ASIC.

According to ASIC's "Update on implementation of Royal Commission recommendations" of February 2019, the following principles will guide ASIC's work including the approach of the Office of Enforcement:

Principle One: Where a possible breach of the law is known to ASIC, ASIC will undertake an assessment and, if appropriate, conduct an investigation by reference to the facts and law. Once ASIC is satisfied that breaches of law are more likely than not, it will ask itself: why not litigate?

Principle Two: Any public interest in pursuing a (non- court) negotiated outcome is weighed against the clear benefits of a judgment and imposition of a prison sentence, civil penalty or other court- based outcome with a negotiated outcome pursued only where objective assessment weighs in favour of the negotiated outcome. This relates the guiding principles and operational guidelines of the Office of Enforcement, and ASIC generally that establish a focus on deterrence, public denunciation and punishment of wrongdoing by way of litigation.

Principle Three: There is a focus on both corporate accountability and individual accountability particularly at executive and board level for breaches of the legislation administered by ASIC.

Principle Four: Emerging technologies are employed to enhance ASIC's enforcement capabilities, and these technologies are monitored so ASIC keeps pace with advances in these technologies.

Principle Five: There is careful monitoring of, and an endeavour to pre-empt, budgeting and resourcing requirements.

Summary—ASIC investigation

ASIC's powers arise from the *ASIC Act*

ASIC regulates the corporate market and provides consumer advice

Inspection of records and examination of relevant persons

Powers to prosecute and bring civil actions—s 49 of the *ASIC Act*

ASIC enforces both the *Corporations Act* and the *ASIC Act*

ASIC's exercise of power is reviewable by AAT or Federal Court

25
Members' Rights

Sources of members' rights

[25.10] Companies must have at least one member (**s 114**). In general terms, members are the owners of a company. They acquire shares as an investment, and the standing and value of the company will reflect on their investment. In a company limited by shares (most companies), the members will be its shareholders. The terms "member" and "shareholder" will in most cases refer to the same person—that is, one of the participants/investors in the company. It is only in companies limited by guarantee (and some pre-1998 unlimited companies) that members are not shareholders. Companies limited by guarantee do not have a share capital.

Members of companies are now reasonably well protected in the *Corporations Act 2001* (Cth) and are the beneficiaries of enhanced disclosure requirements, transparency in management and tighter regulation of the securities market. However, historically their rights have developed slowly. The growing awareness of consumer rights in a general sense has influenced the standing of members of a company. Further, the increasing number of people involved in the share market, in part as the result of the listing of large organisations such as Telstra, or the demutualisation of large entities such as the NRMA, has meant that the number of shareholders (particularly small-holding shareholders) needing protection by the legislation has grown substantially.

Members' rights arise from general law and the *Corporations Act* (including the replaceable rules).

There are two main sources of rights. One source is personal to the member and is an action brought to protect or preserve a right that belongs to, and is enforceable by, the member. A members' personal action can derive in common law or from the *Corporations Act*. The other source of member rights arises from a cause of action that does not actually belong to the member but in fact belongs to the company. However, the member becomes entitled to exercise that right. Accordingly, the right that the member seeks to pursue derives from the company and therefore can be called a members' (or shareholders') derivative action.

Note that there is a distinction between what is referred to as the common law derivative action (which arose from case law and is no longer relevant) and the statutory derivative action, which is contained in **Pt 2F.1A** "Proceedings on Behalf of a Company by Members and Others". **Section 236(3)** sets out that the general law right to bring proceedings is abolished and this thereby means that a member's right to sue on behalf of the company now rests solely within the provisions of the *Corporations Act*.

Directors manage the company. However, company members have the power to vote directors in and vote them out. This is one of the rights attaching to the holding of shares. Removal of directors is dealt with in **ss 203C** and **203D**. Increasingly, members of large public companies are recognising that board unrest can destabilise the company and damage the value of their investment. The issues that members face may vary depending on whether they hold shares in a public or a proprietary company. A benefit of public companies, especially listed public companies, is that a dissatisfied member can withdraw from the company by offering their shares for sale on the open market. The shares in a proprietary company are not as easily transferable and minority shareholders unable to divest themselves of their shares may be locked in. In these situations, the provisions of the *Corporations Act* setting out the rights of members are particularly important.

The range of members' rights

[25.20] When considering the protection of members, such as that in either the derivative action found in **s 236**, that is, the right to bring proceedings on behalf of the company, or the oppression remedy in **s 232**, it must be remembered that it will be minority members who generally seek the protection. Minority members do not control the general meeting and, accordingly, are more likely to look to the provisions of the *Corporations Act* for protection. If the problem faced by the members results from inappropriate or improper decisions of the board of directors, it will be the majority members who will be able to use their voting power to remedy the situation and remove some or all of the current board.

When determining the rights of members, the following issues may be relevant: the benefit of the company as a whole; whether any conduct of the board or the members delivers advantages to the majority; directors' self interest in the outcome of decisions; the balance of voting power and whether opportunities to participate in management exist; and the personal rights of a shareholder arising from share ownership. These and other issues must be considered to determine whether the conduct of the directors, or the majority, is in fact oppressive conduct or merely unpopular or disagreeable to the minority but nonetheless legally permissible conduct. Shareholders may often disagree with board decisions, however, unless it can be shown that those decisions contravene relevant sections of the *Corporations Act* there will be no grounds for bringing proceedings.

Members have certain procedural rights such as to inspect books (**s 247A**), to receive due notice of meetings, and to seek correction of a register kept by the company (**s 175**).

Substantive protection in the *Corporations Act* is found in:

s 232	Oppression, prejudice or discrimination, or conduct contrary to the interests of members as a whole.
s 236	Bringing proceedings on behalf of the company (derivative action).

s 461 Application to wind the company up. Grounds include directors acting in their own interests, oppressive conduct (as in **s 232**) and generally where it is "just and equitable" via **s 461(1)(k)** to wind up.

s 1322 Correct procedural irregularity. This section allows for the court to invalidate a proceeding of the company for an irregularity, such as when a member does not have reasonable opportunity to participate in a company meeting, provided the irregularity has caused or may cause substantial injustice.

s 1324 Injunction. This section may be used by ASIC or a person (including a member) whose interests may be affected by the conduct complained of. To ground the injunction, it must be shown that a person is, or is proposing to, contravene the *Corporations Act*. Note that **s 1324(10)** also provides for the awarding of damages where the court has the power under the section to grant an injunction.

The development of the derivative action

[25.30] A basic foundation of the common law derivative action was that the majority (and directors) should act bona fide for the benefit of company as a whole. In *Foss v Harbottle* (1843) 2 Hare 461; 67 ER 189, certain minority shareholders who considered that the majority were not acting in the best interests of the company, sought the court's approval to bring an action on behalf of the company. They failed and the outcome of this case limited shareholders' rights. The court held:

- that it (the court) will not interfere in the internal management of companies; and
- that if the company suffers loss it is therefore the proper plaintiff and accordingly the appropriate party to bring the action.

To serve the interests of justice, certain exceptions to the rule in *Foss v Harbottle* developed. These enabled the shareholder to force the company to take action. These exceptions basically fell under the umbrella of fraud on the minority and included actions that were not bona fide for the benefit of the company as a whole; expropriation of property; breach of duty by directors; and improper ratification of breaches by the majority shareholders.

An example of the expropriation of the company's property can be seen in *Cook v Deeks* [1916] 1 AC 554 where certain directors diverted the benefit of a company contract to themselves. An example of the expropriation of the shareholders property can be seen in *Gambotto v WCP Ltd* (1995) 182 CLR 432 where the majority sought to amend the constitution to enable the compulsory acquisition of the shares of particular shareholders.

The exceptions to *Foss v Harbottle* provided the shareholder with a common law derivative action. A derivative action is where the cause of action belongs to the company. The rule in *Foss v Harbottle* had been a long running restriction upon members' rights as it was necessary to fit one of the exceptions to the rule before an

action could be commenced. However, as a more enlightened approach to members' rights emerged with expanding consumerism and a larger and more diverse shareholder population, legislation has provided increased opportunities in terms of personal actions concerning oppressive conduct such as the current **s 232**, and importantly since the *Corporate Law Economic Reform Program Act 1999* (Cth), a statutory derivative action via **s 236**. The section enables members and even officers, provided they have been granted leave under **s 237**, to bring, or intervene in, proceedings on behalf of the company. Proceedings must be brought in the company's name.

Accordingly, and in keeping with the expansion of members' rights in the *Corporations Act*, the common law derivative action was replaced by a statutory right of members to bring proceedings on behalf of the company. The fact that the court has a wide discretion as to the awarding of costs provides some incentive for members to use the section. Pursuant to **s 242**, a court can order the company to indemnify the applicant member who applied for or was granted leave under **s 237**. To ensure that members do not misuse their statutory derivative right, leave (approval) must be sought from the court under **s 237** before proceeding. Basically **s 237** is about conditions that must be met before the court will allow the member to proceed. The member must show that the action is brought in good faith (eg that there is no secret agenda). In some cases, the shareholder may have a personal interest in the outcome of the proposed derivative action. However, it has been held that this will not necessarily indicate an absence of good faith (*Maher v Honeysett & Maher Electrical Contractors Pty Ltd* [2005] NSWSC 859).

An example of when leave to bring proceedings will not be granted because of an absence of good faith can be found in *Coeur de Lion Investments Pty Ltd v Kelly* (2013) 302 ALR 771; [2013] QCA 160. In this matter, a shareholder (Coeur de Lion Investments) had sought leave under **s 237(1)** to bring proceedings on behalf of The Presidents Club Limited. The facts related to matters concerning consultancy fees paid to directors of that company as well as issues of control and the possibility of takeover activity. Leave was rejected by the Queensland Supreme Court, and the appeal to the Court of Appeal dismissed. The fact that the appellant took no steps to challenge the consultancy arrangements at the appropriate time and in fact had, as a member, received benefits from the directors conduct was held to mean that that it could not now show that it was acting in good faith in seeking to bring proceedings.

Further matters concerning the company that must also be addressed pursuant to **s 237**, include that the action is in the company's best interests, that the issue to be raised is a serious (important) one and that the company is not going to bring the action itself.

The court considered the issue of the company's best interest in *Huang v Wang* (2016) 114 ACSR 586; [2016] NSWCA 164. In this case, the appellants (Huang) had sought orders to bring proceedings in the name of Ismile Dental Pty Ltd as to a breach by Wang of fiduciary and statutory duties owed to the company. The parties were dentists and directors of the company, and shareholder control was divided equally between them. In this case, the Court of Appeal affirmed the primary judge's findings that part of **s 237** requiring that the granting of an order would be in the

best interests of the company had not been satisfied. If Huang were granted leave, the prospects of the company being successful were low and the financial burden on the company high.

The issue of whether the company will itself bring proceedings was examined in *MG Corrosion Consultants Pty Ltd v Vinciguerra* (2011) 82 ACSR 367; [2011] FCAFC 31. In this case, a divergence of interest between the shareholders and management involving the non-payment of dividends resulted in a shareholder seeking leave to bring proceedings pursuant to **s 236**. The proceedings also included allegations of a breach of directors' fiduciary duties. In finding in favour of the plaintiff/shareholder, the Court of Appeal held that the threshold to be crossed in order to satisfy that the proceedings involved a serious question was low, and that as the proceedings sought were against the company's major shareholder, it was unlikely that the company would initiate the action. Obviously, if the court is satisfied that the company will begin the relevant proceedings, it would be superfluous to grant leave to the applicant member. Another factor that needs to be addressed before leave is granted is whether the member can show that the directors were not complying with the business judgment rule which requires that the directors acted in good faith and for a proper purpose; did not have a material personal interest; informed themselves about the decision made; and had a rational belief that their decision was in the company's best interests (**s 237(3)(c)**). The effect of the section is to establish a presumption in favour of the directors that they are managing appropriately and then put the onus on the applicant member to show they are not. That is, the member must rebut (overturn) the business judgment rule.

Although ratification by members of directors conduct can, in some situations, protect directors from the results of breaches of duty **s 239** makes it clear that ratification will not prevent a person from bringing or intervening in proceedings pursuant to leave under **s 237**. However, the fact of ratification may nonetheless be relevant to any orders made and factors to be considered would include the level of information available to the members at the time of ratification and whether the members involved in the ratification were acting for a proper purpose.

***Corporations Act 2001* (Cth), s 236**

Bringing, or intervening in, proceedings on behalf of a company

(1) A person may bring proceedings on behalf of a company, or intervene in any proceedings to which the company is a party for the purpose of taking responsibility on behalf of the company for those proceedings, or for a particular step in those proceedings (for example, compromising or settling them), if:
  (a) the person is:
    (i) a member, former member, or person entitled to be registered as a member, of the company or of a related body corporate; or
    (ii) an officer or former officer of the company; and
  (b) the person is acting with leave granted under section 237.

(2) Proceedings brought on behalf of a company must be brought in the company's name.
(3) The right of a person at general law to bring, or intervene in, proceedings on behalf of a company is abolished.

***Corporations Act 2001* (Cth), s 237**

Applying for and granting leave

(1) A person referred to in paragraph 236(1)(a) may apply to the Court for leave to bring, or to intervene in, proceedings.
(2) The Court must grant the application if it is satisfied that:
  (a) it is probable that the company will not itself bring the proceedings, or properly take responsibility for them, or for the steps in them; and
  (b) the applicant is acting in good faith; and
  (c) it is in the best interests of the company that the applicant be granted leave; and
  (d) if the applicant is applying for leave to bring proceedings—there is a serious question to be tried; and
  (e) either:
    (i) at least 14 days before making the application, the applicant gave written notice to the company of the intention to apply for leave and of the reasons for applying; or
    (ii) it is appropriate to grant leave even though subparagraph (i) is not satisfied.
(3) A rebuttable presumption that granting leave is not in the best interests of the company arises if it is established that:
  (a) the proceedings are:
    (i) by the company against a third party; or
    (ii) by a third party against the company; and
  (b) the company has decided:
    (i) not to bring the proceedings; or
    (ii) not to defend the proceedings; or
    (iii) to discontinue, settle or compromise the proceedings; and
  (c) all of the directors who participated in that decision:
    (i) acted in good faith for a proper purpose; and
    (ii) did not have a material personal interest in the decision; and
    (iii) informed themselves about the subject matter of the decision to the extent they reasonably believed to be appropriate; and
    (iv) rationally believed that the decision was in the best interests of the company.

The director's belief that the decision was in the best interests of the company is a rational one unless the belief is one that no reasonable person in their position would hold.

The need to seek the assistance of the derivative proceedings found in **ss 236** and **237** often arises when the individuals involved in the company are in dispute. In *Suh*

v Cho [2013] VSC 491, a company was formed with two shareholders who were also the directors. The company (Jeff The Plumber Pty Ltd) carried on a plumbing business. Only one of the two individuals involved was a licensed plumber and after a short time, the director/shareholders were in dispute and the company ceased to operate. Mr Cho (the licensed plumber) then re-commenced business in a company (Jeff & Sons Plumbing Pty Ltd) solely controlled by his wife. The proceedings were brought by Mr Suh and involved a claim that money's advanced were not repaid. The claim was brought against Mr Cho, the first company, and the later-formed company. Orders were made in favour of the Plaintiff, Mr Suh, and leave was granted pursuant to **s 236**, subject to certain conditions regarding costs. In his judgment, Acting Justice Derham considered the criteria that need to be taken into account when deciding whether a statutory derivative action can be pursued under the *Corporations Act*. The following extract highlights certain of the issues involved in the consideration of the application of the shareholders right to bring proceedings on behalf of the company. These are: firstly, the manner in which courts should interpret the overall effect of **s 237(2)** and; factors relevant to identifying whether the company will bring proceedings itself. Obviously, where the issues concerning the members can, and will, be pursued by the company derivative proceedings are not necessary.

Suh v Cho [2013] VSC 491 (Derham AsJ)

Extract from Judgment

At [26]-[29]

I note the following general propositions:

(a) The word 'must' in s 237(2) makes plain that if all five criteria are satisfied, the Court is bound to grant the application.

(b) The cumulative structure of s 237(2) (with 'and' at the end of each criteria in (a) to (d)), the structure of s 237 as a whole, including the rebuttable presumption in s 237(3), and the discretion in s 237(e)(ii), and the nature of the criteria, supports the view that s 237(2) was intended to prescribe the circumstances which must be satisfied before leave is granted, and not to leave open any residual discretion to grant leave if one or more of them were not satisfied: see *Maher v Harvey Honeysett & Maher Electrical Contractors Pty Ltd* [2005] NSWSC 859;

(c) A consequence of the conclusion that, if all five criteria are satisfied leave must be granted, and that otherwise leave must be refused, is that the relevant considerations are limited to the five specified criteria;

(d) The burden of satisfying the Court, on the balance of probabilities, that each criterion specified in s 237(2) has been satisfied is on the applicant;

(e) In deciding whether or not to grant leave under this section, a pragmatic and practical approach is to be adopted;

(f) Leave may be granted nunc pro tunc (now for then), that is after proceedings have been commenced purportedly in the name of the company, so that the

leave is taken to have been given as at the date of the commencement of the proceeding;

(g) Leave may be granted upon terms: see *Fiduciary Ltd v Morning Star Research Pty Ltd* [2005] NSWSC 442.

The requirement for the Court to be satisfied that it is probable that the company will not itself bring the proceedings, or properly take responsibility for them, or for the steps in them, can be satisfied where there is some clear cut authoritative refusal by the company to take the specific proceedings. Where there is no such clear cut or authoritative refusal, the applicant bears the onus of establishing that in all of the relevant circumstances actual refusal or the probability of refusal is to be inferred: see *Swansson v RA Pratt Properties Pty Ltd* [2002] NSWSC 583.

The following facts point inescapably to the conclusion, as a matter of inference, that it is probable that the Company will not itself bring the proceedings:

(a) Each of Mr Suh and Mr Cho are equal shareholders and the only directors of the Company;

(b) Each of Mr Suh and Mr Cho are in dispute about the conduct of the Company, that is, it is in deadlock;

(c) The responses made in the pleadings by Mr Cho to the claims, which are presently identified as requiring leave of the Court; and

(d) Mr Cho's opposition to the present application for the grant of leave.

These factors show quite graphically that Mr Cho does not consent and will not consent to the company bringing the proceedings against him or against the company which is apparently controlled by his wife, Ms Ho, but is likely to be, in reality, his creature, Jeff & Sons Plumbing.

Rights under the Corporations Act regarding oppression

[25.40] **Section 232** lists certain situations that will entitle a member to bring an action. The section sets out that if the court is of the opinion that the affairs of the company have been conducted in a manner that is oppressive or unfairly prejudicial to or unfairly discriminatory against a member, or contrary to the interests of members, or that an act or omission or one proposed, or a resolution or one proposed was or would be oppressive or unfairly prejudicial, then the court may make an order under **s 233**. Under **s 234**, a member is included in that class of persons able to apply for an order under **s 233**. Generally, the conduct that forms the focus of **s 232** is referred to merely as oppression.

Whether a decision of the board, or of individual directors, is oppressive will be viewed by an objective standard having regard to a reasonable board of directors adequately instructed.

In *Wayde v NSW Rugby League Ltd* (1985) 180 CLR 459; 3 ACLC 799, the governing body exercising control over rugby league in NSW sought to remove the Western

Suburbs club from the rugby league competition. Western Suburbs (as did all rugby league clubs) held shares in the NSW Rugby League (the governing body) and by its nominee brought an action under a previous section equivalent to **s 232** to restrain the NSW Rugby League from making the decision to expel it. The governing body's argument was that the season was too long which led to various other difficulties and that accordingly the solution taken to exclude Western Suburbs was in the best interests of the rugby league competition. In making its decision in favour of the NSW Rugby League, the court considered whether the decision to exclude Western Suburbs was within the range of decisions that a board of directors acting reasonably could have made. The court held that this was the case and that clearly Western Suburbs had not shown that the decision was one that no board acting reasonably could have made.

The approach taken in *Wayde v NSW Rugby League* was relevant to the decision in *Mackay Sugar Ltd v Wilmar Sugar Australia Ltd* [2016] FCAFC 133. That case concerned whether changes to a company's constitution amounted to oppressive, unfairly prejudicial or discriminatory conduct. The Full Federal Court affirmed that, although the proposed amendments may have benefits in relation to the regulatory framework, they nonetheless interfered with the rights of members of the overall organisation, and as such the changes amounted to oppression. The Court applied the test from *Wayde* to determine whether reasonable directors, possessing any special skill, knowledge or acumen possessed by the directors and having in mind the importance of furthering the corporate object on the one hand and the disadvantage, disability or burden which their decision will impose on a member on the other, would have decided that it was unfair to make that decision.

If oppression is found (ie the member is successful under **s 232**), the orders that the court can make are set out in **s 233** and include the modification of the constitution and orders requiring the company to institute or defend certain proceedings. For example, the court has a wide discretion in making an order under **s 233(1)(e)** regarding the purchase of an oppressed member's shares, and in fixing a price that is fair in all the circumstances may even ignore, if the interests of justice require, a provision in the company constitution setting out a formula for share value.

Examples of cases dealing with oppression

[25.50] In *Scottish Cooperative Wholesale Soc Ltd v Meyer* [1959] AC 324, a company was set up to market and sell yarn (cloth). Its majority shareholders (who controlled the board) owned another company (Scottish Coop) that supplied the raw material. Those majority shareholders withdrew supply of the raw materials preferring to market the yarn through Scottish Coop. The remaining shareholders in the original company alleged that the actions of the majority shareholders amounted to the diversion of a business opportunity. The court held that the conduct amounted to oppression and ordered that the majority buy out the minority interest in the original company. The price determined to be paid to the minority was based on the value the shares would

have had if the oppression had not occurred. Under the *Corporations Act*, this type of order would be available under **s 233(1)(d)**.

The non-payment of a dividend is another area in which the question of oppressive conduct has been raised in the cases. In *Thomas v HW Thomas Ltd* (1984) 2 ACLC 610 and in *Morgan v 45 Flers Avenue Pty Ltd* (1987) 5 ACLC 394, restricted dividend payments were not considered to amount to oppression. However, in *Sanford v Sanford Courier Service Pty Ltd* (1987) 5 ACLC 394 matters, which included the diversion of business to another company owned by the majority shareholders and high directors salaries combined with no payment of a dividend, resulted in the court finding that the minority shareholder had been oppressed. In *Sumiseki Materials Company Ltd v Wambo Coal Pty Ltd* [2013] NSWSC 235, the shareholder (Sumiseki) sold its interest in a mining operation (Wambo) to the Peabody Energy Australia Group of Companies (specifically here Peabody Australia Mining Limited—PAML), and as a result obtained, the right to receive a dividend linked to shares issued to it in the newly controlled company. In effect, the right to receive a mandatory dividend. As a result of certain actions by the new controllers of the mining venture (through the company's constitution), Sumiseki's right to receive the dividend was extinguished. The Court held that this conduct (which in effect converted Sumiseki's right into a loan arrangement) was oppressive pursuant to **s 232**.

Sumiseki Materials Company Ltd v Wambo Coal Pty Ltd [2013] NSWSC 235 (Hammerschlag J)

Extract from Judgment

At [218]-[225]

The essential criterion of conduct that is "oppressive to, unfairly prejudicial to, or unfairly discriminatory against" within s 232 of the Act is commercial unfairness. Commercial unfairness is assessed objectively in the eyes of a commercial bystander: *Morgan v 45 Flers Avenue Pty Ltd* the test is whether the conduct is so unfair that reasonable directors would have thought it to be unfair. Using a rule in a company's constitution in a manner which equity would regard as contrary to good faith may satisfy this requirement. Unfair or unjust action (or inaction) taken in the interests of a parent company and against the interests of a subsidiary and other shareholders may qualify. That an action of directors is in breach of fiduciary duty will be relevant whether there has been unfairness in the context of oppression.

Sumiseki's claim of oppression is founded on the existence of a legitimate expectation of receiving the B Class dividends. Sumiseki does not seek to impeach the Loan. It relies on the entry into of the Loan as supportive of its contention that the conduct of Wambo's affairs was oppressive to, unfairly prejudicial to, or unfairly discriminatory against Sumiseki.

PAML and Wambo put that neither the directors' determination not to pay dividends nor the entry into of the Loan were oppressive because Wambo (and

> PAML) had legitimate commercial reasons for both. They say that the directors of Wambo legitimately considered it not appropriate to make profits available for dividends, given Wambo's other financial needs and constraints including capital expenditure. They say that they went to great lengths to ensure that the terms of the Loan were at arms-length and that it would not have been possible for Wambo to raise funds in the external funding market on terms which were relevantly materially more advantageous to it. They say that the provision of loan finance on arms-length terms is not oppressive.
>
> (However) the evidence establishes, to my satisfaction, that from about 18 September 2009 a primary goal of PAML and Wambo was to thwart the payment of the B Class dividend, contrary to the legitimate expectations of Sumiseki. In my view, both the goal itself and a significant part of the means by which PAML and Wambo sought to achieve it, that is, by committing Wambo to the Loan incorporating burdensome covenants not in its interests, smack of commercial unfairness.

Other areas that may ground actions in oppression include when shareholders are excluded from management where an expectation of management existed, as was the case in *Campbell v Backoffice Investments Pty Ltd* (2008) 66 ACSR 359; [2008] NSWCA 95 where a director, excluded from the day-to-day management of the company and prevented from accessing the company's accounting system, was held to have been oppressed. Oppression will also arise when directors do not act in the interests of the company because they are conferring an advantage on another company in which they have a present or expected financial interest.

In *Shum Yip Properties Development Ltd v Chatswood Investment & Development Co Pty Ltd* (2002) 40 ACSR 619, oppression was held to arise where a (minority) foreign shareholder was denied relevant company information such as notices of company meetings. *Turnbull v NRMA* (2004) 50 ACSR 44 also concerned a company meeting. In this case, the part of **s 232** targeting the interests of the members as a whole (**s 232(d)**) was considered. The facts were that the machinery for calling a special general meeting of the company under **s 249D** had been validly put in place, however, prior to the date set aside for the meeting, the matter (an industrial dispute concerning the employment conditions of NRMA patrolmen) had been resolved. The NSW Supreme Court held that to allow the meeting to go ahead in the circumstances would be contrary to the interests of the members as a whole in terms of **s 232**. Of particular relevance in the decision was the substantial expense involved in calling and running the meeting.

Proceedings for oppression in **s 232**, and the orders available in **s 233**, are of particular benefit to minority shareholders where the majority seek to limit minority involvement or restrict participation in company affairs. Of course, **s 232** is also of use to majorities but it is its role in enabling minority members to raise matters of poor governance and discrimination that reflects the growing importance of the protection of members rights.

***Corporations Act 2001* (Cth), s 232**

Grounds for Court order

The Court may make an order under section 233 if:

(a) the conduct of a company's affairs; or
(b) an actual or proposed act or omission by or on behalf of a company; or
(c) a resolution, or a proposed resolution, of members or a class of members of a company;

is either:

(d) contrary to the interests of the members as a whole; or
(e) oppressive to, unfairly prejudicial to, or unfairly discriminatory against, a member or members whether in that capacity or in any other capacity.

For the purposes of this Part, a person to whom a share in the company has been transmitted by will or by operation of law is taken to be a member of the company.

***Corporations Act 2001* (Cth), s 233**

Orders the Court can make

(1) The Court can make any order under this section that it considers appropriate in relation to the company, including an order:
  (a) that the company be wound up;
  (b) that the company's existing constitution be modified or repealed;
  (c) regulating the conduct of the company's affairs in the future;
  (d) for the purchase of any shares by any member or person to whom a share in the company has been transmitted by will or by operation of law;
  (e) for the purchase of shares with an appropriate reduction of the company's share capital;
  (f) for the company to institute, prosecute, defend or discontinue specified proceedings;
  (g) authorising a member, or a person to whom a share in the company has been transmitted by will or by operation of law, to institute, prosecute, defend or discontinue specified proceedings in the name and on behalf of the company;
  (h) appointing a receiver or a receiver and manager of any or all of the company's property;
  (i) restraining a person from engaging in specified conduct or from doing a specified act;
  (j) requiring a person to do a specified act.

Order that the company be wound up

(2) If an order that a company be wound up is made under this section, the provisions of this Act relating to the winding up of companies apply:
  (a) as if the order were made under section 461; and
  (b) with such changes as are necessary.

Order altering constitution

(3) If an order made under this section repeals or modifies a company's constitution, or requires the company to adopt a constitution, the company does not have the power under section 136 to change or repeal the constitution if that change or repeal would be inconsistent with the provisions of the order, unless:
  (a) the order states that the company does have the power to make such a change or repeal; or
  (b) the company first obtains the leave of the Court.

An example of the application of both **s 232** (oppression) and **s 236** (statutory derivative action) can be seen in *Vadori v AAV Plumbing* (2010) 77 ACSR 616; [2010] NSWSC 274, a case that involved a breakdown in the relationship of the parties in a plumbing business, AAV Plumbing Pty Ltd. The three directors (Andrew A, Paul A and Mr Vadori) were plumbers by trade, and the plaintiff (Mrs Vadori) was the wife of one of the directors. The plaintiff claimed that as the result of the cessation of the business that the affairs of the company had been conducted in a manner contrary to the interests of the members of the company and oppressive to, unfairly prejudicial to, or discriminatory against, her interests, in breach of **s 232** of the *Corporations Act*. Orders were sought, including an order for the purchase of her shares pursuant to **s 233**. Together with the **s 232** claim, leave was sought under **s 236** to bring proceedings on behalf of the company to return to the company the benefit (assets) utilised by the other parties, predominantly through a company set up by them, A & P Plumbing Pty Ltd. Ward J held the **s 232** claim successful and granted of an order under **s 233**. However, having regard to the plaintiff's success under **s 232**, and the costs involved, she did not consider an order under **s 236** was appropriate.

The following extract from the judgment provides useful insights into the application of both **ss 232** and **236**.

Vadori v AAV Plumbing [2010] NSWSC 274 (Ward J)

Extract from Judgment

At [249], [252]-[265], [267], [268], [273], [276], [279], [280], [286]-[289], [293], [294]

Section 236 and 237

Mrs Vadori seeks leave as an alternative to her oppression suit to bring a derivative action on behalf of AAV and to seek a return to AAV of all of the profits utilised by A & P Plumbing and indeed Vadori Plumbing so that those assets can be brought back into the company and the company wound up in a manner in which it ought to have been some time ago.

Part 2F.1A of the *Corporations Act* allows the court to permit a member or officer to bring proceedings on behalf of a company, or intervene in any proceedings to which the company is a party for the purpose of taking responsibility on behalf of

the company for those proceedings, or for a particular step in those proceedings (s 236(1)). There is no issue that Mrs Vadori, as a member of the company is entitled to seek leave to bring a derivative suit (s 236).

Mrs Vadori relies upon the statutory duties owed by the directors to the company to exercise their powers with a reasonable degree of care (s 180) and in good faith in the best interests of the Company for proper purposes (s 181), and not improperly to use their position to gain an advantage for themselves or detriment to the company (s 182). She also asserts breach of the fiduciary duties considered above.

What s 237(2) requires is that there be a serious question to be tried. A party seeking leave to bring a derivative suit does not need to prove any element of the derivative suit in order to satisfy s 237(2).

The criteria to be considered upon an application for leave to commence a derivative suit are: the probability that the company will not itself bring the proceedings, or properly take responsibility for them; whether the applicant is acting in good faith; whether it is in the best interests of the company that the applicant be granted leave; whether there is a serious question to be tried by the court (if the applicant is applying for leave to bring proceedings rather than intervene in any proceedings to which the company is a party); and either that at least 14 days before making the application to the court, the applicant gave written notice to the company of the intention to apply to the court for leave and of the reasons for applying; or that it is appropriate for the court to grant leave even though notice was not given to the company: s 237(2).

Each of these five criteria must be satisfied. If all five criteria are satisfied, then the court is bound to grant the application. Turning to the respective criteria, I note briefly as follows.

Inaction by the company—The court must be satisfied that it is probable that the company will not itself bring the proceedings, or properly take responsibility for the proceedings. In circumstances where two of the three directors and the two remaining shareholders have denied any wrongdoing or oppressive conduct, it seems likely that AAV will not commence any proceedings against any of the directors in relation to the matters of which Mrs Vadori complains.

Applicant's good faith—The court will have regard at least to the following matters: (i) whether the applicant honestly believes that a good cause of action exists and has a reasonable prospect of success; and (ii) whether the applicant is seeking to bring the derivative action for a collateral purpose which amounts to an abuse of process. However, the inquiry concerning the applicant's good faith is not limited to these two matters.

In *Swansson v RA Pratt Properties Pty Ltd* [2002] NSWSC 583 it was said (at 320-21) that it will be relatively easy for the applicant to demonstrate good faith where the applicant is a current shareholder of the company who has more than a token shareholding and the derivative action seeks recovery of property so that the value of the applicant's shares would be increased.

The two factors identified by the court in *Swansson* as being relevant to consideration of the good faith requirement in s 237(2) were applied by Barrett J in *Goozee v Graphic World Group Holdings Pty Ltd* [2002] NSWSC 640. His Honour held

that the applicants were acting for a collateral purpose in that the applicants' purpose in seeking to bring the derivative action was to force the directors to pay dividends or else force the directors to arrange for the applicants' shares to be purchased. The application to bring a derivative action was therefore denied. The evidence before me does not permit a conclusion that these proceedings or the derivative claim sought to be pursued is being pursued for a collateral purpose.

Best interests of the company—It is for Mrs Vadori to establish that it is in the best interests of the company that she be granted leave. In determining whether an application is in the best interests of the company, it is said that the fact that the applicant has a personal interest in the outcome of the action or the applicant has personal animus against other members of the company is not significant or decisive because this would be common in the types of disputes which lead to derivative actions. Clearly, if there were to be a compulsory purchase order then it could not be suggested that it would be in the best interests of the shareholders, other than Mrs Vadori, for such proceedings to be commenced (they having acquiesced to date in the events which have transpired), particularly in light of the likely cost of such proceedings. In light of my finding on the compulsory purchase order, this criterion could not be satisfied.

A serious question to be tried—In order to determine whether there is a serious question to be tried, the applicant must provide the court with sufficient material to enable the court to make this determination. There is the same relatively low threshold to surmount as in the case of an application for an interlocutory injunction (*Swansson*).

It has been said that whether there is a serious question to be tried can be answered only by reference to an infringement of some legal or equitable right or the commission of some legal or equitable wrong (*Goozee v Graphic World Group Holdings Pty Ltd*, above, at 542). I consider that here a serious question has not only been established but the claimed breaches of duty have been made out.

Notice of proceedings to company—Section 237(2)(e)(ii) contemplates that a court can grant leave even if the applicant has not given written notice to the company of the intention to apply for leave and of the reasons for applying. It is not clear to me whether written notice was in fact given within the time required of intention to commence these proceedings and seeking the relief in this regard. However, AAV and its remaining shareholders and directors have been on notice of Mrs Vadori's intention to seek relief of this kind since the commencement of the proceedings. I consider that any failure to notify of an intention to make such an application strictly within the section should not preclude the grant of leave.

Therefore, but for the fact of the compulsory purchase order that I propose to make, I would have considered it appropriate to grant leave to bring the derivative proceedings. As it is, the requirement for the bringing of such a claim to be within the best interests of the company is not met and I do not grant any such leave.

Section 232 and 233

Mrs Vadori says that, without consultation with her (and in fact having excluded her from the initial meeting and not invited her to the subsequent decision meeting),

the directors of AAV (having agreed that they could no longer work together as tradesmen) chose to divide up the assets of the company between themselves and proceeded to divert the business from the company to their respective new entities (and in terms of the employees/work/client opportunities, the diversion was largely to the new company with which Andrew and Paul were associated). In so doing, they rendered of no value any goodwill that there may have been in the company and Andrew and Paul took for themselves the substance of the business of the old company (of which they nevertheless remained directors). Mrs Vadori was left as a one-third shareholder in a company in which there was little value, but which was continuing to incur costs by reason of its ongoing existence as a corporate entity and whose only function was as trustee for the directors' investment vehicle and superannuation trust.

Andrew and Paul (who remain as directors of AAV), and their wives, as directors and shareholders, respectively, of their new corporate entity, have not only taken the existing work (with all but one of the company's employees and making use of the existing business premises) but have had the benefit of ongoing work by reason of the decisions made by the company's two main clients (a business opportunity clearly deriving from the relationship between those clients and Andrew), that ongoing work having represented at least a potential business opportunity for AAV.

Significant in my view is the fact that Mrs Vadori had made it known that she wanted to attend at least the first meeting at which the future of the company was to be discussed and had been excluded from that meeting by Andrew. I do not think she can be criticised for forming the view that similar requests would be met with the same opposition.

As directors of the company, it was not the place of Andrew Paul and Peter to divide up the company between themselves and to divert its existing business and then business opportunities away from the company to their respective new corporate entities. A closer case to that considered in *Cook v Deeks* would be hard to find.

However, what Andrew and Paul did was, in effect, to take for themselves and their new company the benefit of AAV's resources (both in terms of its manpower and the facilities available to it, including its business premises which it occupied rent-free for a number of months), at least two-thirds (or more, depending on how the stock is viewed) of the company's plant, equipment and tangible assets; and the benefit of both its existing work and the business opportunities it had based on Andrew's relationship with the clients, without the consent of at least Mrs Vadori. Consent from her, as a one-third shareholder, was simply not sought (and seems to have been regarded as unnecessary).

That conduct seems to me to be in clear breach of their duties as directors (both under statute and by reason of their position as fiduciaries), and was oppressive in breach of s 232 of the *Corporations Act*. Insofar as it is suggested that any oppression was prior to the date pleaded (and hence irrelevant to the claim as pleaded), I do not agree. Apart from anything else, the oppression pleaded includes the alleged breaches of duty in having made use of their position as directors to take the benefits

they did from the ongoing work. Further, it seems to me that the implementation of decisions reached at an earlier point was itself oppressive conduct.

However, looked at in practical terms, what Andrew and Paul did was to divert to their new company, and in effect re-badge as the business of A & P Plumbing, the whole of the business operations of AAV, at the same time as they owed statutory and fiduciary duties to AAV to act in the best interests of that company, and not to put themselves in a position of conflict with that company or to take make use of their position to make a profit in effect at the expense of the company. In my opinion, as there has been a clear breach by Andrewand Paul of the duties owed by them as directors of AAV, AAV's assets as at 1 December 2006 must be taken to include the chose in action comprised by any claim it was in a position to make in relation to that breach of duty.

In essence, Mrs Vadori's one-third share of the AAV business now reposes in A & P Plumbing. I am of the view that where this is a result of the fact that the directors have improperly diverted business from the company in breach of their duties, the value of Mrs Vadori's share should take into account the amount for which they could or would be likely to be required to account to the company for the said diversion of its business.

With that in mind, I consider that the appropriate amount for which Mrs Vadori's share is to be purchased is $190,800. I have reached that amount on the basis that the value of her one-third share in the business of AAV as at 1 December 2006 was valued by the experts at approximately $83,000, of which she has received around $50,000 comprised of cash and the equity in the car/excavator taken by Peter from the company; that a one-third share of the remaining stock as at 1 December 2006 was in the order of $16,300 (ie one-third of $49,000); that Mrs Vadori should be paid one-third of the profit conceded by Andrew on the existing work taken over from AAV (just over $16,400 which I have rounded up to $16,500); and that the amount for which Andrew and Paul should account to the company for the breach of their duties should be measured by the profits reasonably likely to have been obtained from or referable to that business for the 2007 year.

As to the last component of the award, I have worked on the basis that the 2006 financial accounts for AAV showed a profit of $375,000 and that there is no reason to think that the profits of A & P Plumbing would be materially less (given that both AAV's clients made the decision to follow Andrew and Paul to A & P Plumbing—Montgomery Homes absolutely and Contour Building, until its receivership to a large extent). I have therefore allowed a sum of $125,000 for the value of the chose in action.

That, together with the sums of $33,000, $16,300 and $16,500, leads to a purchase price of $190,800.

For completeness, I note that had I not been prepared to make a compulsory purchase order that reflected the value to the company of a claim against Andrew and Paul for breach of directors' duty, I would have considered it appropriate to grant Mrs Vadori leave to bring derivative proceedings in the name of the company against them.

> For the reasons set out above, I propose to make the following orders:
> 1. Declare that the affairs of the first defendant have been conducted in a manner that is oppressive to, unfairly prejudicial to, or unfairly discriminatory against the plaintiff within the meaning of section 232 of the *Corporations Act* (Cth) 2001.
> 2. Order the fourth and fifth defendants to purchase the share of the plaintiff in AAV Plumbing Pty Limited for the sum of $190,800.

Although **s 232** of the *Corporations Act* will assist shareholders in situations where oppression is found, it is not applicable in all circumstances. Oppression is more than mere disagreement between shareholders and the company. In *Australian Institute of Fitness Pty Ltd v Australian Institute of Fitness (Vic/Tas) Pty Ltd (No 3)* (2015) 109 ACSR 369; [2015] NSWSC 1639, a shareholder/licensee brought oppression proceedings claiming that the manner in which the business was organised (including the commencement of certain claims) was oppressive. The Australian Institute of Fitness provided education and training services in the fitness industry. The Institute operated its business through its shareholders and licensees. Each shareholder/licensee had the right and duty to operate the Institute's business in their respective Australian state or territory. The court held that there was no oppression and that therefore proceedings under **s 232** were dismissed. Sackar J pointed out that the test was objective, and that the fact a minority shareholder does not get her or his way in relation to the conduct of the affairs of the company will not be sufficient, in and of itself, to constitute oppression.

Members' personal rights

[25.60] Together with their statutory rights, members have personal rights (including common law rights) in relation to the following matters:

- Fraud on the minority. Fraud here means an abuse of power and the action is brought against those who control the company. Generally, where an action is brought, a minority member's personal right will exist against both the majority and the company.
- Improper modification of the constitution leading to an expropriation of shares (*Gambotto v WCP Ltd* (1995) 182 CLR 432; 13 ACLC 342). In *Gambotto*, the court proposed a twofold test; first the modification must be for a proper purpose and second fair in all the circumstances. As with all personal actions, the loss must be one suffered by the member and distinct from the company's loss. Note that the *Corporations Act* now enables, in effect, an expropriation in certain circumstances set out in **s 664A**. In that section, the holder of a full beneficial interest in at least 90% of the company's voting shares can compulsorily acquire the balance on certain terms.
- Protection of the dilution of voting rights. Note also that **s 246D** of the *Corporations Act* protects members regarding the variation of share rights. If members in a class

do not all agree to a variation or cancellation of their rights, or to a modification of the constitution to that effect, then provided at least 10% oppose such variation, they can apply to the court to have it set aside.

- The ability to enforce the constitution via **s 140** is a contractual right belonging to a member. Note, however, that the section is not enforceable by an outsider.
- If the *Corporations Act* or the constitution requires a special resolution (75% majority) in relation to the transaction of certain company business, then members have a personal right to enforce compliance in a situation where the company is attempting to substitute an ordinary resolution (above 50%).

Generally, because of the range of conduct and orders covered by the statutory provisions (such as **s 232**), members will favour action under such provisions. However, the common law actions remain as an important part of a member's arsenal of rights.

Class actions

[25.70] A class action is a legal proceeding where a group of persons with similar claims sue someone else (usually a company) in relation to a breach of their rights. Class actions have been in existence in Australia since 1992 when they were introduced in the Federal Court. Class actions are a means by which a single judge can decide many separate cases at the same time, thus saving court time and resources.

A shareholder class action is based on the shareholder suffering lost profit which is usually measured by a fall in the share price. Shareholder class actions generally target failure by the company to give proper public disclosure regarding the state of the company's business. In essence, shareholders in a class action contend that if they had been given accurate information by the company then they either would not have bought shares in the company, thereby avoiding loss, or would have sold their shares sooner and thereby achieved a higher profit.

Because of their size and importance to investors generally, class actions often attract media attention. The substantial costs that would inevitably arise for the plaintiff/shareholders of the (generally) large class actions are offset by the sharing of these costs between this group. A particularly important trend in relation to shareholder class actions has been the growth of litigation funding providing financial support for litigants. Without litigation, funding many shareholder class actions would not be able to proceed. An example of a shareholder class action can be seen in *Sons of Gwalia Ltd v Margaretic* (2007) 231 CLR 160; [2007] HCA 1, where a claim was made that the company engaged in misleading or deceptive conduct regarding the overstatement of its gold reserves. Because they have the capacity to result in a substantial award of damages, class actions have been vigorously defended by the companies being sued. For example, the voluntary administrators in the *Sons of Gwalia* matter successfully challenged the right of the litigation funders (those providing finance for the litigation) to have access to the company's shareholder register for the purpose of contacting past

and present shareholders to join the class action (*IMF (Australia) Ltd v Sons of Gwalia Ltd* (2005) 143 FCR 274; [2005] FCAFC 75).

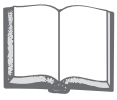
A feature of class actions is their scale. The ability of members to pool interests and resources and the advantages of singular but shared legal representation provides an opportunity otherwise unavailable because of the complexity involved in detailed legal proceedings. Clearly, the substantial financial risk (which includes legal costs) to a company/defendant where the plaintiff/shareholders succeed in a class action is an incentive for companies to settle rather than proceed to a full hearing. In *Dorajay Pty Ltd v Aristocrat Leisure Ltd* [2009] FCA 19; (2008) 67 ACSR 569, a shareholder class action was brought on behalf of shareholders who acquired their interest in Aristocrat Leisure between 19 February 2002 and 26 May 2003. The action alleged that shareholders who purchased shares in this period suffered loss as the share price was inflated and the market not properly informed. The hearing of the matter took place in October 2007. In May 2008, and before judgment was delivered, a settlement was reached between the parties. The Federal Court approved the settlement amount totalling $144.5 million.

The *Centro Properties* matter (see [20.90]) gave rise to a class action based on the company's failure in 2007 to properly disclose its true financial position and thereby engage in misleading conduct by misclassifying current debt as non-current. One of the matters to arise in the litigation was the level of responsibility of the reformulated corporate group structure for the liabilities of its predecessor. Separate proceedings were commenced against the company's auditors PwC for approving Centro's financial accounts and failing to detect errors in the classification of its debt situation. The hearing of the class actions commenced in March 2012, however after several weeks of hearing a settlement was reached between all parties. The settlement, which, at $200 million including costs is the largest in Australia to date in relation to securities class actions, was in June 2012 approved by the court as fair and reasonable to all parties.

Parliament has now excluded litigation funding from falling within the definition of a "managed investment scheme" in **s 9**. Previously however, the uncertainty of the issue created barriers to its usefulness. A case decided prior to the amendment to the legislation illustrates the difficulties of classification. In *Brookfield Multiplex Ltd v International Litigation Funding Partners Pte Ltd* (2009) 180 FCR 11; [2009] FCAFC 147, the Full Federal Court considered that the class action funding arrangement in that matter included the following purposes: to facilitate realisation of claims by the members; to enable International Litigation Funding Partners to be reimbursed and draw profits from the realisation; and, by the Funder undertaking to meet any orders for costs, to protect the members from liability for costs. Having regard to these purposes, and certain other matters, the Court held that the funded class action brought against Brookfield Multiplex Ltd was a managed investment scheme in accordance with **s 9**. A managed investment scheme must be registered with ASIC and to qualify for registration it must comply with the provisions of **Ch 5C**, including, in **s 601FA**, that the responsible entity for the scheme hold an Australian financial

services licence. Initially following this decision (and a further decision in the area *International Litigation Partners Pte Ltd v Chameleon Mining NL* (2011) 82 ACSR 517; [2011] NSWCA 50), ASIC took steps to preserve the ability of shareholders to seek funding assistance for the purposes of litigation. The uncertainty in the area has now been resolved permanently by amendment to the *Corporations Regulations 2001*, where in Reg 5C.11.01 it sets out that a litigation funding scheme that has certain features including that its dominant purpose is for each of its general members to seek remedies to which one of those members may be legally entitled is declared not to be a managed investment scheme.

The article from which the following excerpt is drawn outlines the importance of shareholder class actions. It also questions whether their substantial cost and complexity may detract from their benefits.



[Miller P, "Shareholder Class Actions: Are they good for shareholders?" (2012) 86 ALJ 633 at 633, 634, 649]

From a slow start, such shareholder class actions in Australia have been gathering pace in recent years.

Like Centro, most shareholder class actions centre upon allegations of inadequate or inaccurate disclosure, and in particular a failure to comply with continuous disclosure rules. These rules require listed companies to report material events or changes in their condition as and when they occur. Provided the information is price-sensitive, in the sense that a reasonable person would expect it to have a material effect on the company's value or share price (and subject to certain specified exceptions), a listed company must disclose such information immediately upon becoming aware of it. Where a company breaches this obligation, shareholders who claim to have suffered a financial loss as a consequence may sue the company.

There seems to be a general acceptance in Australia today that the right of shareholders to sue the company in these circumstances, and in particular to come together en masse in a class action, serves an important and socially useful function. In 2005, Deputy Chairman of the Australian Securities and Investments Commission (ASIC), Jeremy Cooper, welcomed shareholder class actions (albeit "cautiously") as a valuable self-help mechanism for shareholders. More recently ASIC Chairman, Greg Medcraft, has described them as "a good market-driven solution". What concerns there have been have tended to focus on the large costs of running and defending actions and on specific procedural elements, with a vigorous debate centring on the proper role and regulation of entrepreneurial litigation funders, which bankroll actions in return for a proportion, typically between 25% and 40%, of any recovery. In cost/benefit terms, this means that much of the focus has been on the costs side of the equation. As Finklestein J (in *Kirby v Centro Properties Ltd* (2008) 253 ALR 65 at 67-68) has put it:

While there are problems with securities class actions, it must, I think, be accepted that they serve a useful function. It is often said that these actions promote investor confidence in the integrity of the securities market. They enable investors to recover

past losses caused by the wrongful conduct of companies and deter future securities law violations.

There is no doubt that shareholder class actions are incredibly costly. The applicants' direct legal costs alone were $15 million in the case of GIO, $8.5 million in the case of Aristocrat, $11 million in the Multiplex action, and $31.16 million in the Centro actions. To this must be added the respondent company's own costs (both legal and other indirect costs, such as management distraction and diversion of company resources), the costs incurred by other interested parties (including litigation funders, insurers and individual members of the class), and the public expenditure on court resources.

Given such considerable costs, the question posed above – are shareholder class actions good for shareholders? – suggests that it might be worth looking again at the benefits side to confirm whether the shareholder class action, at least as currently conceived, stands up to a rigorous cost-benefit comparison. Recent analysis from the United States suggests that the benefits that have so far been taken for granted warrant closer scrutiny.

Summary—Members' rights

Derivative actions (actions on behalf of the company)

Originally arose as an exception to the rule in *Foss v Harbottle*

Now a statutory derivative action is available under **s 236**

The action is the company's—member exercises company's rights

To succeed under **s 236**, the member must satisfy the criteria in **s 237**

Section 237 includes: act in good faith; in company's best interests

Member must also rebut presumptions in the business judgment rule

Personal actions

Personal actions are available in the common law and in the *Corporations Act*

Common law actions include fraud on the minority

Member has contractual right to enforce constitution under **s 140**

Personal actions under the *Corporations Act*

To inspect books; to correct the register; right to notice of a meeting

To apply to wind the company up: **s 461**

To correct a procedural irregularity: **s 1322**

To apply for an injunction: **s 1324**

An action for oppression under **s 232** and orders available in **s 233**

Oppression

Oppression can arise from conduct of the majority or the board

As to directors' conduct, oppression will be judged by an objective, reasonable board test

Cases concerning oppression: *Wayde*; *Morgan*; *Scottish Cooperative*

Orders under **s 233** include: modify constitution; purchase of shares

26
Members' Meetings

Company meetings transact business

[26.10] Members are entitled to participate in their company's affairs, and their rights in relation to meetings reinforce this. A company is governed by its directors by way of day-to-day management decisions; directors make the large proportion of the company's decisions. However, a company is also governed by its members by means of meetings. Decisions such as amendment of the company constitution, or changing the company name, are for the members to vote upon at shareholder meetings. There are three types of members meetings:

- Annual general meetings (AGMs) are compulsory for public companies but optional for proprietary companies. A public company must hold its first AGM within 18 months after its registration and each AGM thereafter annually within five months after the end of its financial year (**s 250N**). Members are allowed a reasonable opportunity to ask questions or make comments about management (**s 250S**).
- Extraordinary general meetings may be called at any time by, amongst others, members, and allow urgent matters to be raised and dealt with.
- Class meetings may be called where specific classes of members seek to vary their class rights by way of special resolution.

A meeting of members must be held for a proper purpose (**s 249Q**) and at a reasonable time and place (**s 249R**). In *NRMA v Parker* (1986) 6 NSWLR 517; 4 ACLC 609, it was held that the shareholders' right to requisition a meeting was not effective if the matters to be considered at the meeting were matters of management exclusively vested in the directors. However provided the resolutions sought are of the kind that can be passed by the general meeting, the motivation of the requisitioning shareholders will not necessarily amount to improper purpose (*NRMA v Scarlett* (2002) 43 ACSR 401).

Extraordinary general meetings (known as "general meetings" or "members meetings") may be called by a director or directors, members, or the court. **Sections 249C** and **249CA** both set out that a director may call a meeting of the company's members. The right of a director to call a general meeting may differ between a proprietary and a listed public company. **Section 249C** is a replaceable rule and therefore the right of a director to call a general meeting under this section could be removed by amendment to the replaceable rules/company constitution. This is the situation in proprietary companies. However, **s 249CA,** which applies to listed public companies only, is not a replaceable rule and the right of a director to call a general meeting is accordingly protected notwithstanding anything in the company's constitution.

Where it is impracticable for a meeting to be called, the court may order the calling of a meeting upon the application of any director or member entitled to vote at the meeting (**s 249G**).

The ability of members to call a meeting is important and is dealt with in two ways in **Ch 2G**. In the first instance pursuant to **s 249F**, members with at least 5% of the votes that may be cast at a general meeting can call and hold a meeting. Under this section, the costs of calling and holding the meeting must be paid by the members calling the meeting. Where the cost of the meeting would be substantial, there is another way for members to cause a general meeting to be held. In **s 249D**, the directors must call and arrange to hold a general meeting of the company if requested to by members holding at least 5% of the votes that may be cast at the general meeting. The request must be in writing, state the resolution proposed, and be signed by the members making the request. The directors must call the meeting within 21 days of the request, and the meeting must be held not later than two months after the request. If the directors fail to call a meeting when requested to do so under **s 249D** then provided above 50% (by voting power) of the members requesting the meeting are in favour they can then call the meeting themselves with the reasonable cost of the meeting borne by the company (**s 249E**).

Prior to the *Corporations Legislation Amendment (Deregulatory and Other Measures) Act 2015* (Cth), a request to the directors under **s 249D** to hold a general meeting was also available to 100 members regardless of the percentage of shares held. This method of bringing about a general meeting no longer exists. One of its disadvantages was that it could lead to outcomes where special interest groups exert pressure and influence to the detriment of the vast majority of members. Today, listed companies have large shareholder numbers and the ability of a small minority with possibly an insignificant proportion of the shares to requisition a meeting, which can often be at substantial cost to the company, provides unnecessary influence to an unrepresentative sector of the company. The simplifying of the manner in which a general meeting can be called is consistent with the federal government's commitment to repealing "red tape" to facilitate the better functioning of companies.

Company resolutions

[26.20] To transact business at meetings, resolutions are passed. There are two types of resolution, ordinary and special, and the nature of the matter to be decided determines which of the resolutions is appropriate. At a company meeting, motions are put to the members and they vote on each motion. A meeting of the company's shareholders requires 21 days' notice to members. For listed companies, notice to members is 28 days (**s 249HA**). For ordinary resolutions, a simple majority vote is required (above 50%). An ordinary resolution is sufficient to elect and remove directors and to remove an auditor. Shorter notice of meetings can be given for an AGM where all the members entitled to attend and vote agree before the meeting or for other

types of meeting where members with at least 95% of the votes that may be cast at the meeting agree beforehand (**s 249(H)(2)**). However, the provision for shorter notice does not apply to a resolution to remove or appoint a director or to remove an auditor (**s 249H(3)** and **(4)**).

A special resolution requires 21 days notice, and a majority of 75% is necessary. A special resolution will vary class rights, change the company name and amend the constitution. In order to give notice of the intention to propose a special resolution, the notice of meeting sent to the members advising them of the meeting must set out an intention to propose the special resolution and state the special resolution (**s 249L(1)(c)**).

Where members seek to propose a resolution at a general meeting of the company, **ss 249N** and **249O** are relevant. **Section 249N** sets out that notice of a proposed resolution may be given by members with at least 5% of the votes that may be cast on the resolution; or, by at least 100 members entitled to vote. The notice must be in writing, set out the wording of the proposed resolution, and be signed by the members proposing to move the resolution. The 100-member requirement regarding the proposal of resolutions is important to ensure that issues that affect not only large shareholders but also groups of smaller like-minded shareholders are aired at company meetings. **Section 249P** contains similar criteria for members seeking to distribute a statement concerning a resolution or other matter that may be considered at a general meeting.

All members' meetings require the following information to be provided in the notice of a meeting: the place, date and time of the meeting; the general nature of the meeting's business; and where applicable, information about proxy votes.

Particulars relating to notice of meetings now take into account the possibility that directors may be forced to face re-election if the "two strikes rule", giving shareholders the opportunity to vote on director remuneration (see [18.50] under "Remuneration"), applies. **Section 249L(2)** sets out that the notice of the AGM in a listed company must inform members: that the resolution referred in **s 250R(2)**, that is, the resolution on the remuneration report, will be put to the AGM; and that if at the previous AGM at least 25% of the votes were against the adoption of the remuneration report at that meeting, then a spill resolution pursuant to **s 250V(1)** will be put.

Before resolutions can be passed, a quorum must be present. A quorum is the minimum number of members necessary to be present at a meeting for business to be validly transacted and resolutions passed. For a single member company, the quorum is one; for proprietary and public companies, it is two [**s 249T** (replaceable rule)].

Irregularities will not invalidate a proceeding unless substantial injustice occurs via **s 1322**. This section enables the court to cure procedural defects at meetings, for example, where a quorum is not present or voting procedures discriminate between members. Note that a proprietary company with more than one member can pass a resolution without the need for a meeting if all of its members entitled to vote sign a document indicating that they are in favour of the resolution (**s 249A**).

***Corporations Act 2001* (Cth), s 249D**

Calling of general meeting by directors when requested by members

(1) The directors of a company must call and arrange to hold a general meeting on the request of the members with at least 5% of the votes that may be cast at the general meeting.
(2) The request must:
  (a) be in writing; and
  (b) state any resolution to be proposed at the meeting; and
  (c) be signed by the members making the request; and
  (d) be given to the company.
(3) Separate copies of a document setting out the request may be used for signing by members if the wording of the request is identical in each copy.
(4) The percentage of votes that members have is to be worked out as at the midnight before the request is given to the company.
(5) The directors must call the meeting within 21 days after the request is given to the company. The meeting is to be held not later than 2 months after the request is given to the company.

***Corporations Act 2001* (Cth), s 249E**

Failure of directors to call general meeting

(1) Members with more than 50% of the votes of all of the members who make a request under section 249D may call and arrange to hold a general meeting if the directors do not do so within 21 days after the request is given to the company.
(2) The meeting must be called in the same way—so far as is possible—in which general meetings of the company may be called. The meeting must be held not later than 3 months after the request is given to the company.
(3) To call the meeting the members requesting the meeting may ask the company under section 173 for a copy of the register of members. Despite paragraph 173(3)(b), the company must give the members the copy of the register without charge.
(4) The company must pay the reasonable expenses the members incurred because the directors failed to call and arrange to hold the meeting.
(4A) An offence based on subsection (3) or (4) is an offence of strict liability.
Note: For strict liability, see section 6.1 of the Criminal Code.
(5) The company may recover the amount of the expenses from the directors. However, a director is not liable for the amount if they prove that they took all reasonable steps to cause the directors to comply with section 249D. The directors who are liable are jointly and individually liable for the amount. If a director who is liable for the amount does not reimburse the company, the company must deduct the amount from any sum payable as fees to, or remuneration of, the director.

As well as advice for those wishing to manage companies, ASIC provides information to shareholders—the following Information Sheet encourages shareholders to play a

part in their company's AGM. Note that Information Sheets are updated and revised periodically.

ASIC Information Sheet—Shareholders Have Your Say

Annual general meetings

You will be told when the annual general meeting (often called AGM) of your company is to be held. AGMs are generally held by public companies once every calendar year. Matters usually considered at an AGM are the: annual financial report, directors' report and auditor's report; election of directors; appointment of the auditor.

The chair of an AGM must give shareholders a reasonable opportunity to ask questions about, or make comments on, the management of the company.

Why should I read the financial and auditor's reports? Before an AGM you will usually receive an annual report, containing the directors' report, the financial statements and other management reports on the company's activities. Read these reports and work out how the company is going. The financial statements are often neglected by shareholders. However, they contain vital information about, for example, profits and losses and the company's assets and liabilities (including its debts). Unless you specifically ask to be sent full financial reports, the company may send you a concise report. In either case, read the report(s). If you do not understand them, ask an independent accountant or financial adviser. You can also ask questions at the AGM. Look also at the auditor's report, especially to see if the report is "qualified". A qualified report will tell you why the auditor was not completely satisfied. If the auditor is at the AGM, you can generally ask them about the preparation and content of their report.

Can I have my say about who is a director? Quite often at an AGM you will be asked to re-elect one or more directors or approve the appointment of a new director. Before you do remember you can ask questions or comment on the management at the AGM. If a new director is to be appointed, make sure you are given enough information to decide whether this is the person you want managing your company.

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The following newspaper article sets out several issues that may be canvassed at AGMs and argues that shareholder participation is important if matters such as director remuneration and payment of dividends are to be fully considered. The business of the AGM may include matters set out in **s 250R** even if not referred to in the notice of the meeting. These include: the company's annual financial report, directors' report and auditor's report; the election of directors; the appointment of auditors; and the auditor's remuneration. Where the company is a listed public company, the AGM must also consider the remuneration report.

AGM season to reveal the reality

There has been public debate about the future of the annual general meeting. Various pundits and experts expressed opinions. Some declared it an anachronism and pronounced death, while others prescribed reinvention. However, the AGM has proved its usefulness. Meetings of Boral, Wesfarmers, Transurban and Valad produced a majority against votes on the resolution approving the remuneration report. Shareholders also used the meetings to express displeasure over the handling of risk, performance and remuneration.

Recently the financial crisis has ravaged listed companies. While many have paid down debt this has been at a heavy cost to small shareholders. Capital raised during the crisis has been done so largely by calling on large institutional investors, subsequently diluting small shareholdings.

Chairs had to justify why they did not use a pro-rata rights issue, which would have afforded small shareholders an opportunity to stave off dilution. Many chairs also dealt with shareholders angry about the cutting or complete withdrawal of dividend payments. Changes to dividend policy have cut into the incomes of self-funded retirees and others dependent on this income. Shareholders might have begrudgingly accepted that it is necessary to divert funds to reduce debt, however boards that have increased, or even held executive pay steady while cutting dividends were always going to have a very hard sell.

Companies have reviewed remuneration and it will be interesting to see how many others have responded to shareholder and public pressure to act on this issue. With many long-term incentives out of the money during periods of financial crisis, shareholders should lookout for increases in fixed pay and short-term incentives (STIs) and ask how they can be justified in the current circumstances. Fixed pay and STIs, which can often account for up to two thirds of an executive's total package, are easily the least transparent areas of pay.

Shareholders should be wary of the worst of the effects of poor performance being hidden by convenient accounting practices, such as changes to valuation methods and focusing on "underlying", instead of statutory profit.

It is hoped that all of these issues will boost meeting attendance, but timing and location remain significant barriers. Appointing a proxy, or voting directly where available, is not difficult and shareholders are advised to think long and hard this year before consigning a proxy form to the recycling, and opt to fill it out instead

Original source article by Stuart Wilson, *The Australian*

Shareholder engagement has become an important factor in how companies are managed. Where shareholders are actively engaged in company issues, particularly management decisions and culture, there is more likelihood that adherence to regulatory standards and ethical practices will take place. A key forum for shareholder engagement is the AGM and this was recognised by the federal government when it initiated an inquiry into AGMs and the issue of their relevance in a digital age ("The AGM and shareholder engagement"). The framework and functioning of AGM's is changing in response to improvements in technology, which have resulted in continuous real-time dissemination of company information, and as the result of the application of the two-strikes rule. The goal is effective management practice through improved shareholder engagement. For this, the AGM must remain responsive to the needs of shareholders and stakeholders in the company, and continue to serve

its intended purposes, including providing a valuable forum to facilitate responsible corporate governance.

How companies behave or act is often as important as how they perform. Investors can assess a company's prospects from a number of perspectives including financially, organisationally, managerially, and having regard to the satisfaction or cohesion of the shareholders. Transparency is essential to the relationship between the company and its shareholders, and meetings are particularly relevant in this regard. The issue here, as before, is shareholder engagement and in this regard the European Commission in its "Europe 2020" Action Plan in relation to corporate governance sets out the following:

> Shareholder engagement is a purposeful dialogue with companies on matters such as strategy, performance, risk, capital structure, corporate governance, including remuneration, etc. It is therefore more than just voting at the general meeting. Shareholder engagement (or "stewardship") aims to promote long term success of companies. Effective engagement benefits companies, shareholders and the economy as a whole.

Proxies

[26.30] A member who is entitled to attend and vote at an AGM has a right to appoint a proxy to attend and vote on their behalf. The relevant sections are **ss 249X-250M**. When a shareholder appoints a proxy, they may specify how the proxy is to vote on their behalf or leave the vote to the proxy's discretion. In *Campbell v Jervois Mining Ltd* (2009) 27 ACLC 690; [2009] FCA 401, shareholders were informed that the chair would be voting proxies in a particular way. Thereafter, proxies were received that did not specify how they should be voted (undirected, or open, proxies). The chair changed his mind and at the meeting did not vote these undirected proxies as initially indicated. The court held that this did not ground any action by the shareholders as undirected proxies enabled the proxy holder to vote in accordance with their discretion at the time of the vote. In contrast, the appointment of a proxy may specify the way the proxy is to vote on a particular resolution (directed proxy). In these circumstances, **s 250BB** sets out a number of matters that will be determinative of the rights of the parties. These include: that the proxy need not vote on a show of hands, but if the proxy does so they must vote as directed; that if the proxy is the chair of the meeting at which the resolution is voted on then they must vote on a poll as directed; that if the proxy is not the chair (this means other directors, or shareholders) then they need not vote on a poll but if they do vote they must vote as directed. Accordingly, whereas the chair is required to vote proxy votes on a poll, and in accordance with the shareholders' instructions, other proxy holders are not under the same obligation. This can give rise to "cherry-picking" to suit the proxy holder, that is the proxy holder will choose whether or not they will vote the proxy. In some cases, the rights attaching

to proxy votes will be lost if procedures at the meeting are not carried out properly. This occurred in *Whitlam v ASIC* (2003) 57 NSWLR 559; [2003] NSWCA 183, where a failure by the chair of the meeting (who was the proxy holder) to sign a document (poll paper) disenfranchised the shareholders giving the proxies.

Voting procedures

[26.40] Company meetings provide an opportunity for members to air their views and ask questions of the board. Voting can be by a show of hands or by a poll. In a company with share capital (most companies) on a show of hands, each member has one vote and on a poll each member has one vote for each share held (**s 250E**). If voting is by way of a poll, any proxy votes held must be counted. In certain circumstances, members can demand a poll. Pursuant to **s 250K**, a poll can be demanded on any resolution, with certain exceptions where the company's constitution sets out otherwise. A poll may be demanded by: at least five members entitled to vote; members with at least 5% of the votes; or the chair (**s 250L**). Timing of the poll is determined by **s 250M**. If the poll is not in relation to the election of the chair or the question of an adjournment, then it is for the chair to decide when and how the poll is to be taken. However, where the poll relates to the election of the chair or an adjournment then it must be taken immediately.

Summary—Meetings

Types of company meetings: AGM; class; extraordinary general meetings

AGMs are compulsory for public companies, optional for proprietary

Members with 5% of vote can call (and pay for) general meetings: **s 249F**

Members can request that the directors hold a general meeting: **s 249D**

If directors do not call the meeting, shareholders can (company pays): **s 249E**

Members are entitled to due notice of meeting (usually 21 days)

Members vote on either ordinary (over 50%) or special (75%) resolutions

Ordinary resolution needed to elect and remove directors

Special resolution needed to amend constitution

Shareholders who cannot attend a meeting can vote via a proxy

27
Takeovers

Effects of a takeover

[27.10] A takeover occurs when a company (the bidder) seeks to gain control of another company (the target) by acquiring its shares. The level of acquisition will determine the level of control. For example, the election of directors requires an ordinary resolution (50%) whereas the amendment of the constitution requires a special resolution (75%). If all of the target's shares are acquired by the bidder, the target will become a wholly owned subsidiary.

Takeovers are regulated in **Ch 6** of the *Corporations Act 2001* (Cth), and **s 602** sets out that the purpose of the Chapter is to ensure that the acquisition of control in a listed company or an unlisted company with over 50 members takes place in an efficient, competitive and informed market. Accordingly, the takeover provisions protect the market and the target shareholders.

Downsides of takeover activity include the possibility that monopolies may arise or that directors may implement short-term strategies having a negative effect on the company's stability. On the other hand, there may be certain advantages, and provided the *Corporations Act* is effective in its protection of shareholders' access to relevant information, an active takeover market can result in benefits such as economies of scale (synergy gains) and active management as directors may seek to secure their positions by improving their performance. Also, shareholders are usually offered a premium over and above the market value for their shares and if they choose to sell can reinvest funds in the market. Obviously, it would be difficult to entice the shareholders to sell unless the bidder was prepared to offer something above what could be obtained on the open market. Even the prospect of a takeover bid can cause a target company's shares to increase in value, as the following newspaper article reveals (note that the takeover referred to in the article did not eventuate and that the Insurance Australia Group share price is currently above the amount quoted therein).

IAG jumps 4.6pc on hopes of takeover

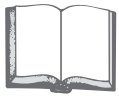
Australia's biggest general insurer, Insurance Australia Group, yesterday experienced one of its biggest share price gains, possibly driven by investors believing rival QBE Insurance might attempt a takeover.

The stock bounced up 22c or 4.64 per cent to $4.96, with more than 20 million shares changing hands. One source said IAG might be seen by investors as a potential takeover candidate. Another source said it was "not beyond credibility that something could occur". "IAG are at a low point at the moment … (and) QBE has made no secret that it wants to buy IAG".

Original source article by Katherine Jimenez, *The Australian*

The takeover provisions operate by prohibiting acquisition of shares once a certain entitlement is achieved (**s 606**). The concept of entitlement to shares is defined widely to guard against several shareholders each below the threshold associating and then using their combined vote for control. Accordingly, the 20% threshold prohibition set out in **s 606** is not based on ownership but on the concept of a relevant interest.

The issues upon which the prohibitions are based are: control → relevant interest (**s 608**) → voting power → (**s 610**) → prohibitions on acquisition (**s 606**). A person will have a relevant interest in securities if they hold the securities, have the power to control the right to vote in relation to the securities or have power to control the disposal of the securities. Accordingly, a person will have a relevant interest in the voting power of not only their own shares but also those of any associate. The concept of "associate" for the purposes of **Ch 6** is set out in **s 12** and includes a company that the person controls, a company that controls the person, or another person with whom an agreement to control is in place. In *Re Winepros Ltd* [2002] ATP 18; (2002) 43 ACSR 566, the Takeovers Panel refused to make a declaration of unacceptable circumstances based on association where a bidder relied on their own shareholding and proxy votes from other shareholders opposed to certain resolutions to defeat those resolutions at a meeting of the target. The Panel held that the shareholders merely opposed the resolution and that a finding that parties are associated will require more than a mere concurrence of views and may involve inferences from patterns of behaviour and commercial logic.



[Langley R, "Information access denied … Is the Australian takeovers market really efficient, competitive and informed?" (2009) 27 *Company and Securities Law Journal* 344.]

> Takeover bids are an integral part of the operation of equity markets. The possibility or threat of takeovers provides a continuing stimulus to existing management to maintain and improve performance, profit results and share prices, exerts discipline on management to avoid self-interests and encourages economic efficiency. The existence of an efficient, competitive and informed market for corporate control also provides a mechanism by which company assets can be channelled to those who are most efficient in using them which, in turn, contributes to the efficiency of the economy as a whole.

Threshold for control

[27.20] The legislation has determined that the threshold where control may commence is 20%. This is a relevant assumption particularly in large public companies where some shareholders may not vote at the AGM.

A person is not to acquire a relevant interest in the issued voting shares of a company (listed, or unlisted with more than 50 shareholders) if to do so would increase that

persons voting power from 20% or below to more than 20%, or from above 20% to any amount below 90%. The prohibitions in **s 606** do not apply if a person has over 90% of the voting shares. **Section 606** extends the ambit of the prohibition by including not only the person who acquires a relevant interest in the securities but also any other person who, as a result of the first person's acquisition, acquires a relevant interest. The section also prohibits causing an offer or invitation to be made or the making of an offer or invitation that if it were accepted would breach the threshold prohibitions in the section. A defence to a contravention of **s 606(1)**, **(2)** or **(4)** is available if a person can prove inadvertence or mistake; or that they were not aware of a relevant fact or occurrence (**s 606(5)**).

A breach of **s 606** can result in imprisonment for five years (**s 606(4A)** and **Sch 3**) and a pecuniary penalty (**s 606(4B)** and **Sch 3**). Other orders per **s 1325A** may be sought such as direct disposal of shares.

Compulsory acquisitions

[27.30] During a takeover, a shareholder will have a choice as to whether they hold onto their shares or accept the bidder's offer and sell. If a choice is made to hold onto their shares, the shareholder may find that they become a minority interest if the takeover is successful. This may not suit them or the successful bidder. The shareholder may be isolated and experience a fall in the value of their investment. The new majority controlling interest may fear disruption from the minority. The *Corporations Act* provides a mechanism whereby this potential conflict can be avoided.

Section 661A sets out that if the bidder achieves in total a relevant interest in 90% of the voting shares and 75% of the bid is accepted, then a compulsory buy out of the remaining securities in the bid class is possible. If the bidder chooses to exercise its rights under **s 661A**, then the relevant procedure to be followed is outlined in **s 661B** and the bidder must acquire the shares on the same terms as applied to the takeover bid (**s 661C**). To similar effect, shareholders who have held onto their shares can avoid being locked in. **Section 662A** sets out that if the bidder and associates have relevant interests in at least 90% of the securities in the bid class at the end of the offer period, the bidder must offer to buy out the remaining holders of bid class securities in accordance with **ss 662B** and **662C**.

Further to the above, where a person has a full beneficial interest in 90% (even if not acquired during a takeover), they may subject to certain conditions, compulsorily acquire the balance within six months (**ss 664A** and **664AA**).

Note also "substantial holding" provisions in **ss 9** and **671B**. These sections provide for the notification of increasing influence within a company's shareholders. Pursuant to **s 671B** once a 5% holding (a "substantial holding" as defined in **s 9**) in a listed company is attained, the company itself, and the market operator, such as the ASX, must be notified. Thereafter, information must be provided if the person ceases to have a substantial holding or there is a movement of at least 1% in the persons holding.

***Corporations Act 2001* (Cth), s 606**

Prohibition on certain acquisitions of relevant interests in voting shares

Acquisition of relevant interests in voting shares through transaction entered into by or on behalf of person acquiring relevant interest

(1) A person must not acquire a relevant interest in issued voting shares in a company if:
  (a) the company is:
    (i) a listed company; or
    (ii) an unlisted company with more than 50 members; and
  (b) the person acquiring the interest does so through a transaction in relation to securities entered into by or on behalf of the person; and
  (c) because of the transaction, that person's or someone else's voting power in the company increases:
    (i) from 20% or below to more than 20%; or
    (ii) from a starting point that is above 20% and below 90%.

(1A) However, the person may acquire the relevant interest under one of the exceptions set out in section 611 without contravening subsection (1).

Acquisition of legal or equitable interest giving rise to relevant interest for someone else

(2) A person must not acquire a legal or equitable interest in securities of a body corporate if, because of the acquisition:
  (a) another person acquires a relevant interest in issued voting shares in a company that is:
    (i) a listed company; or
    (ii) an unlisted company with more than 50 members; and
  (b) someone's voting power in the company increases:
    (i) from 20% or below to more than 20%; or
    (ii) from a starting point that is above 20% and below 90%.

(2A) However, if the acquisition of the relevant interest is covered by one of the exceptions set out in section 611, the person may acquire the legal or equitable interest without contravening subsection (2).

50 member threshold

(3) In determining whether the company has more than 50 members for the purposes of subsection (1) or (2), count joint holders of a particular parcel of shares as 1 person.

Offers and invitations

(4) A person must not:
  (a) make an offer, or cause an offer to be made on their behalf, if the person would contravene subsection (1) or (2) if the offer were accepted; or
  (b) issue an invitation, or cause an invitation to be issued on their behalf, if the person would contravene subsection (1) or (2) if:
    (i) an offer were made in response to the invitation; and
    (ii) the offer were accepted.

Fault-based offence

(4A) A person commits an offence if the person contravenes subsection (1), (2) or (4).

Absolute liability offences

(4B) A person commits an offence of absolute liability if the person contravenes subsection (1), (2) or (4).

Defences

(5) It is a defence to the prosecution of a person for contravening subsection (1), (2) or (4) if the person proves that they contravened the subsection:
  (a) because of inadvertence or mistake; or
  (b) because the person was not aware of a relevant fact or occurrence.

[Note – some parts of this section are not reproduced]

***Corporations Act 2001* (Cth), s 661A**

Compulsory acquisition power following takeover bid

Threshold for compulsory acquisition power

(1) Under this subsection, the bidder under a takeover bid may compulsorily acquire any securities in the bid class if:
  (a) the bid is:
    (i) an off-market bid to acquire all the securities in the bid class; or
    (ii) a market bid; and
  (b) during, or at the end of, the offer period:
    (i) the bidder and their associates have relevant interests in at least 90% (by number) of the securities in the bid class; and
    (ii) the bidder and their associates have acquired at least 75% (by number) of the securities that the bidder offered to acquire under the bid (whether the acquisitions happened under the bid or otherwise).

This is so even if the bidder subsequently ceases to satisfy subparagraph (b)(i) because of the issue of further securities in the bid class.

Note: Subsection 92(3) defines securities for the purposes of this Chapter.

(2) For the purposes of subsection (1), disregard any relevant interests that the bidder has merely because of the operation of subsection 608(3) (relevant interest by 20% interest in body corporate).

Court may allow compulsory acquisition even if threshold not reached

(3) Under this subsection, the bidder under a takeover bid may compulsorily acquire securities in the bid class with the approval of the Court.

Acquisitions that do not breach the prohibitions

[27.40] The effect of the prohibitions in **s 606** is to impose regulation on share acquisitions that may lead to the control of a company. The regulation imposed seeks to achieve the aims of the legislation, namely equity in the market and the availability of both time and information for target shareholders to enable the best possible decision on whether to sell or not. There are basically two paths by which shares can be acquired beyond the threshold: (i) exempt acquisitions that involve one of the permitted means of acquisition and (ii) other exempt acquisitions.

Acquisitions exempt from the prohibitions

[27.50] Acquisitions exempt from the prohibitions are set out in **s 611** and include:

- permitted means of acquisition (takeover bids);
- creeping takeover—as it sounds, this does not deliver immediate control. However, it does allow a potential bidder who is about to exceed, or has exceeded, 20%, to edge closer to the perimeter of control and thereby make the jump to the desired level of control less severe. **Section 611** sets out that if throughout the six months before an acquisition a person has had voting power in the company of at least 19% and as a result of the acquisition the person would have voting power in the company to a level of not more than 3% higher than they had six months before the acquisition then such acquisition is exempt from the prohibitions. Accordingly, a person with at least 19% voting power for a continuous period of six months can acquire up to a further 3% in the six month period immediately following;
- acquisition under a will or by operation of law; and
- acquisition that results from an issue under a disclosure document in relation to an initial public offering (a company is floated onto the stock exchange and offers its shares to the public for the first time).

Note also that pursuant to the effect of **s 602**, the prohibitions on acquisition in **s 606** do not apply to an unlisted company with 50 members or less.

Permitted means of acquisition

[27.60] Together with acquisitions that are exempt because of their nature (such as under a will), **s 611** also sets out the means by which a bidder may proceed with a takeover even though the bid seeks to acquire an interest above the threshold of 20% in **s 606** and would therefore be otherwise in breach of that section. The permitted means are:

Off-market bid: This is an offer for securities in the target that must conform to the procedure outlined in **ss 632** and **633**. The relevant steps include the bidder preparing,

lodging with ASIC, and forwarding to the target a bidder's statement. The target also has responsibilities in that it must prepare a target statement and forward it to the bidder and its own shareholders. The target may be listed or unlisted, the bid may be partial, by way of cash and/or securities and some conditions are permitted.

Market bid: This type of offer takes place on the stock exchange. The relevant steps are set out in **ss 634** and **635** and are reasonably similar to an off-market bid. However, the target must be listed, the bid cannot be partial or conditional (the bid must be for all remaining securities in the class) and the consideration can only be cash. Note that Pt 5.12 of the *ASIC Market Integrity Rules (Securities Markets) 2017* impose various conditions upon announcements in relation to market bids.

Takeover procedure

[27.70] In both forms of permitted means of acquisition, the *Corporations Act* requires preparation of documentation aimed at providing sufficient information for the target company and its shareholders. The bidder must prepare a bidder's statement setting out its identity, intentions, means of payment and other material information. This is forwarded to the target company. The target company then prepares a target's statement for its shareholders. This is effectively giving the target's shareholders the benefit of the target directors' recommendations as to the bid. All relevant material enabling a decision by the shareholders is included together with an expert's report in certain circumstances (**s 640**).

The specific content of a bidder's statement is contained in **s 636**. The bidder must set out details of its intentions in relation to the continuation of the business of the target and any major changes to be made to that business. The bidder must also disclose its plans for the future employment of the present employees of the target. Various reports may be included in the bidder's statement such as an expert's report on non-cash consideration (**s 636(2)**). Where information (by experts or others) is included in a bidder's statement, it must be accompanied by a statement indicating the person's consent to the use of the information. The target's response must include all information that the holders of the bid class securities and their professional advisers would reasonably require to make an informed assessment whether to accept the offer under the bid. Directors of a target company who do not make recommendations in the target's statement must give reasons as to why a recommendation is not made (**s 638**).

Most takeover bids are off-market and involve consideration by way of cash and shares (that is, the target shareholder who sells their shares gets a cash amount plus a number of shares in the bidder company). In these situations, the material outlined in the bidder's statement as to its own business structure and prospects is particularly important in helping target shareholders decide whether to accept the offer.

The *Corporations Act* looks at parties' conduct regarding a takeover including: legitimacy of defence strategies, false and misleading conduct, and unsuitable information regarding offers. For example, **s 670A(1)** prohibits misstatements in, or

omissions from, takeover and compulsory acquisition and buy-out documents and includes in the conduct prohibited a misleading or deceptive statement in a document. Civil penalties apply to the section. An offence is committed pursuant to s **670A(3)** if a person contravenes **s 670A(1)** and the misleading or deceptive statement, or the omission or new circumstance is materially adverse from the point of view of the holder of securities to whom the document is given. The maximum penalty for the offence in Sch 3 is 5 years imprisonment. Note also the powers of the Takeovers Panel in **Pt 6.10 Div 2** regarding disputes relating to a takeover bid.

The following newspaper article indicates how takeovers often proceed, with bids being increased as a result of target board resistance to the offer and information concerning the takeover in both bidder's and target's statements being continuously modified and updated. As can be seen from the consideration offered, the bid is an off-market bid. Note that the takeover negotiations did not end with the offer referred to in the following article. The Dioro directors later recommended rejection of the Avoca offer although certain major Dioro shareholders had already accepted. There was also interest from another bidder, Ramelius Resources.

Dioro accepts sweetened takeover offer from Avoca

Dioro Exploration has caved in to predator Avoca Resources by recommending shareholders accept an improved takeover offer from the company after weeks of fighting against the move. Overnight, Avoca agreed to again sweeten its bid for Dioro by offering one share for every 2.3 Dioro shares held—an improvement on the previous offer of one-for-2.4 shares.

The new offer values Dioro at 74.6 cents a share compared with 71.7 cents under the previous offer, based on Avoca's last trading price of $1.715. The agreement comes after Dioro revealed its discussions with possible white knight bidder, Canadian miner Northgate Minerals, had collapsed and Avoca announced it had increased its stake in Dioro to 21.61 per cent.

Dioro said it would release it sixth target's statement soon, setting out reasons for the directors' recommendation.

Avoca chairman Robert Reynolds said he was pleased Dioro's board had decided to support the increased offer, which would allow shareholders to retain an interest in the company's 49 per cent owned Frog's Leg mine while becoming a shareholder in a mid-tier Australian gold producer with significant growth potential.

Avoca said it would release a formal notice of variation increasing its offer as well as a fourth supplementary bidder's statement soon.

Original source article by Stuart McKinnon, *The West Australian*

Conduct during a takeover

[27.80] Directors have both statutory and fiduciary duties. They may be exposed to liability during a takeover if they prefer their own interests above that of those shareholders they are elected to consider. In some cases, directors fear a takeover as they believe that a new controlling interest in the company will vote them out of office. Accordingly they may be inclined to recommend to the shareholders that they reject the offer. Clearly, a conflict of interest may arise. Conversely directors may see

benefits for themselves if a takeover succeeds and act accordingly. Not only are the duties in **ss 181, 182** and **183** relevant but as well **s 670A** specifically focuses upon takeover situations and prohibits misleading and deceptive statements in takeover documentation.

Defence strategies and tactics

[27.90] There are various long-term strategies that can be adopted by companies wishing to insulate themselves from takeovers. An example would be amending the constitution to provide that any proportional takeover bid require a resolution regarding the registration of the transfer giving effect to a takeover contract (see **s 648D**). Defence tactics can include a recommendation by the target's directors that the bid is inadequate. The bid can be criticised or the directors can release favourable information to the target's shareholders encouraging them to hold on to their shares. The payment of higher dividends or the issue of bonus shares may also achieve this purpose. However, with all defence tactics, directors of the target company must be particularly careful not to prefer their personal interests if such conduct is not in the interests of the target's shareholders. Directors may breach their duties if their recommendations are self-serving.

Obviously defence tactics and/or strategies will be relevant where the target board are opposed to, or have reservations about, the bid or the bidder. In a general sense, such takeovers are referred to as "hostile" takeovers. However, where both bidder and target are in agreement (a "friendly" takeover), a possible means of proceeding is pursuant to a scheme of arrangement in **ss 410-415**. Provided the scheme of arrangement is not being used to avoid the provisions of **Ch 6** (the area of the *Corporations Act* outlining the law as to takeovers), it will achieve the same result as a takeover—that is, control. In fact, the result of a scheme of arrangement will be that the major shareholder in the target (in effect the "bidder") moves to 100% ownership of the target. There are several differences though between schemes of arrangement and off-market takeovers. For example, schemes of arrangement must be approved by the court, takeover bids need not, and in schemes shareholders vote on the proposal whereas in a takeover target shareholders decide individually whether to sell or not.

The following newspaper article gives an example of the use of takeover tactics and refers to a standstill agreement of which there are several types. Generally a "standstill" limits, for a period of time, the number of shares a potential bidder can acquire in the target and allows for negotiation between the parties.

Cape and Caliburn try to solve standstill dilemma by making PCH takeover bid conditional

Cape, and its advisor Caliburn Partnership, has come up with an innovative attempt to overcome the refusal of the board of PCH to release the UK-based group from a standstill agreement

that prevents it from launching a hostile bid for, or buying shares in, the local contracting services group.

Cape has announced a formal cash offer of $1.30 a share—and made the bid conditional on PCH releasing Cape from the standstill. This completely alters the dynamics of the situation … and there is a formal offer under the *Corporations Act*.

Cape's wily tactics strongly ramp up the pressure on the PCH board. If the directors won't budge they run the risk that the institutional shareholders will requisition a meeting of shareholders to vote on board replacements. Any such initiative would have a strong chance of success, as the board and management speak for only 7 per cent of the capital.

Last month PCH announced it had unanimously agreed not to support a proposed cash offer of $1.30 a share because the directors considered it undervalued PCH and that shareholders would be better off in the medium to long term by holding on to their shares.

But now that Cape has announced a formal offer it will have to release a bidder's statement and PCH will be forced to issue a target's statement with its recommendation. Given the board is known to have obtained valuations, it's strongly arguable that such material will need to be included so target holders have all information they need to make an informed decision.

Original source article by Bryan Frith, *The Australian*

The Takeovers Panel

[27.100] The Takeovers Panel is set up under the *ASIC Act 2001* (Cth). It is a specialist panel designed to deal with takeover disputes quickly and efficiently. Target companies opposed to takeover bids may seek to disrupt the bid by challenging various aspects, but the Takeovers Panel's aim is to deal promptly with issues to allow transparency and genuine market forces to operate. If there are matters that need resolution, such as the failure of a bidder to provide prospective financial information when it could have done so, the Takeovers Panel is given power under **s 657A** to make a declaration of unacceptable circumstances. Following a declaration the Takeovers Panel may be entitled to make an order under **s 657D**, for example to protect the rights or interests of an affected party. Included in the orders available are the "remedial orders" set out in **s 9** (such as directing a person to disclose information).

The Takeovers Panel is, pursuant to **s 659AA**, the main forum for resolving disputes about a takeover bid. Its authority continues however it has come under scrutiny in a number of cases. In *Glencore International AG v Takeovers Panel* (2006) 151 FCR 77; (2006) 56 ACSR 753, Glencore breached the substantial holding provisions of the *Corporations Act*, where pursuant to **s 671B** a relevant interest in 5% or more of a listed company's shares must be disclosed. The breach occurred through the use of equity swaps (agreements that involve payments between parties dependant on the rise or fall in the share price). The Takeovers Panel declared that Glencore's conduct constituted unacceptable circumstances under **s 657A**. However, the court found that the Takeovers Panel had failed to give proper reasons to support its declaration and consequential orders and that accordingly it did not have jurisdiction to exercise the powers under **s 657D**. Further the term "substantial interest" in **s 657A** was held to mean an interest in the company's shares that could impact on the control of the

company, however in this case it was held that Glencore's conduct did not amount to this.

In response to the *Glencore* decision, and to dispel any uncertainty concerning the powers of the Takeovers Panel, the *Corporations Amendment (Takeovers) Act 2007* (Cth) was introduced in May 2007. The *Corporations Act* was duly amended to expand the definition of a "substantial interest" in **s 602A** by setting out that a "substantial interest" is not limited to: a relevant interest in the company's securities; a legal or equitable interest in the company's securities; or a power or right in relation to the company or securities in the company. Pursuant to **s 657A(2)(a)**, the Takeovers Panel may make a declaration of unacceptable circumstances even if it considers that the effect of the conduct complained of is only "likely" to be unacceptable. **Section 657A(2)(b)** allows a declaration of unacceptable circumstances where such circumstances are unacceptable because they contravene a provision of **Ch 6**. The purposes of **Ch 6** are set out in **s 602**. **Section 657D(2)(a)** enables the making of orders protecting the rights of parties, even if the rights protected by the orders were not necessarily the rights affected by the conduct. This was a technical issue that arose in the *Glencore* case regarding the impact of the Takeover Panel's orders.

The effectiveness of the Takeovers Panel was further and more critically challenged in *Australian Pipeline Limited v Alinta Ltd* (2007) 159 FCR 301; [2007] FCAFC 55. The issue revolved around whether the Takeovers Panel was, in the carrying out of its role, exercising judicial functions. The decision of the Full Federal Court was reversed on appeal to the High Court. The case involved a takeover by Alinta of AGL in 2006 that led to an agreed merger of their infrastructure businesses. Alinta's initial takeover had generated acceptances from some AGL shareholders. These acceptances meant that Alinta had a "relevant interest" in those AGL shares, which combined with its pre-existing shareholdings in AGL gave it more than 20% of the voting shares in AGL. **Section 608(3)** provides that once the 20% threshold is obtained, the shareholder will have a "relevant interest" in the securities held by the takeover target. In this case, this meant that Alinta had a "relevant interest" in the securities held by AGL in the gas pipeline trust APA (approximately 30% of all units in APA). Alinta then purchased more units in APA on the market in breach of **s 606** which prohibits the acquisition of relevant interests above 20% without a formal takeover being announced (or another exception to the prohibition being available under **s 611**).

The Takeovers Panel ruled that Alinta's conduct amounted to unacceptable circumstances under **s 657A** because the level of its holding in APA discouraged a competing takeover and therefore led to an inefficient market for the units in APA. The Takeovers Panel ruling was challenged in the Full Federal Court. In that Court, it was held (by majority) that the Takeovers Panel's power to declare actions to be unacceptable circumstances on the basis of breaches of the *Corporations Act* (**s 657(2)(b)**) was an exercise of judicial power because it decided upon the legal rights of the parties arising out of prior conduct. The Full Federal Court held that as the Takeovers Panel was not a federal court established under the Constitution, it could not exercise judicial power and that therefore its ability to make declarations of unacceptable

conduct were unconstitutional. On further appeal to the High Court, the decision of the Full Federal Court was overruled. The High Court held that the Takeovers Panel was not a judicial body exercising judicial functions (*Attorney-General v Alinta Ltd* (2008) 233 CLR 542; 82 ALJR 382). Kirby J considered that the manner in which the Takeovers Panel received its powers went "beyond the language in which judicial decision-making functions are typically conferred". He also focused on the fact that the Takeovers Panel's powers were not absolute or conclusive and that the Takeovers Panel does not have capacity to enforce its own orders. Accordingly, the constitutional objection to the Panel's authority was not considered decisive and it continues to function as the main forum for the resolution of takeover disputes.

The Takeover Panel's power to declare circumstances to be unacceptable is very wide, and it is not necessary for the Panel to decide that a person or company caused the relevant circumstances or is responsible for them. Circumstances may be unacceptable due to inadvertence, and despite the best of intentions. The Panel is required to take the public interest into account when considering whether or not to make a declaration of unacceptable circumstances. Accordingly, the Takeovers Panel will not merely consider the commercial interests and convenience of the parties and their shareholders directly involved before it in a dispute but will also consider wider issues such as the perception or outlook of the market and the wider investing community. The following newspaper article includes some examples of matters that may be considered by the Takeovers Panel.

Rey taken to panel

NSW coal producer Gujarat NRE Minerals has taken its takeover target Rey Resources to the Takeovers Panel in relation to a rights issue Gujarat believes is designed to frustrate its bid. At the very least, the issue is opportunistic because the offer has significantly boosted Rey's share price, enabling it to pitch the issue at a much higher price per share than would otherwise have been possible.

Directors of Rey rejected the offer as inadequate and said they, as owners of approximately 20 per cent of the capital, would not accept, which would mean that the minimum acceptance condition (of 90%) could not be satisfied (however, that can be waived by Gujarat).

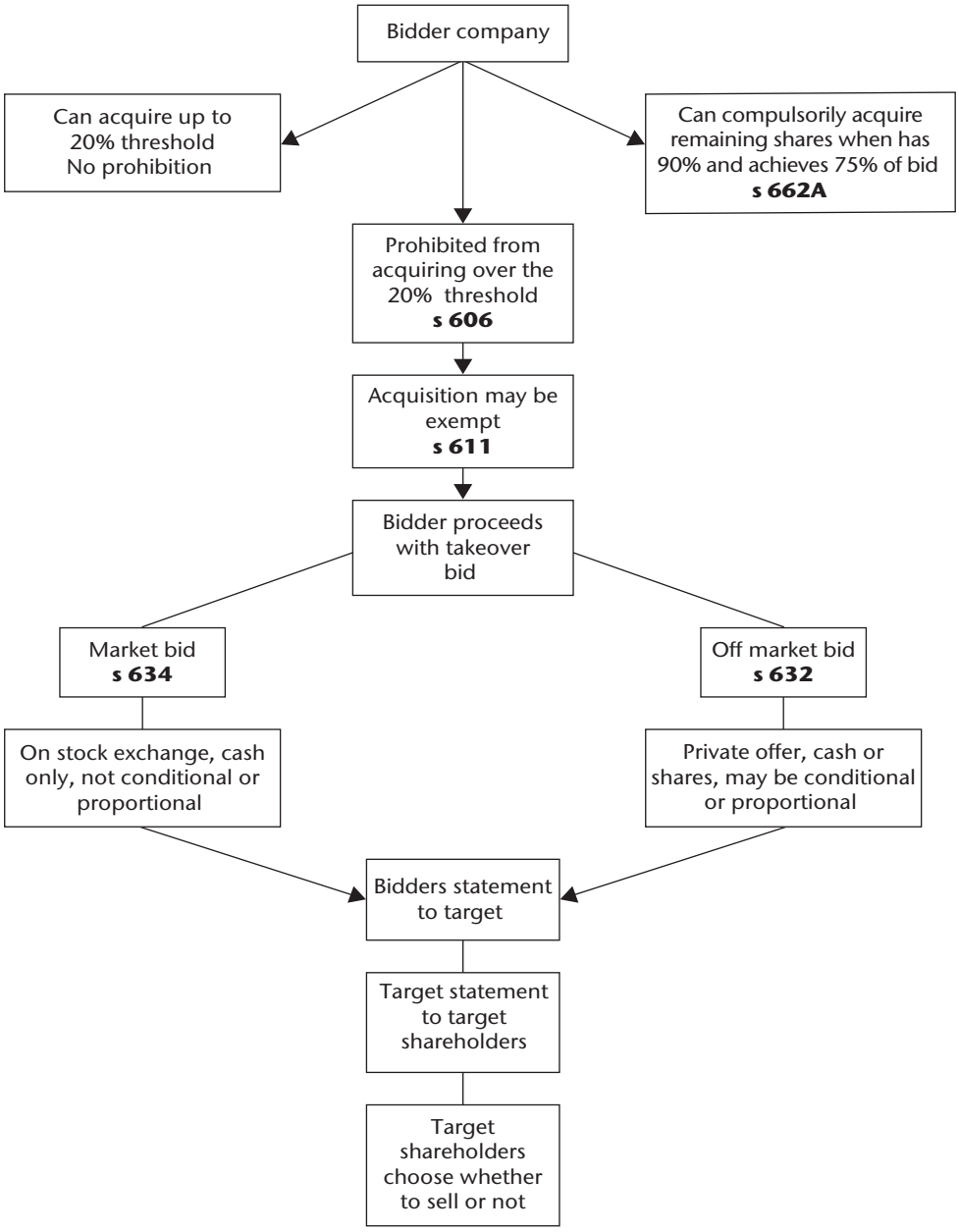
The panel in the past has required companies to seek shareholder approval for proposals that could defeat a condition of a bid. Rey doesn't intend to seek shareholder approval, claiming it is not needed because the issue is fair to shareholders as a whole and does not defeat the Gujarat scrip bid.

The panel considers a number of factors in determining whether a rights issue during a takeover might constitute unacceptable circumstances. Key issues are whether there is a genuine need for the funds; the issue discount; whether it is renounceable or non-renounceable; and whether steps have been taken to deal with a shortfall, such as a shortfall facility to enable shareholders to take up shares not subscribed for by other holders.

Original source article by Bryan Frith, *The Australian*

Overview of a takeover

[27.110]



Summary—Takeovers

Involve a company (the bidder) seeking control of another (the target)

Control is achieved by the bidder acquiring the target's shares

The aim of the *Act* is to allow target shareholders ample information

There is a threshold for acquisition of 20% in **s 606**

Takeovers regulation becomes relevant once the bidder acquires over the 20% threshold

Regulation applies to acquisitions between 20% and 90%

Once bidder at 90%, provisions as to compulsory acquisitions may apply

Acquisitions that are exempt from the prohibitions in **s 606** are found in **s 611**

Exceptions include creeping takeover; acquire under a will; IPO

Main exceptions are acquisitions by one of the permitted means of acquisition

Permitted takeovers can be by way of a market bid or an off-market bid

Off-market bids are more flexible and consideration can be by way of cash and shares

Procedure involves a bidder's statement which sets out the terms of the bid

Following the bidder's statement there is a target's statement from the target to its shareholders

Target's statement includes directors' recommendations

Directors must comply with their duties

If there is a dispute between the parties to a takeover, it is referred to the Takeovers Panel

28
Financial Services and Markets

Regulating for an efficient and equitable market

[28.10] **Chapter 7** of the *Corporations Act 2001* (Cth) regulates the provision of financial services, individual and corporate conduct in relation to financial products, the offer of financial products for sale and the operation of financial markets. This regulation involves trading in shares, debentures and options (these are included in the definition of a "security" in **s 761A**) as well as the establishment and operation of managed investment schemes. The definition of a managed investment scheme is contained in **s 9**. It will have the following features: contributions of money or money's worth as consideration to acquire rights to benefits produced by the scheme; the contributions will be pooled or used in a common enterprise; members do not have day-to-day control over the operation of the scheme. Examples include cash management trusts and schemes offering investment in forest plantations.

Chapter 7 was introduced to compliment the reforms brought about by the *Financial Services Reform Act 2001* (Cth) and creates a framework for regulation of financial products and services generally. A financial product includes making a financial investment (**s 763A**), which includes giving money or money's worth (non-cash benefit) to another to generate financial return. This includes investing in shares, debentures and managed investment schemes (see **s 763B**). Also included in the description of a financial product is managing a financial risk such as taking out insurance (**s 763C**) and making non-cash payments such as making payments by means of a facility for direct debit of a deposit account (**s 763D**). To further clarify which financial products are regulated by **Ch 7**, **s 764A** specifically lists financial products that are included in the regulation and **s 765A** specifies those that are not.

A financial service is provided by those who provide financial product advice or deal in a financial product (**s 766A**). Financial product advice means making a recommendation or statement that is intended (or could reasonably be regarded as intended) to influence a person's decision in relation to a financial product or class of financial products (**s 766B**) and dealing in a financial product involves applying for, acquiring, issuing or disposing of that financial product (**s 766C**). A financial service also involves making a market for a financial product, which includes the provision of a trading facility such as that currently undertaken by ASX.

Specifically, in relation to the trading of securities, **Ch 7** focuses on:

- the conduct of the stock exchange;
- the relationship between the participants in the market and the stock exchange, that is, the market's operating rules (**Pt 7.2, ss 793A-793E**);

- the licensing of dealers, advisers and others, that is, the providers of financial services (**Pt 7.6**); and
- improper market practices (**Pt 7.10**).

The regulation of financial markets in **Ch 7** is achieved by:

- promoting the supply of accurate and timely information (efficiency, flexibility and innovation);
- policing instances of market manipulation;
- maintaining dealer standards (fairness, honesty and professionalism); and
- promoting an unfettered secondary market and investment efficiency (fair, orderly and transparent markets for financial products).

Note that the regulation found in **Ch 7** is supplemented in other parts of the *Corporations Act*. For example, the important concept of disclosure to the market, which is particularly relevant to the trading of financial products such as securities, is addressed in the continuous disclosure provisions found in **ss 674-678**. ASIC plays an important role in the regulation of financial markets and the provision of financial services. It is given wide powers by the *ASIC Act 2001* (Cth) and investigates the practices and misconduct of listed companies as well as brokers and traders. It monitors the ASX and provides standards for the education and training of financial service providers.

An efficient and equitable market for securities encourages investment in public companies. If investors are confident, they will readily participate in company fundraising, thereby contributing the capital needed for commercial growth. Shares will be traded more readily, where effective regulation is in place. In June 2009, former government advisory body CAMAC released a report concerning aspects of market integrity. The report looked at how market and investor confidence could be maintained, focussing on dealings by directors in the shares of their companies, spreading of false and misleading information (rumour-mongering) and the relationship between market disclosure and corporate briefing of analysts. The following newspaper article discusses CAMAC's report and raises issues concerning the effectiveness of the regulation of the securities market. Note that the report resulted in ASIC introducing regulations to monitor market integrity. ASIC's Market Integrity Rules are now an important part of the overall regulation of share trading and investor confidence. The article nonetheless provides a perspective on the need for the improvement of industry standards regarding the responsible handling of rumours and more generally the spreading of misleading information. This issue is related to the corporate management of confidential information and has been the subject of an ASIC report, *Consultation Paper 118 Responsible handling of rumours*. In the paper, ASIC noted that confidence in the integrity of Australia's markets could be undermined if investors believe rumours are actively spread in the market to distort proper price discovery.

Heard the whisper about integrity?

In a perfect world there would be perfect dissemination of information and the integrity of share markets and investor confidence would be … well, perfect. But because market participants are not perfect, regulators are forever corralling new groups of experts to research ways to limit all those behavioural characteristics that disadvantage ill-informed mug punters and reward those with superior market intelligence.

Information is power and no matter which market constituent is examined those with better information will naturally try to use it for their own advantage.

Even discounting such extreme behaviour as insider trading or spreading false information to manipulate share prices for direct personal gain, there is a whole other level of information arbitrage that operates in markets and is near impossible to police. Company directors or executives massage information and its delivery to enhance their company's prospects—which in turn enhances the company's share price. They do this through the media or through stockbrokers.

Stockbrokers understand the value of superior corporate intelligence and trade this to their institutional clients. This enhances their value to clients and ultimately they will be paid for it via share trading commissions. The media seek an information edge and use it to sell more newspapers—thus increasing readership and the commercial returns for their proprietors.

Institutional shareholders are willing recipients of any information from stockbrokers or companies that will improve the performance of their funds. Better information means better returns and leads to better inflow of funds. All the participants understand that there is money to be made in having better information. Much of this information is about shades of grey and as such it is particularly difficult to regulate and even harder to prosecute.

At the height of the market meltdown plenty of—if not false—exaggerated rumours were spread to manipulate stock prices. No meaningful prosecutions ensued. The regulator, the Australian Securities and Investments Commission, couldn't find participants to turn themselves or their competitors in.

CAMAC suggested guidelines on rumour-mongering, including policies and procedures to deal with rumours received, such as reporting to ASIC anyone suspected of spreading them, and the ability for the watchdog to make banning orders against people who contravene the guidance on rumour mongering. It is difficult to see how this would make any meaningful difference.

I wouldn't be betting the farm on prosecutions from "dobbing in a gossip". In my view it will continue to be a hard-fought battle.

Original source article by Elizabeth Knight, *The Sydney Morning Herald*

The issues surrounding the spreading of rumours are similar to those arising when a hoax is perpetrated by a person creating a fake media release about a company. **Section 1041E** targets making or disseminating statements that are false or misleading in circumstances, where the information is likely to induce trading in financial products (shares). In 2013, a hoax in relation to mining company, Whitehaven Coal Ltd, led ASIC to pursuing criminal charges under **s 1041E**. In its Media Release, 13-187 ASIC set out its allegation that the accused individual "disseminated a false media release which stated the ANZ Banking Group Ltd (ANZ) had announced that it had withdrawn its $1.2 billion loan facility to Whitehaven Coal which was primarily intended to develop the Maules Creek Coal Project. ANZ had not made any such announcement". At the hearing of the matter (*R v Moylan* [2014] NSWSC 944), the defendant pleaded

guilty to a breach of **s 1041E** and was sentenced by the Supreme Court of NSW to imprisonment for one year and eight months but immediately released on payment of a recognisance to be of good behaviour.

The relevance of ASIC's policing of conduct concerning misleading information (such as rumours) or false press releases is that they are examples of conduct that has the possibility of panicking investors and skewing share price. This then can have a severe effect on a company's worth in the market. The issue is related to the focus of both the continuous disclosure provisions in **s 674** and the insider trading prohibitions.

A large number of Australians own shares. Most share ownership is direct, through shares or other listed investments and accordingly, the successful regulation of the share market is an important priority of parliament and legislators. The goal is a fair and accessible market and to achieve this end parliament and the relevant reform bodies must constantly monitor market sentiment and trends. In this regard, a significant change to the operation of the market occurred upon the introduction of the *Corporations Amendment (Financial Market Supervision) Act 2010* (Cth). From 1 August 2010, ASIC took over the functions previously performed by the ASX regarding the supervision and surveillance of financial markets and market participants. Previously, each individual financial market, and particularly the ASX, supervised the operation of its own market. The changes introduced in 2010 created a single unified supervisor for market participants. However, the ASX has not lost all of its supervisory functions as it is still responsible for companies listed on the ASX, including continuous disclosure obligations.

Section 798F sets out that ASIC has the function of supervising financial markets whose operators are licensed under **s 795B**. This section deals with granting an application for an Australian market licence, which pursuant to the definition in **s 761** authorises a person to operate a financial market. A financial market includes a facility through which offers to acquire or dispose of financial products are regularly made or accepted (**s 767A**), and a financial product is a facility through which, or through the acquisition of which, a person makes a financial investment, manages a financial risk, or makes non-cash payments (**s 763A**).

Through the implementation of its market integrity rules, ASIC has taken on a more detailed role in the oversight of the financial market. **Section 798G** provided for the introduction of the market integrity rules. ASIC can enforce the rules and to this end **s 798H** requires compliance and **s 798J** enables ASIC to make directions. The rules apply to: the activities or conduct of the markets; the activities or conduct of persons in relation to the markets; and the activities or conduct of persons in relation to financial products traded on the markets. ASIC requires Ministerial consent before making any rules. The rules cover several aspects of the market. For example, where a market participant has reasonable grounds to suspect conduct amounting to suspicious activity in relation to a share transaction, including insider trading, or conduct creating an artificial price, or creating a false or misleading appearance of active trading, the market participant is required to notify ASIC (Pt 5.11, *ASIC Market*

Integrity Rules (Securities Markets) 2017). Different penalties apply to each of the market rules. For instance, the maximum penalty under Pt 5.11 (concerning suspicious activity reporting) is $20,000, whereas the penalty under Pt 7.4.2 (concerning providing regulatory data) is $1 million.

The ASX

[28.20] Securities are traded on the stock exchange (ASX). ASX Limited is the holding company of a group with a diverse range of market activities. ASX Limited is responsible for primary and secondary market services. It functions as a market operator, clearing house and payments system facilitator. It polices compliance with its operating rules and sets standards of corporate governance. Since 2011, new financial market operators, including Chi-X Australia Pty Ltd, began offering alternative markets for trading ASX listed securities. However, the ASX remains the most dominant and important financial market. If a company is listed on the ASX, members of the public, as well as institutional investors, can buy its shares. Not all public companies are listed. When a company seeks listing, it must apply to the ASX and comply with the ASX Listing Rules, which contain requirements as to the minimum number of shareholders, the proportion of related party shareholders, and importantly the profitability or the assets of the company seeking listing. Where companies or government bodies seek funding and issue their securities to the public for the first time (ie, by way of an initial public offering—IPO) the market created for the raising of this new finance is called the primary market. Once securities are issued, they can be traded by investors seeking profit. This is called the secondary market. Even though the term "securities" includes forms of investments other than shares (such as debentures), most trading on the stock market involves shares. Shares return a revenue profit when a dividend is received and a capital profit (or loss) upon sale (disposition).

The primary responsibilities of the ASX are to monitor its markets and, in accordance with, and to the extent of, it is designated role, to oversee and supervise market participants. Its objectives are to provide a fair and well-informed market for financial securities together with an internationally competitive market. It oversees compliance with its operating rules, promotes standards of corporate governance among Australia's listed companies and provides information aimed at the education of retail investors.

The ASX operating rules and procedures currently regulate in a number of ways. The companies and trusts whose securities are listed are regulated by the ASX Listing Rules. These impose strict requirements on listed companies and set out prerequisites to listing, such as minimum numbers of shareholders and profit or asset tests, and impose ongoing regulation such as the continuous disclosure requirements. The relationships between market participants such as stockbrokers, their clients and the ASX are also regulated. These rules, which may be referred to as market rules, have the effect of, and are enforceable as, a contract between the ASX and the market participants, and between the market participants themselves (**s 793B**). Both the listing rules and the

market rules are included within the definition of operating rules in **s 761A** and are enforceable pursuant to **s 793C**.

Australian financial services licences

[28.30] Persons involved in the securities industry in general (eg, stockbrokers and investment advisers) must be licensed. The requirement in **s 911A** is for a person who carries on a financial services business providing financial services to hold an Australian financial services licence. Civil penalties apply to the section. ASIC must be satisfied that there is no reason to believe that the applicant is not of good fame and character (**s 913B**). If the applicant is a company, it will be the character of its officers that will be relevant, if a partnership, it will be the character of the partners relevant to the licence. In assessing this requirement of good fame and character, ASIC must have regard to any conviction within the last 10 years for serious fraud or whether the applicant has had a previous financial services licence cancelled.

An Australian financial services licensee may authorise a representative to provide financial services on their behalf. This could include an employee or, specifically where the licensee is a company, a director. Holders of an Australian financial services licence would include businesses that buy, sell or underwrite shares, or advise upon securities, or publish securities analysis.

An important goal of the *Corporations Act* and an essential component of the confidence of investors in the share market is the principle of adequate and timely disclosure. The main types of disclosure documents in **Ch 7** are a Financial Services Guide (**ss 941A** and **941B**), which includes information about the provider of the services, details of any commission payable and remuneration generally and any relevant associations (**s 942B**); a Statement of Advice (**s 946A**), which includes the financial advice, information as to its basis and commissions and other remuneration (**s 947B**); and a Product Disclosure Statement, which will be prepared by the issuer of the financial product in certain circumstances. Holders of an Australian financial services licence have various obligations that include providing efficient, honest and fair service, complying with the licence conditions and complying with the financial services laws. Further, all representatives of the licence holder must be adequately trained and risk management must be in place.

For the purposes of the disclosure obligations of financial services licence holders, **Ch 7** distinguishes between a "retail" client and a "wholesale" client. The particulars of the distinction are set out in **s 761G**. The client (being the recipient of the financial services or product) will be a wholesale client where (figures are from *Corporations Regulations 2001* (Cth)): the price for the provision of, or the value of, the financial product is at least $500,000 (this category of investor is referred to in **s 708** as a "sophisticated investor"); the financial product or service is used in connection with a business that is not a small business (ie, over 100 employees in a manufacturing business, and over 20 otherwise); the financial product or service is provided in relation to a business and the person who acquires the product or service has net assets

of at least $2.5 million or a gross income for each of the last two financial years of at least $250,000; or they are a professional investor. Where a person does not satisfy the criteria for a wholesale client, they will be classified as a retail client (subject to certain exclusions, including general insurance and superannuation products). The distinction between a retail client and a wholesale client is basically that between the smaller investor that requires greater disclosure to assist decision making (retail) and the larger or more experienced and resourced investor that will have access to more detailed information and be less dependent on information provided by the company (wholesale).

Chapter 7 has been amended in line with the Future of Financial Advice (FoFA) reforms. The initial regulatory changes came about as the result of the *Corporations Amendment (Future of Financial Advice) Act 2012*. The reforms have affected the ways in which financial advisers deal with their clients, particularly in relation to imposing a statutory duty on advisers to act in the best interests of their clients and by banning certain types of conflicted remuneration. Pursuant to **s 963A**, "conflicted remuneration" means any monetary or non-monetary benefit given to a licensee or representative who provides financial product advice to retail clients that could reasonably be expected to influence financial product advice, by either influencing the choice of financial product being recommended or by otherwise influencing the financial product advice. Legislative amendment in relation to the offering of financial products is ongoing. For example, the *Corporations Amendment (Financial Advice Measures) Act 2016*, which identifies benefits that will fall outside of the definition of conflicted remuneration.

Regulating market conduct

[28.40] To ensure an equitable market, certain conduct regarding financial products such as securities is prohibited. Unfair advantages and false markets result in an overall lack of confidence in the ability of the *Corporations Act* to effectively regulate the market for financial products. Accordingly, matters such as short selling, market manipulation or rigging, false or misleading statements or conduct, and insider trading, are prohibited in **Ch 7** with both civil and criminal penalties available.

Those involved in the securities market rely on the legislation to nullify, as best as possible, the results of improper conduct. Because the trading of shares, and in fact the value of shares, are intricately related to the market's perception of the worth of the relevant corporation, any false or artificial foundations for the establishment of the share price directly affects investor confidence. Investors must not be left in any doubt that the provisions of the *Corporations Act* are capable of, and in fact are, ensuring that the market for financial products is equitable, predictable, transparent and secure. **Chapter 7** seeks to do this by regulating conduct (regarding financial products generally, including securities) in the following sections:

Section 1020B—This section prohibits short selling, which involves contracting to sell securities, managed investment products or other financial products (called collectively

s 1020B products) at a time when the seller does not own them. The section sets out that a person can only sell **s 1020B** products if they have a presently exercisable and unconditional right to vest them in the buyer. Breach is an offence (**s 1311**).

Section 1041A—This section is headed "Market manipulation" and prohibits transactions which have the effect, or are likely to have the effect, of creating, or maintaining, an artificial price for trading in financial products.

Section 1041B—False trading and market rigging which creates a false or misleading appearance of active trading in, or with respect to the market for, financial products by fictitious or artificial transactions is prohibited by this section. In *North v Marra Developments Ltd* [1979] 2 NSWLR 887; (1979) 4 ACLR 585, the court held that even though the actions taken by the directors were aimed at the share price reflecting the true worth of the company, a misleading appearance was still created and the relevant section breached. Regardless of the good intentions of the directors, the share price must be established by the forces of genuine supply and demand. For the purposes of **s 1041B**, a person is taken to create a false or misleading appearance of active trading, where any transaction to buy or sell a financial product does not involve any change in the beneficial ownership; that is, the person or entity entitled to the benefit, profit or advantages in relation to the financial product remains the same even though a transaction takes place.

Section 1041C—This section prohibits entering into or engaging in fictitious or artificial transactions or devices if they result in maintaining, inflating or depressing, or cause fluctuations in, the price of financial products such as securities.

Section 1041D—Circulation or dissemination of statements or information, or involvement in such action, that affects the price of a financial product and contravenes **ss 1041A**, **1041B** and **1041C**, as well as **ss 1041E** and **1041F**, is prohibited.

For each of **ss 1041A**, **1041B**, **1041C** and **1041D**, breach is an offence (**s 1311** and **Sch 3**: 15 years' imprisonment and a pecuniary penalty for an individual calculated pursuant to **s 1311B**). The sections are also civil penalty provisions.

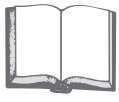
Section 1041E—Pursuant to this section, a person must not make a statement or disseminate information if the statement or information is false or materially misleading and likely to induce persons to apply for or dispose of financial products. The section also targets statements or information that affect (increase, reduce, maintain, or stabilise) the price for trading in financial products.

Section 1041F—Conduct which is prohibited by this section includes inducing persons to deal in financial products by false or deceptive forecasts, dishonest concealment, or by the recording or storing (by mechanical, electronic or other device) information known to be false or misleading.

Section 1041G—This section targets dishonest conduct in relation to a financial product or service by those persons engaged in the course of carrying on a financial services business.

For each of **ss 1041E**, **1041F** and **1041G**, breach is an offence (**s 1311** and **Sch 3**: 15 years' imprisonment and a pecuniary penalty for an individual calculated pursuant to **s 1311B**). Though these three sections are not civil penalty sections, civil liability under **s 1041I** may apply. The imposition of civil liability for breach of **ss 1041E**, **1041F** and **1041G** means that a person who suffers loss and damage by the conduct of another person engaged in a contravention of one of these sections may recover the amount of that loss and damage from that other person.

Section 1041H—A person must not engage in conduct in relation to a financial service or financial product that is misleading or deceptive or likely to mislead or deceive. This is a civil liability section only. In *ASIC v Narain* (2008) 66 ACSR 688; [2008] FCAFC 120, an announcement released to the ASX by a company concerning a product alleged to be a solution to the spread of the HIV virus was held to be misleading or deceptive even though the announcement did not refer directly to the company's shares. The company's conduct came within the matters set out in **s 1041H(2)(b)**, which include doing any act related to the publishing of a notice in relation to a financial product. Another example of conduct that was held to breach **s 1041H** is found in *ASIC v Macdonald (No 11)* (2009) 71 ACSR 368; [2009] NSWSC 287. In this matter (see facts under "Corporate social responsibility and corporate governance" in [20.100]), the court held that by forwarding information (PowerPoint slides) to the ASX indicating a medical foundation set up to pay future claims upon the company was sufficiently funded, the company breached **s 1041H**. The breach arose by engaging in conduct that was misleading or deceptive, or likely to be so, in relation to a financial product, being the company's shares. **Section 1041H** is one of the several sections in the *Corporations Act* that imposes either direct or accessorial liability on directors. Business confidence requires an effective balance between encouraging, and regulating, entrepreneurship.



[Jason Harris and Suzanne Webbey, "Personal liability for corporate disclosure problems" (2011) 29 *Companies and Securities Law Journal* 463 at 476.]

> The importance of timely and accurate disclosure of corporate information to the Australian capital markets is undoubted. However, seeking full and fair disclosure of accurate information does not require disclosure of information at any cost. We must recognise that the disclosure imperative comes at a considerable economic cost, and we should attempt to balance the cost of disclosure laws with the economic prosperity that the laws aim to further. It is clear that for disclosure laws to have widespread impact requires the establishment of effective enforcement mechanisms against both the individuals involved and the corporations for which they work.

Insider trading

[28.50] The insider trading provisions of prior legislation regulating corporations had not been extensively used and successful prosecutions had been difficult to achieve.

This resulted from the need to satisfy the strict criminal burden of proof. Since the introduction of the *CLERP Act 1999* (Cth), the civil penalty provisions have applied to insider trading. This, together with the fact that ASIC has become more active in relation to policing market manipulation generally, has resulted in a greater focus on insider trading.

Section 1043A sets out the prohibited conduct, which includes the possession of inside information and **s 1042A** sets out the meaning of inside information. An insider is a person who deals in **Div 3** (of **Ch 7**) financial products (this is the description given by the *Corporations Act* to the various products and interests covered by the insider trading provisions and includes financial products, debentures and importantly, securities) when they possess price sensitive information that is not generally available but if it were generally available a reasonable person would expect it to have a material effect on the price or value of the particular **Div 3** financial product. It is a reasonable, hypothetical person who will be relevant to the objective standard as to whether the information would have a material effect on the price of the securities. This means it would influence persons who normally deal in securities as to whether they buy or sell.

As insider trading depends upon a person having inside information, the means and scope of assessing what such information should include are relevant to the effectiveness of the prohibitions. The definition of information is in **s 1042A** and is wide enough to enable the effective implementation of the insider trading provisions. **Section 1042A** includes in the definition of "information" matters of supposition and other matters that are sufficiently definite to warrant being made known to the public, and matters relating to the intentions or likely intentions of a person. A body corporate will be deemed to possess information that is possessed by its officers if the information came into the officer's possession during the course of performing their duties (**s 1042G**). Once it is determined that a person possesses inside information that person is prohibited, via **s 1043A**, from dealing with that information if they know or should reasonably know that it is not generally available but if it were, a reasonable person would expect it to have a material effect on the price. According to **s 1043A**, an insider must not apply for, acquire, or dispose of the relevant financial products (or procure another person to) or enter an agreement to that effect. That is, the insider cannot trade or tip in relation to the securities and cannot induce or encourage (**s 1042F**) others to do so. No connection between the insider and the relevant body corporate is necessary for the application of the prohibitions.

In the matter of *Hannes v Director of Public Prosecutions (Cth) (No 2)* (2006) 60 ACSR 1; [2006] NSWCCA 373, the court dismissed an appeal by Mr Simon Hannes against a conviction recorded against him in 2001 in relation to the insider trading provisions of the *Corporations Act*. Mr Hannes was a director of Macquarie Corporate Finance (MCF), a division of Macquarie Bank Ltd during the time that the company advised TNT Ltd (TNT) in relation to a friendly takeover by a Dutch company. Approximately two weeks prior to the takeover, a large amount of call options in TNT were purchased by Mr Hannes under another name. When the takeover announcement was made

public, the call options retuned a profit of over $2 million. Mr Hannes was not part of the team providing advice to TNT, however, the prosecution alleged that he had access to the relevant information and made use of it. Mr Hannes was sentenced to a jail term (which has been completed) and fined.

The Court of Criminal Appeal in dismissing the appeal considered various aspects of the offence including the width of the definition of "information" (the relevant section is **s 1042A**). In essence, the court held that even though the information may be vague or imprecise, the source of information may outweigh the imprecision and take considerable importance. Further, it could not be concluded that just because a part of the information was generally available that the information as a whole was generally available.

Market confidence is an important outcome of efficient insider trading laws. Accordingly, the accuracy or otherwise of information relied upon by the insider will not determine whether the relevant provisions can be invoked. In *Mansfield v The Queen* (2012) 247 CLR 86; [2012] HCA 49, a managing director of a listed company allegedly provided incorrect information to certain shareholders who then purchased shares in the relevant company. The High Court held that the fact that the information may have been inaccurate did not prevent the prosecution preceding. As to the meaning of information, the Court set out at [29] of the judgment:

> The word "information" in its ordinary usage is not to be understood as confined to knowledge communicated which constitutes or concerns objective truths. Knowledge can be conveyed about a subject-matter (whether "fact, subject, or event") and properly be described as "information" whether the knowledge conveyed is wholly accurate, wholly false or a mixture of the two. The person conveying that knowledge may know or believe that what is conveyed is accurate or false, whether in whole or in part, and yet, regardless of that person's state of mind, what is conveyed is properly described as "information".

Defences to insider trading

[28.60] The *Corporations Act* enables a person possessing inside information to avoid a breach of **s 1043A** in circumstances where they trade on the basis of their own intentions or activities. **Section 1043H** sets out that a person does not contravene **s 1043A(1)** by entering a transaction or agreement regarding securities merely because they are aware that they have entered or propose to enter a transaction or agreement regarding securities of the relevant company.

Another instance where a person does not contravene **s 1043A(1)** will be where the relevant information had been known for a reasonable period and came into their possession by means available to normal, regular or usual investors. That is, it had been made known in a manner that would in all likelihood bring it to their attention. Accordingly, if the relevant information is generally available (ie, observable or discoverable), then the possessor of that information will not have "inside information"

for the purposes of **s 1042A**. In **s 1042C**, information is described as generally available if it consists of readily observable matter or it has been made known in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest and that since it was made known, a reasonable period of time has elapsed. In *R v Firns* (2001) 51 NSWLR 548, the court held that information may be "readily observable" in terms of **s 1042C** even if no one actually observed it.

Other exceptions to the prohibitions in relation to insider trading exist in **ss 1043C** (underwriters), **1043D**, **1043E** (legal requirement), **1043F**, **1043K** (holders of financial services licence), and **1043F** and **1043G** (Chinese walls). The last of these, Chinese walls, are important in large organisations, where different parts of the company structure have different responsibilities in relation to the trading of securities. **Section 1043F** sets out that a body corporate does not contravene **s 1043A** merely by entering a transaction upon the basis of certain information if: the decision to enter the transaction was taken on behalf of a person other than the officer or employee in possession of the information; the company had in operation at the time arrangements that could reasonably be expected to ensure that the information, or any advice in relation to the transaction, was not communicated to the person who made the decision; and any such information or advice was not in fact communicated.

Criminal penalties for insider trading

[28.70] **Section 1043A** sets out conduct that is prohibited by a person in possession of inside information. The section provides for both civil and criminal penalties. A breach of the prohibited conduct in **s 1043A** is an offence under **s 1311** and **Sch 3** (15 years imprisonment and a pecuniary penalty for an individual calculated pursuant to **s 1311B**). These penalties are substantial and reflect the importance of regulating for an equitable and transparent market for securities.

An example of an insider trading matter where a criminal penalty was imposed is *R v Rivkin* (2003) 45 ACSR 366; [2003] NSWSC 447. Mr Rivkin was negotiating the sale of his property (real estate) to Mr McGowan, the CEO of Impulse Airlines. Qantas was about to purchase Impulse Airlines (thereby taking a competitor out of the market). McGowan informed Rivkin about the confidential transaction and Rivkin arranged for his family company to acquire Qantas shares. When the transaction became public knowledge, Qantas shares rose in value and Rivkin sold at a profit. He was convicted of insider trading, sentenced to nine months periodic detention and fined $30,000. In his judgment, at first instance, Whealy J (at [44]) summarised important principles in considering sentencing in insider trading cases:

> The element of general deterrence is important in white collar crimes. An important reason why this is so, relates to the often remarked difficulty in detecting and investigating white collar crime. Insider trading is particularly hard to detect. It may often go unnoticed but where it occurs it has the capacity to undermine to a serious degree the integrity of the market in public securities. It is especially important

that the sentencing process provide a firm disincentive to the carrying out of illegal activities especially by those who are engaged in the securities industry.

The facts of *R v Rivkin* are illustrative of the nature of inside trading and although Mr Rivkin made only a small profit on the trading of the shares his conduct was held sufficient to contravene the *Corporations Act*. An extract from the judgment of the Supreme Court follows (note that the decision was confirmed on appeal).

R v Rivkin [2003] NSWSC 447 (Whealy J)

Extract from Judgment

At [5]-[14], [20]-[24], [29], [67]-[70]

The starting point is the proposed sale of a property at 5 Rose Bay Avenue, Bellevue Hill. In April 2001 this property was owned by a company called Timsa 43 Pty Limited. This company was owned and controlled by the offender and his wife, Mrs Rivkin. The property was placed on the market for sale sometime prior to April 2001. It had in fact been passed in at auction. At the time the Group Operations Manager for the Rivkin Group was Spiros Dassakis. His responsibilities related to and included financial matters and organising contracts for the Rivkin Group. He had been instructed that the property was to be placed on the market for sale and it was his job to supervise and arrange the sale.

An Estate Agent was retained to effect the sale. This was Mr Bart Doff of Laing & Simmons at Double Bay.

Mr Gerard McGowan and his wife had been to inspect the property at 5 Rose Bay Avenue, Bellevue Hill and were very interested in buying it. Mr Gerard McGowan was the Chief Executive Officer of Impulse Airlines at the time. A meeting was organised at the office of Laing & Simmons for the morning of 24 April 2001. The meeting was scheduled for about 11.30am. Those present at the meeting included Mr Dassakis for the Rivkin Group and Mr Doff the agent involved in the sale. Mr Gerard McGowan attended and brought with him his brother Mark McGowan.

Prior to the meeting Gerard McGowan had spoken to Mr Doff and expressed an interest in buying the property. He had told him that he was waiting on a sale of part of his business to come through. He asked whether the Bellevue Hill property was likely to be on the market at a later date. He did not at that time inform Mr Doff of the nature of the sale to which he had made reference during their conversation. The agent had made clear to Mr McGowan that he could, if he wished, make a conditional offer. At that point of time it was Mr McGowan's understanding that Mr Rivkin owned the property.

The events of the meeting at the office of Laing & Simmons on 24 April 2001 were critical to the charge contained in the indictment. The meeting was relatively brief and, according to Mr McGowan, it began by his saying to Mr Dassakis that he was interested in the property. He was waiting, he said, for a sale of part of his business and for that reason it would be necessary for him to make a conditional offer. There was some further discussion during which Mr McGowan said that he informed Mr Dassakis that he did not want to tell him the details of the sale because it could

compromise Mr Dassakis and the other people in the room. Mr Dassakis, according to Mr McGowan, pressed to be told of the details of the negotiation to enable Mr Rivkin to make an assessment as to whether he would accept the conditional offer. Mr McGowan said that he then told Mr Dassakis that he was looking to merge Impulse with Qantas, and that he was waiting on ACCC approval at that stage. He also stated that he said to both Mr Dassakis and Mr Doff that now they were aware of the transaction, they could not trade in Qantas shares.

Mr Dassakis then tried to contact Mr Rivkin on his pager. He left a message for Mr Rivkin to call back urgently. Mr Dassakis spoke briefly to Mr Rivkin when he called on the telephone. Gerard McGowan was then invited to speak to Mr Rivkin on the phone. The conversation which followed was a brief one.

According to Mr McGowan he said to Mr Rivkin "I'm interested in purchasing your property. However, I am currently in merging my Impulse business with Qantas. We are waiting ACCC approval for that transaction". According to Mr McGowan, Mr Rivkin replied, "I don't believe that the ACCC would approve such a thing". Mr Gerard McGowan said to Mr Rivkin "I believe they will approve it". He told Mr Rivkin that he had several months of negotiation with ACCC on a variety of matters and he believed that they would approve the deal. He also said to Mr Rivkin—"Obviously now that you are aware of this you cannot trade in Qantas shares". According to Mr McGowan, Mr Rivkin responded, "Obviously a person of my standing would not contemplate such a thing".

I am satisfied beyond reasonable doubt that the conversation occurred substantially in the terms described by Mr McGowan. I am equally satisfied to the requisite degree that the version of the conversation given by Mr Rivkin in evidence was not true and that it did not occur in the terms he described. Although a major attack was launched on Mr McGowan's credit by senior counsel for the offender during the trial, it is quite apparent that the jury in substance accepted the evidence of Mr Gerard McGowan and, consistently with the jury's verdict, I do so as well. In addition, I am satisfied beyond reasonable doubt that Mr McGowan gave a warning to Mr Rivkin in the terms mentioned in his evidence. Mr McGowan said that he had taken advice from Impulse's legal counsel, Mr Rob Paice. It was explained to him that he had to warn people not to trade, that is, any person who was made aware of the dealings between Impulse and Qantas during the confidential period of the negotiations. This had been explained to Mr McGowan at the very commencement of the negotiations with Qantas. It seems quite clear and I accept that the warning given by Mr Gerard McGowan to Mr Rivkin was made as a consequence of the advice Mr McGowan had received from the company's legal advisor.

I am further satisfied beyond reasonable doubt that the effect of the conversation between Mr Gerard McGowan and Mr Rivkin on 24 April 2001 was to put Mr Rivkin in possession of the following information: (i) Mr Gerard McGowan said that there was a deal for the merging of Impulse's business with Qantas, (ii) Mr McGowan said that he had to wait until he had ACCC approval of the deal before making the purchase of the property at 5 Rose Bay Avenue, Bellevue Hill, and (iii) Mr McGowan said that he believed that ACCC approval would be forthcoming.

It is necessary at this point to say something of the deal between Impulse Airlines and Qantas. On 1 May 2001 at approximately 2pm, a joint announcement was made by the two companies. Impulse Airlines announced that it would withdraw from operating scheduled air services in Australia under its own brand. At the same time the joint announcement placed on public record that the two airlines had entered into a long term commercial relationship involving Impulse contracting to Qantas its eight Boeing 717 and thirteen Beechcraft aircraft complete with pilots and cabin crew. Impulse would operate Boeing 717 services for Qantas under the Qantas brand and livery to a number of destinations including the Gold Coast, Maroochydore, Hamilton Island and also between Melbourne and Hobart. Qantas would loan funds to allow Impulse to buy back its institutional shareholders' shares and also to provide working capital.

I return now to the events of 24 April 2001. It appears that following the conversation between Mr McGowan and Mr Rivkin on the telephone that morning, Mr Rivkin instructed Mr Dassakis to go ahead with the preparation of a contract for the sale of the house on the basis of a conditional contract containing a right of recision after seven days. Mr Dassakis organised the preparation of the contract through the solicitors who were acting for Timsa 43 Pty Limited. He said that it was his understanding that the sale was to be subject to Impulse Airlines entering into a financial arrangement with Qantas and that it required ACCC approval. The conditional contract was to be for a seven day period. Mr Dassakis executed the contract under a Power of Attorney given by Timsa 43 Pty Limited in his favour. Mr Dassakis said that he did not show the contract for sale to Mr Rivkin nor did he read to him any of the conditions in the contract.

At about ten to three in the afternoon of 24 April 2001 Mr Rivkin directed Adrian Kerstens, a SEATS operator for Rivkin Discount Stockbroking to purchase 50,000 Qantas shares in the name of Rivkin Investments Pty Limited. Thereafter, Mr Kerstens carried out Mr Rivkin's instructions and 50,000 shares were acquired at an average price of approximately $2.78 per share.

I am satisfied beyond reasonable doubt that on 24 April 2001 when Mr Rivkin gave instructions to Mr Kerstens he knew that the information which had been conveyed to him by Mr McGowan during the telephone conversation earlier on that day was information that was not generally available. I am also satisfied beyond reasonable doubt that at that time, Mr Rivkin knew that if the information were generally available, it might have a material effect on the price or value of Qantas shares.

The factors that have led me to conclude that Mr Rivkin knew that the information was not generally available and that it was, to use a shorthand phrase, price sensitive, are these: First, he caused the shares to be bought on the very day he received the information from Mr McGowan. It is quite clear that when he had the telephone discussion with Mr Kerstens the statements made by Mr McGowan to him about the deal with Qantas were virtually ringing in his ears. There can be no doubt whatsoever that he knew the information was not generally available and this is made clear beyond argument by the fact that Mr McGowan warned him that he was not to trade in Qantas shares. In addition, the entire circumstances surrounding

the telephone conversation on that day would have left Mr Rivkin in no doubt that the information was of a confidential nature.

Secondly, in relation to the price sensitivity of the information, it was, as I have suggested, no mere coincidence that the shares were bought on 24 April 2001. It is true that Mr Kerstens rang Mr Rivkin and during the course of the conversation remarked that there had been a lot of activity in Qantas and that "they looked interesting". It is of course, not necessary for the Crown to prove, as an essential element of the offence, that Mr Rivkin procured the purchase of the Qantas shares because of his possession of the insider information. But I am satisfied beyond reasonable doubt that, despite Mr Rivkin's evidence to the contrary, the insider information was an important factor in his decision to order the purchase of the 50,000 shares on 24 April 2001. I reject his evidence to the contrary as untrue.

On 1 May 2001 Mr Kerstens left a pager message for Mr Rivkin. Mr Kerstens had noticed that the share price in Qantas had gone up sharply. The share price hit a high of $2.90 per share just before Mr Rivkin received the pager message and rang Mr Kerstens back. The share price started to fall from its high of $2.90 and Mr Rivkin instructed Mr Kerstens to sell 50,000 shares at $2.85. The shares were then sold achieving a modest profit of $2,664.94. There was no contest in the proceedings and it is the fact that Rivkin Investments Pty Limited was at the time a wholly owned subsidiary of Rivkin Financial Services Limited, a publicly listed company. Mr Rivkin at that time held approximately 13 per cent of the shares in Rivkin Financial Services Limited. He was however a director and secretary of Rivkin Investments Pty Limited at all relevant times.

Rene Walter Rivkin, I record that a jury found you guilty on 30 April 2003 of an offence of Insider Trading as defined in s 1002G of the *Corporations Act 2001*.

In relation to that offence, you are convicted. I sentence you to imprisonment for a term of nine months, such sentence to be served by way of Periodic Detention. I decline to make a recognizance release order.

In addition, I impose a fine of $30,000.

Another case that indicates the type of conduct that will be found to breach **s 1043A**, and that resulted in criminal sanctions was *R v Hall (No 2)* [2005] NSWSC 890. The defendant was a former director of the Clifford Corporation Ltd Group of companies (Clifford), which collapsed in late 1998, leaving creditors and shareholders with a deficiency in excess of $90 million. The defendant was held to have contravened the *Corporations Act* in that he procured a private company (Leisuremark P/L, owned in part by interests associated with him) to sell 850,000 Clifford shares between 28 October 1998 and 13 November 1998 while in possession of inside information, namely, a letter dated 22 October 1998 from the auditors of Clifford which stated, among other matters, that: the Clifford draft consolidated 1997-1998 financial accounts had a potential overstatement of profits in excess of $15 million; and there was some doubt as to the ability of the Group to continue as a going concern, unless new strategies and financing arrangements were put in place. The sale of the shares yielded over $215,000. Shortly afterwards, on 11 November 1998, the ASX suspended

trading in Clifford shares because of its failure to lodge its accounts. The company was placed in voluntary administration on 9 December 1998, and shortly thereafter went into liquidation.

R v Hall (No 2) [2005] NSWSC 890 (Kirby J)

Extract from Judgment

At [88]-[90], [124], [125]

I then come to the issue whether it can be said, beyond reasonable doubt, that Mr Hall knew that the information provided by the auditors was not generally available, and was price sensitive, such that it was his duty not to trade in Clifford shares. I have no doubt that he did know, and recognised that he should not trade.

It is difficult to imagine more price sensitive information than that which the auditors provided on 22 October 1998. The letter was marked "private and confidential". It was the culmination of work by the auditors over many months. It expressed an opinion, not yet final, that there had been a potential overstatement of profits of $15 million. The auditors were concerned that the company was trading whilst insolvent.

The letter was a "bombshell", as Mr Hall and other Board Members would have recognised. It had implications, not only for the share price, but in respect of the attempts by Clifford to replace its financier. I have no doubt that Mr Hall well appreciated the need to keep it secret and the effect it would have, were it to become public. He well understood that the share price would plummet and the Corporation may well collapse were the information to get out. Further, the auditors in the letter reminded directors, including Mr Hall, of the importance of price sensitive information. As mentioned, the letter included these words:

> We also remind the Directors of their responsibilities under ASX Rule 3.1 which requires that once an entity is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entities securities, the entity must immediately tell the ASX that information.

It was said by Mr Hall, in submissions, that he and other directors did not accept the auditor's opinion. Certainly there are expletives on Mr Hall's copy which suggest that, in respect of some items, he emphatically differed from the auditors. But again, that is not the point. Until these differences were resolved and the opinion was revised or withdrawn, the information was explosive, and Mr Hall knew it. Knowing that, he nonetheless traded in Clifford shares.

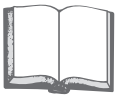
Here, the Crown submits, and I accept, that the criminality on the part of Mr Hall was very significant. In many cases of insider trading, the offender seeks to profit from information that comes into his possession. Ordinarily, in such cases, the profit is confiscated once the crime has been detected. Such cases involve no monetary loss to an individual. There is, nonetheless, damage to the investing public's confidence in the integrity of the market. Such damage is serious enough. Here, it was worse. Here it can be inferred that, in addition, many people or institutions who bought shares in Clifford from Leisuremark in good faith lost their money (s 16A(2)(e)).

> Some 850,000 shares, yielding over $215,000, were sold on the instructions of Mr Hall, those instructions being given on six separate occasions. Mr Hall was a mature businessman. He was an experienced company director. He held a position of trust within Clifford Corporation. He had experience in share dealing, although he could not be described as an expert share trader.
>
> In my view, no punishment other than a custodial sentence would be appropriate.

Insider trading actions are generally brought against individuals, however, in *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 160 FCR 35; [2007] FCA 963, ASIC commenced proceedings against large investment bank Citigroup. The bank had acted as adviser to Toll Holdings Limited in relation to its 2005 takeover bid for Patrick Corporation Ltd. ASIC alleged that Citigroup: did not adequately manage conflicts of interest between it and its client Toll; engaged in unconscionable conduct; breached the insider trading provisions of the *Corporations Act*; and that in this regard failed to implement effective mechanisms to ensure that information remained confidential. **Section 1043F** of the *Corporations Act* permits, in certain circumstances, a body corporate to trade in a financial product, even though one of its officers or employees may possess inside information regarding that product, for example, if it has set up a means to prevent the information being passed to other persons—this is referred to as a "Chinese wall".

In this matter, one section of Citigroup (its corporate advisory department) was advising Toll on its imminent takeover bid for Patrick, while at the same time another section (its proprietary trading desk) was acquiring, and then sold, Patrick shares. Citigroup had attempted to keep these two sections of its business separate (Chinese wall), and even though the trader engaging in the acquisition of the Patrick shares was not alleged to have had actual information of the role of his employer (Citigroup) in the takeover, it was this conduct, and particularly the actions of the Citigroup traders after they had been instructed to stop buying Patrick shares (involving the sale of a proportion of the shares) that was the basis of the action brought by ASIC. ASIC sought a declaration that Citigroup engaged in inside trading (prohibited pursuant to **s 1043A**).

Both of the claims relating to the insider trading provisions failed. The individual Citigroup trader who sold the Patrick shares (following instructions given to him not to buy any further Patrick shares) was held by the court not to be an officer (definition in **s 9**) of Citigroup and therefore his knowledge was not attributable to Citigroup for the purposes of the insider trading provisions. The second claim relied on the attribution of the knowledge of certain senior officers to Citigroup, however, this claim failed because the court considered that at the time the shares were traded Citigroup had in place Chinese walls that satisfied **s 1043F**.



[Overland J, "Corporate liability for insider trading: How does a company have the necessary 'mens rea'?" (2010) 24 *Australian Journal of Corporate Law* 266.]

Insider trading laws are intended to apply to companies as well as to natural persons. The fault element for insider trading is the knowledge that certain inside information is not generally available and that a reasonable person would expect the information to have a material effect on the price or value of relevant financial products. Where an alleged insider trading is a company, the relevant intention can be attributed to it through the statutory rules of attribution found in s 769B(3) of the *Corporations Act* as well as through general law principles of organic theory. Through the combined operation of the laws, the fault element for insider trading may exist if any of the following people have the relevant knowledge:

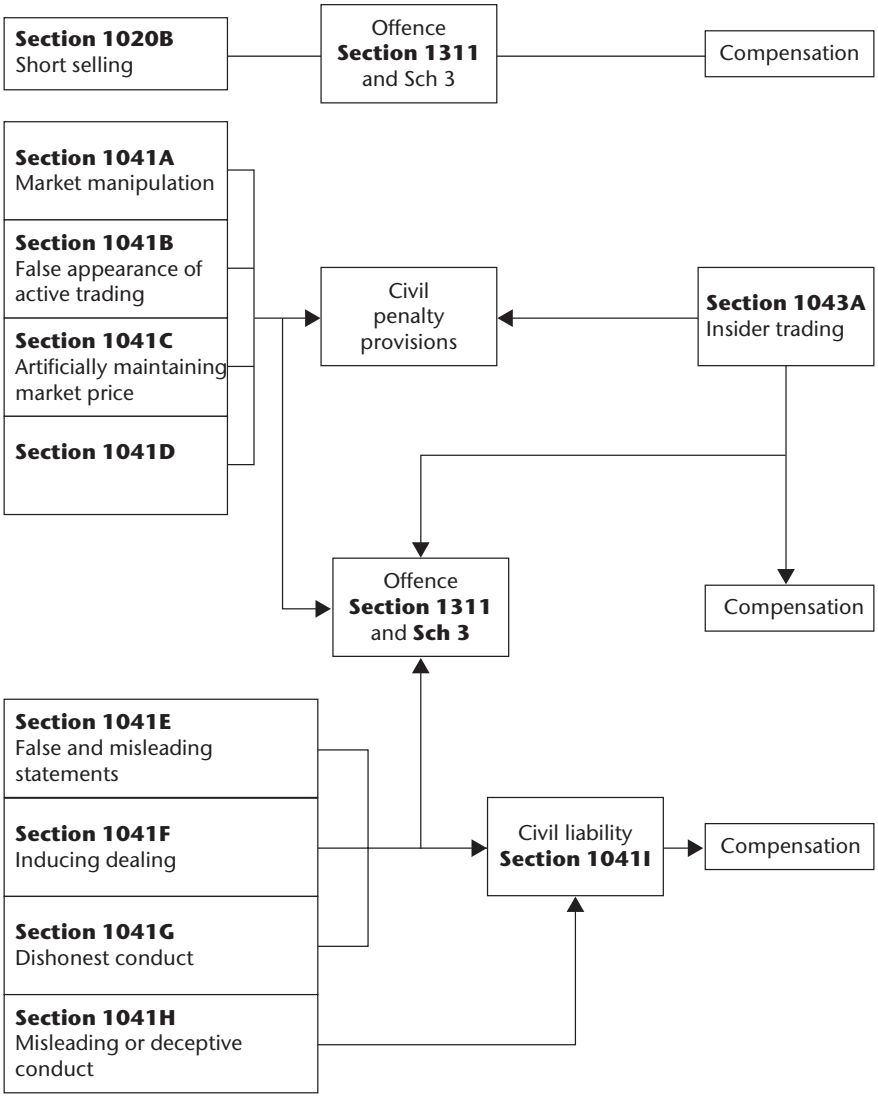
(a) a director, employee or agent of the company who had the relevant knowledge and engaged in the relevant conduct within the scope of their actual or apparent authority; or (b) a person who is regarded as the directing mind and will of the company, who had the necessary knowledge and engaged in the relevant conduct.

Compensation

[28.80] **Section 1043L** identifies those entitled to compensation, where there is a breach of the insider trading provisions. The action for compensation will be brought under **s 1317HA**. Included in those able to seek compensation are shareholders in the relevant body corporate (seller/disposer) pursuant to **s 1043L(3)**; purchasers of shares from the insider (buyer/acquirer) pursuant to **s 1043L(4)**; and the body corporate that issued the securities (the issuer of the financial product) pursuant to **ss 1043L(2)** and **1043L(5)**. The compensation is calculated as the difference between the price at which the securities were dealt in (the inside traded price) and the price they would have achieved had the information been generally available. Note also **s 1043O** which enables orders, other than as to compensation, to be made for a breach of **s 1043A**. These include restraining the issue or acquisition of **Div 3** financial products, including shares, and cancelling an Australian financial services licence.

Prohibited conduct in relation to securities

[28.90]



Characteristics of an equitable market for financial products and services

[28.100] Having price sensitive information in relation to a financial product, such as securities, and then dealing in those securities may, as has been seen, breach the insider trading provisions. From a strict economic position, the exploitation of

information may be judged a reward for enterprise and therefore justify such conduct. However, if such conduct is in breach of the *Corporations Act*, it is in a general sense a disincentive to legitimate investment. Fairness and integrity in the market, and among its participants, has been the predominant philosophy behind the insider trading provisions. Transparency is also an important issue, particularly when the range of, and access to information of market participants is not evenly distributed. Overall, the efficient and diligent use of the insider trading laws should result in investor confidence and create a market that is accessible to all investors, large or small. The following newspaper articles set out examples of the type of conduct that, in circumstances where the information involved is price sensitive may amount to breach of the insider trading provisions.

Bankers fined for insider trading

Two former employees of the ANZ and Westpac banks were fined $130,000 and ordered to repay a similar amount to securities dealers they ripped off in an insider trading scam involving options on BRL Hardy shares.

The Federal Court heard earlier that the ANZ client relationship manager found out in January that the bank was advising BRL on a potential takeover offer from US liquor group Constellation Brands. He then phoned a former colleague who was at that time working in Westpac's commercial lending section, to tell him about the deal. The two agreed to purchase $35,000 worth of call options over BRL shares in the colleague's name to take advantage of the likely price surge once news of the takeover became public.

When the merger discussions were formally announced the next day, the shares rocketed 17 per cent higher.

Original source article by Blair Speedy, *The Australian*

Easy insider trading case

As insider trading cases go they don't get easier than the matter of Mr J Orr and Indophil. It has presented ASIC with a welcome victory given a guilty plea is indicated.

The case alleged that Orr, who served on the Lion board, acquired shares in Indophil Resources having heard Xstrata was about to bid for the company. Given Orr was on the Lion board and the company was negotiating to sell its stake to Xstrata in a pre-bid agreement, when he told his broker to buy 50,000 shares in the target on May 8 he was relying on good inside information.

Lo and behold, on May 15 Xstrata did bid for Indophil. Ultimately, of course, the takeover didn't succeed even though Lion had tipped most its 25.7 per cent stake in the company. After the takeover failed, Indophil put its stake in the company on the market.

Original source article by John Durie, *The Australian*

***Corporations Act 2001* (Cth), s 1042A**

Definitions

"inside information" means information in relation to which the following paragraphs are satisfied:

(a) the information is not generally available;
(b) if the information were generally available, a reasonable person would expect it to have a material effect on the price or value of particular Division 3 financial products.

"material effect", in relation to a reasonable person's expectations of the effect of information on the price or value of Division 3 financial products, has the meaning given by section 1042D.

***Corporations Act 2001* (Cth), s 1042C**

When information is generally available

(1) For the purposes of this Division, information is generally available if:
  (a) it consists of readily observable matter; or
  (b) both of the following subparagraphs apply:
    (i) it has been made known in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest in Division 3 financial products of a kind whose price might be affected by the information; and
    (ii) since it was made known, a reasonable period for it to be disseminated among such persons has elapsed; or
  (c) it consists of deductions, conclusions or inferences made or drawn from either or both of the following:
    (i) information referred to in paragraph (a);
    (ii) information made known as mentioned in subparagraph (b)(i).
(2) None of the paragraphs of subsection (1) limits the generality of any of the other paragraphs of that subsection.

***Corporations Act 2001* (Cth), s 1043A**

Prohibited conduct by person in possession of inside information

(1) Subject to this Subdivision, if:
  (a) a person (the insider) possesses inside information; and
  (b) the insider knows, or ought reasonably to know, that the matters specified in paragraphs (a) and (b) of the definition of inside information in section 1042A are satisfied in relation to the information;
  the insider must not (whether as principal or agent):

(c) apply for, acquire, or dispose of, relevant Division 3 financial products, or enter into an agreement to apply for, acquire, or dispose of, relevant Division 3 financial products; or

(d) procure another person to apply for, acquire, or dispose of, relevant Division 3 financial products, or enter into an agreement to apply for, acquire, or dispose of, relevant Division 3 financial products.

Note 1: Failure to comply with this subsection is an offence (see subsection 1311(1)). For defences to a prosecution based on this subsection, see section 1043M.

Note 2: This subsection is also a civil penalty provision (see section 1317E). For relief from liability to a civil penalty relating to this subsection, see sections 1043N and 1317S.

(2) Subject to this Subdivision, if:

(a) a person (the insider) possesses inside information; and

(b) the insider knows, or ought reasonably to know, that the matters specified in paragraphs (a) and (b) of the definition of inside information in section 1042A are satisfied in relation to the information; and

(c) relevant Division 3 financial products are able to be traded on a financial market operated in this jurisdiction;

the insider must not, directly or indirectly, communicate the information, or cause the information to be communicated, to another person if the insider knows, or ought reasonably to know, that the other person would or would be likely to:

(d) apply for, acquire, or dispose of, relevant Division 3 financial products, or enter into an agreement to apply for, acquire, or dispose of, relevant Division 3 financial products; or

(e) procure another person to apply for, acquire, or dispose of, relevant Division 3 financial products, or enter into an agreement to apply for, acquire, or dispose of, relevant Division 3 financial products.

Note 1: Failure to comply with this subsection is an offence (see subsection 1311(1)). For defences to a prosecution based on this subsection, see section 1043M.

Note 2: This subsection is also a civil penalty provision (see section 1317E). For relief from liability to a civil penalty relating to this subsection, see sections 1043N and 1317S.

Summary—Financial services and markets

The *Corporations Act* regulates financial products, services and markets

A financial product includes securities (shares)

Shares are traded on the stock exchange

The stock exchange is regulated via the ASX operating rules and the *Corporations Act*

ASIC has a supervision and surveillance role concerning financial markets and participants

Regulation covers the ASX and listed companies

Regulation includes standards and conduct of stockbrokers and investors

Examples of prohibited conduct: market rigging; misleading information

Also prohibited is insider trading (**ss 1042A** and **1043A**)

Inside information is price sensitive and not generally available

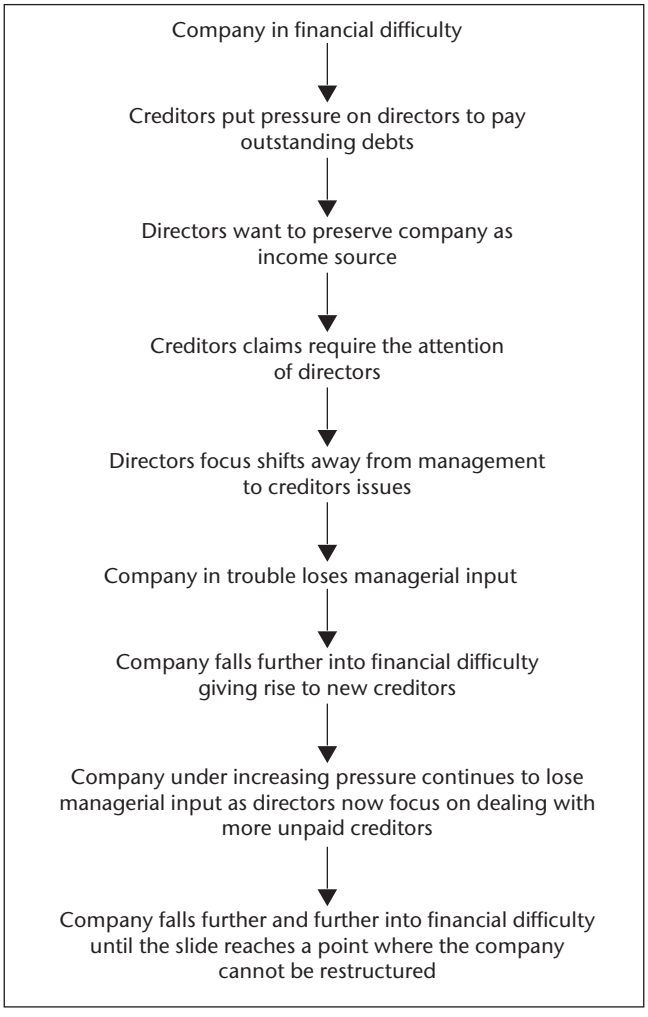
Once a person possesses inside information they are prohibited from dealing in the shares

Defence to insider trading: information was, in fact, available to investors, readily observable

Example of insider trading prosecution: *R v Rivkin*

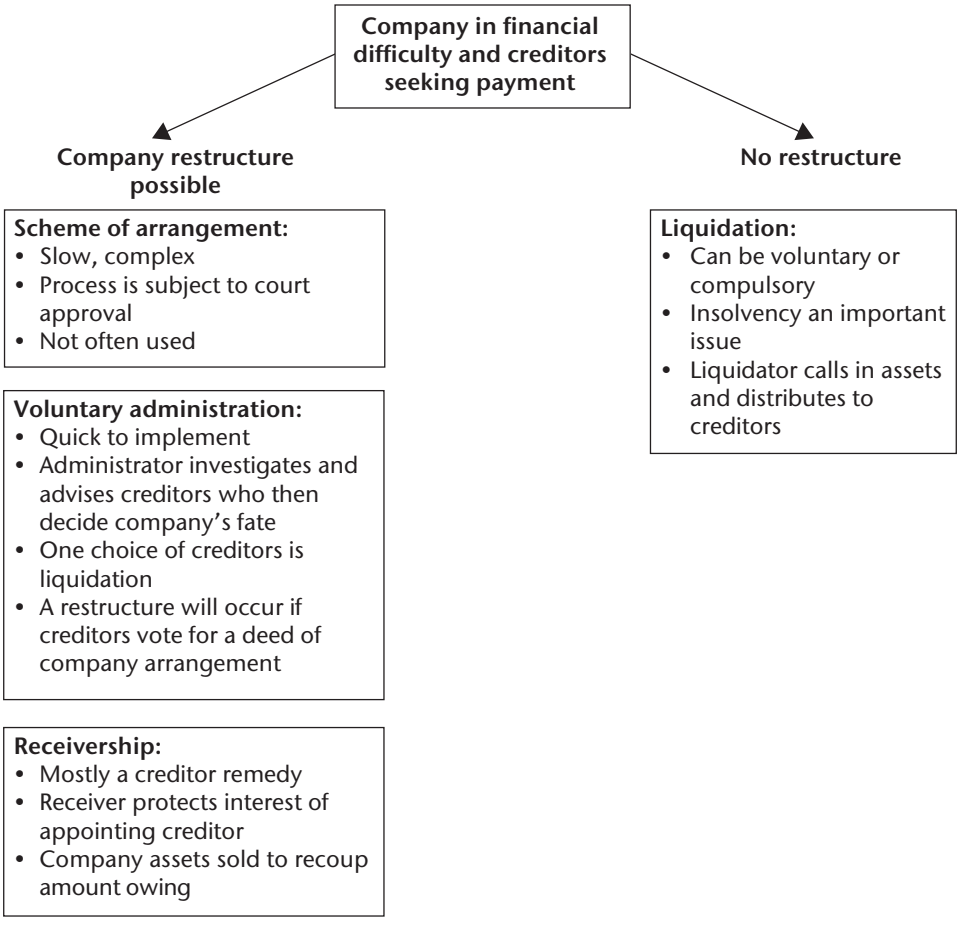
29
Insolvency

[29.10] If company insolvency is not addressed, it can lead to an irreversible slide into liquidation. A purpose of the mechanisms available in the *Corporations Act 2001* (Cth) (particularly voluntary administration) is to enable the company, via a person appointed to oversee the company, to achieve some stability for itself and its creditors and then to possibly restructure for the benefit of all parties concerned. Generally, ordinary creditors receive little of what they are owed once a company has been wound up. Accordingly, the earlier a company seeks to restructure, the greater the possibility it will have the funds to meet its creditors' claims.



Approaches to insolvency under the Corporations Act

[29.20] There are several mechanisms outlined in the *Corporations Act* that provide a regulatory framework for companies in financial trouble. A scheme of arrangement (**Pt 5.1**) and voluntary administration (**Pt 5.3A**), specifically a deed of company arrangement, are designed for the purpose of a restructure or resurrection of the company. Receivership (**Pt 5.2**), although not strictly a restructuring mechanism, may result in a similar outcome if certain factors are favourable following the withdrawal of the receiver from the company. The final form of external administration is liquidation (**Pt 5.4B**). Liquidation does not result in a restructure; in fact, the opposite occurs and the company is wound up, ceases to trade and is eventually deregistered.



The choices made by creditors will depend on various factors including whether they have security over assets, whether they are a priority creditor, the amount of their debt or the nature of their trading arrangement.

For example, an ordinary unsecured creditor ranks last in the list of priority creditors for the purposes of a distribution by the liquidator, where a company has been placed into liquidation. Their chance of any substantial return on their debt is often minimal. However, with voluntary administration, the possibility that the company may restructure and continue trading could provide unsecured creditors with more of an opportunity to recoup amounts outstanding.

ASIC Information Sheet—Your Company and the Law

What if your company can't pay its debts?

You must ensure that your company is able to pay all of its debts as and when they become due for payment. A company is "insolvent" if it cannot pay all of its debts as they become due and payable.

By law, you must prevent your company from incurring a debt when it is insolvent or about to become so. This means you must consider whether you have reasonable grounds to believe (suspect) that the company will be able to pay a new debt when it becomes due, as well as pay all the other debts.

You may expose yourself to criminal prosecution, substantial fines or to action by a liquidator, creditors of the company or ASIC to recover amounts lost by creditors due to your actions. Your personal assets—not just your company's—may be at risk.

Common signs of financial trouble are:

- low operating profits or cash flow from the main business;
- problems paying trade suppliers and other creditors on time;
- trade suppliers refusing to extend further credit to the company;
- problems with meeting loan repayments on time or difficulty in keeping within overdraft limits;
- legal action taken, or threatened, by trade suppliers or other creditors over money owed to them.

If your company is in financial difficulty or in danger of being insolvent, seek immediate advice from an insolvency professional. They will be able to explain your options to you. Your options may include re-structuring your company's affairs, changing your company's activities or appointing a voluntary administrator or liquidator to the company.

Do not assume that you will be able to trade out of the problem. Delay could be damaging to the company and to you personally, and may reduce the options available.

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When is a company insolvent?

[29.30] For the purposes of determining whether a company is insolvent, the court can take into account both contingent and prospective liabilities together with any

other relevant matters (**s 459D**). The cases, for example, *Downey v Aira Pty Ltd* (1996) 14 ACLC 1,068, make it clear that a temporary lack of liquidity does not necessarily signify insolvency. Increasingly, the courts have taken the approach that insolvency should be considered from the perspective of whether the company can pay all its debts as they become payable by reference to the commercial realities. This allows for the fact that companies often have resources available (such as unsecured borrowings or extension of credit arrangements with creditors) that while not strictly satisfying the test that they could meet their debts "out of their own moneys", nonetheless produces a satisfactory commercial outcome for their creditors (*Lewis v Doran* (2004) 50 ACSR 175; [2004] NSWSC 608). In *Southern Cross Interiors Pty Ltd v Deputy Commissioner of Taxation* (2001) 53 NSWLR 213; [2001] NSWSC 621, the outcome of the commercial realities of debtor/creditor relations was considered to include taking into account the fact that creditors do not always insist on payment strictly in accordance the terms of the contract.

***Corporations Act 2001* (Cth), s 95A**

Solvency and insolvency

(1) A person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable.
(2) A person who is not solvent is insolvent.

In forming a view on which debts should be included in an assessment of a company's insolvency at any given stage, a court will focus on present or contingent liquidated debts rather than uncertain or yet to be formulated future debts. In *Box Valley Pty Ltd v Kidd* [2006] NSWCA 26, a case that concerned whether a company was insolvent at the time of entering future contracts to sell white cottonseed, Basten JA considered the importance of certainty as regards the application of the concept of solvency.

Box Valley Pty Ltd v Kidd [2006] NSWCA 26 (Bryson JA, Basten JA, Gzell J)

Extract from Judgment

Basten JA at [66]-[67]

The Court is entitled to look at debts which were not due and payable as at the date in question, if they were debts which arose under an existing agreement. If the white cottonseed contracts required the Company to purchase white cottonseed at a fixed price, the Court would be entitled to consider whether the Company could pay for those purchases when they fell due. On that hypothesis, payment would have been contingent upon delivery, but the amount was a liquidated sum and the date for payment was fixed. By contrast, where the existing agreements required the sale of white cottonseed, the Company had then incurred no debt. It

> had an obligation (which it may not have been likely to meet) to deliver goods at a particular price on a particular date. However, if it failed to purchase the necessary supplies and defaulted, no liquidated debt would arise until the purchasers took further steps, namely to obtain white cottonseed from alternative sources, at a price which was not then known.
>
> Although, in commercial terms, the distinction between these two situations may not be critical (if the company will not be able to meet its obligations) nevertheless, in legal terms the distinction is important in determining insolvency. The trial judge held that he was not entitled to take into account prospective liabilities arising from default on the white cottonseed sale contracts: in my view his Honour was correct in that respect. Because the Claimant did not establish that the Company was not otherwise unable to pay its debts as and when they fell due, the Claimant failed to establish its insolvency as at the date on which the Company incurred debts payable to the Claimant. I agree with the orders proposed by Bryson JA.

When a court is considering the issue of insolvency of a company, it will of course be looking at events that have already taken place and assessing how the directors could, or perhaps should, have reacted to various circumstances. It is accordingly important for directors to be aware at any particular time of the factors that may indicate financial trouble and actively seek to avoid them. ASIC has useful advice for directors on its website in relation to insolvency, including examples of signs that may suggest financial difficulty. These include: continuing losses; poor cash flow; absence of a business plan; incomplete financial records or disorganised internal accounting procedures; lack of cash-flow forecasts and other budgets; increasing debt (liabilities greater than assets); problems selling stock or collecting debts; unrecoverable loans to associated parties; creditors unpaid outside usual terms; solicitors' letters, demands, summonses, judgements or warrants issued against the company; suppliers placing the company on cash-on-delivery (COD) terms; issuing post-dated cheques or dishonouring cheques; special arrangements with selected creditors; payments to creditors of rounded sums that are not reconcilable to specific invoices; overdraft limit reached or defaults on loan or interest payments; problems obtaining finance; change of bank, lender or increased monitoring/involvement by financier; inability to raise funds from shareholders; overdue taxes and superannuation liabilities; board disputes and director resignations, or loss of management personnel; increased level of complaints or queries raised with suppliers; unrealistic expectations about the success of upcoming contracts.

The category of external administrator in **Sch 2** distinguishes between the roles of liquidators and administrators on the one hand and receivers on the other. Both liquidation and voluntary administration are focused on outcomes for the creditors as a whole, whereas most receivers are privately appointed by a single secured creditor and will have their appointing creditors' interests as their focus. Note though that liquidators, administrators and receivers all must be registered liquidators, and in this respect, all are subject to the relevant *Corporations Act* obligations.

Insolvency reforms and outcomes

[29.40] When economies are under financial pressure, the law has an important role in regulating corporate failure. The number of companies in Australia is increasing rapidly. Together with this growth there has also, of course, been corporate insolvency and failure, in some cases of large listed public companies. The following Chapters (Chs 30-33) explain how corporate insolvency is dealt with in the *Corporations Act*. However, it must be noted that because of the ongoing market exposure to insolvency, the law is continually being assessed and reformed to ensure that it is applicable. Insolvency law reform has developed out of a number of reviews of the law carried out by former government advisory bodies such as CAMAC and by the Parliamentary Joint Committee on Corporations and Financial Services. Since the *Corporations Amendment (Insolvency) Act 2007* (Cth) reforms have focussed on four main areas: improving the outcomes of insolvency procedures for creditors; deterrence of misconduct by company officers; improving the regulation of insolvency practitioners; and enhancing the efficiency of external administration.

The internationalisation of business and the widespread effect of corporate activity have required cooperation between countries to minimise the downsides of corporate insolvency. To address this issue, the Federal Government introduced the *Cross-Border Insolvency Act 2008* (Cth), which is based on the United Nations Commission on International Trade Law (UNCITRAL) model.

Significant insolvency reforms were introduced by way of the *Insolvency Law Reform Act 2016* (Cth). The Act introduced changes, commencing 2017, to both corporate insolvency in the *Corporations Act* and personal insolvency in the *Bankruptcy Act 1966* (Cth). Reforms include removing distinctions between official and registered liquidators; aligning registration requirements and disciplinary procedures for personal and corporate insolvency practitioners; introducing a registration renewal process; increasing penalties for reckless conduct by insolvency practitioners; introducing maximum default remuneration procedures. All of these changes represented a tightening of the regulatory control over insolvency practitioners. The reforms also gave creditors greater access to information during an insolvency process and allowed them to more easily remove insolvency practitioners. ASIC's powers to monitor and audit insolvency practitioners have also been improved.

The *Insolvency Law Reform Act 2016* created a new schedule (**Sch 2**) to the *Corporations Act* (the Insolvency Practice Schedule (Corporations)). The main objectives of the Schedule are to regulate the registration of liquidators and to regulate the external administration of companies in a consistent manner and to give the creditors greater control. The Insolvency Practice Rules accompany the Schedule. The reforms have added detail to the area of insolvency practice and required various amendments to **Ch 5** of the *Corporations Act*. Relevant process provisions are included in the Insolvency Practice Schedule (eg, registering and disciplining liquidators). The Insolvency Practice Schedule defines an external administrator as: an administrator

of the company or under a deed of company arrangement; a liquidator or provisional liquidator. A person is not an external administrator merely because they have been appointed as a receiver.

The *Insolvency Practice Rules (Corporations) 2016* (Cth) are made pursuant to **s 105-1** of **Sch 2** of the *Corporations Act*. They deal with matters such as the registration and qualifications of external administrators, meetings during an external administration, and remuneration of external administrators. Under those Rules, ASIC may convene a committee to consider certain matters before registration is complete. These include certain academic requirements and, if the applicant wishes to be registered to practise as an external administrator of companies, receiver and receiver and manager that the applicant has, during the five years immediately preceding the day on which the application is made, been engaged in at least 4,000 hours of relevant employment at senior level.

Together with the legislative changes that have focused on improving insolvency outcomes, ASIC is also active in ensuring the market is informed as to the alternatives available, where companies are insolvent or are nearing insolvency. ASIC has an online insolvency portal to provide information specific to each stakeholder group about their rights and obligations and provide responses to frequently asked questions. It also assists stakeholders to understand the technical jargon of insolvency and outlines the most common forms of corporate insolvency administration. In addition to assisting company directors, the website provides links for company creditors (eg, suppliers) and for employees to assist them in identifying possible signs of insolvency in companies with which they are involved. For insolvency practitioners, the portal includes existing website information about their registration and compliance obligations. ASIC compiles statistics useful in tracking insolvency issues. ASIC's insolvency statistics are based on external administrators' reports (comprising liquidators, receivers and voluntary administrators) and reveal that three of the most prominent causes of company failure are: poor strategic management of business; inadequate cash flow or high cash use; and trading losses. ASIC statistics also indicate that the three most common civil penalty breaches identified by external administrators are insolvent trading (**s 588G**); obligations to keep financial records (**s 286** and **s 344**); and care and diligence (**s 180**). A factor common to all insolvency outcomes, liquidations, receiverships and voluntary administrations, is that ordinary unsecured creditors often receive little of the total amounts owing to them. ASIC statistics confirm this reality in setting out that that in around 97% of external administrations, the dividend estimate to unsecured creditors was less than 11 cents in the dollar.

External administrations

Companies entering external administration (liquidation, receivership, voluntary administration). Figures from Australian Securities & Investments Commission.

Year	Number
2012-2013	10,746
2013-2014	9,882
2014-2015	9,177
2015-2016	9,848
2016-2017	8,031
2017-2018	7,747

Summary—Insolvency

Insolvency of a company affects its creditors

Restructure is possible if intervention is early

The most common restructure is voluntary administration

Without restructure, a company may go into liquidation

Insolvency is not merely temporary lack of liquidity: *Downey v Aira*

The commercial realities of business, and industry norms, are relevant to assessing insolvency

Directors should be alert to the signs of financial difficulty such as poor cash flow

30
Arrangements and Reconstructions

[30.10] This part of the *Corporations Act 2001* (Cth) enables companies to enter into a scheme of arrangement and includes a number of mechanisms to allow the rehabilitation of the company or the reorganisation of the members' rights. All of the mechanisms involve a number of steps and court intervention. The first step is an application by the company, a creditor or a member to the court for an order that a meeting of creditors or members be held (**s 411(1)**). If the order is made for a meeting, the company prepares an explanatory statement for the purposes of informing those at the meeting of the proposals sought. If the scheme affects creditors, a 75% majority (by way of total debt) is required. If the scheme affects members, the requirement is a majority in number (overall) and 75% of those votes cast at the meeting (**s 411(4)**). The scheme must then be approved by the court (**s 411(4)(b)**).

There are several types of schemes. One of these may be used between the company and its creditors in an attempt to rescue a company in financial difficulties. This form of restructuring is not often chosen in situations of insolvency because it is slow to complete and the need for the courts consideration of the scheme before it is finalised creates uncertainty among creditors. If such schemes are approved, they will generally involve either a compromise (creditor accepts part of debt and/or an instalment arrangement is adopted) or a moratorium (creditor waits for part or all of debt).

The popularity of voluntary administration has meant that since its introduction, schemes of arrangement between companies and creditors have substantially decreased in frequency. Despite the fact that the provisions of **s 411** allow the company the choice of a number of means to reorganise its relations with creditors, the possible risk of a scheme becoming stalled in its progress through the court as the result of a challenge by a member, creditor or ASIC remains a substantial discouragement to their use. However, where there is a need to restructure an insolvent company in complex financial circumstances and particularly where third party contributories are involved, there may be advantages in using a creditor's scheme of arrangement. In *Fowler v Lindholm, in the matter of Opes Prime Stockbroking Limited* (2009) 178 FCR 563; [2009] FCAFC 125, the Full Federal Court affirmed the decision of Justice Finkelstein in the Federal Court approving a scheme of arrangement which included the release of third parties. The rejection of the notion that a scheme can only bind a creditor in their capacity as a creditor and in no other capacity suggests that schemes of arrangement may have a wider application in the reorganisation of insolvent companies and their creditors.

Although most creditors' schemes of arrangement arise from the company's insolvency, this is not essential (*Re Crusader Ltd* [1996] 1 Qd R 117; (1995)17 ACSR 336). Once a company has successfully entered a scheme of arrangement with its creditors,

all creditors will be bound. It would of course be possible for a company in financial difficulty to merely negotiate with its creditors informally; however, as each individual creditor would have different expectations, negotiation would be difficult. Further, any informal arrangement would not be binding, and would be compromised if an individual creditor opted out and pursued its claim to the disadvantage of the other creditors. The provisions of **s 411** will only be applicable if what is proposed between the company and its creditors or its members is a "compromise or arrangement". In *Re NFU Development Trust Ltd* [1972] 1 WLR 1548, the court rejected a scheme that resulted in the cancellation of membership of a company limited by guarantee. It set out that the essence of a successful scheme involved "give and take".

Reorganisation of members' rights (such as in a takeover situation) is also possible under this part of the *Corporations Act* and it is in this context that **s 411** is more readily used. Pursuant to that section, the following may occur:

- share rights may be altered or classes of shares converted;
- members may agree to a transfer of the company's assets to another company, cancelling their shares and then receiving shares in the other company;
- where a scheme involves the acquisition of shares and the acquirer has achieved 90% of the offered shares a compulsory buy-out of the remaining shares is possible. Similarly, the remaining shareholders can force the bidder to buy them out (**s 414**). This restructure is not intended to avoid the takeover provisions and operates with the same level of disclosure.

A members' scheme of arrangement is one way a company can be reorganised while it is still solvent. This could also take place by way of amendment to the constitution. However, there are limits to constitutional amendment (*Gambotto v WCP Ltd* (1995) 182 CLR 432). If the reorganisation takes place under **Pt 5.1**, there are safeguards such as the requirement of disclosure and the necessity for court approval. A scheme sanctioned under **s 411** must not contravene the *Corporations Act* nor involve an improper purpose. An example of a members' scheme of arrangement involved the acquisition of Coles Group Ltd by Wesfarmers Ltd in 2007. In November 2007, Coles Group Ltd shareholders voted in favour of the scheme (**s 411(4)(a)**). Under the terms of the scheme, each Coles Group shareholder transferred their shares to a wholly-owned subsidiary of Wesfarmers and received for each share a cash amount ($4.00) plus Wesfarmers shares (0.14215 ordinary shares and 0.14215 partially protected shares). Coles Group shareholders also received a fully franked final dividend of 25 cents per share. The scheme was approved by the court pursuant to **s 411(4)(b)** and an announcement made to that effect to ASX. The implementation date of the scheme was in November 2007 and at that time the cash consideration was paid and the Wesfarmers shares issued.

Whereas each scheme will be distinct on its facts, the exercise by the court of its discretion in the weighing up of the benefits of the scheme will ensure that if finally approved a scheme of arrangement pursuant to **s 411** delivers an equitable outcome.

In *Re Airtrain Holdings Ltd (No 2)* [2013] FCA 377, a matter where the company sought, and was granted, approval of a scheme of arrangement between itself and each of the classes of its shareholders Reeves J (at [11]) set out matters relevant to the exercise of discretion as to final approval of the scheme pursuant to **s 411(4)(b)**. These are: whether the members have voted in good faith to approve the scheme; whether the proposals contained in the scheme are fair and reasonable; that all relevant matters have been brought to the court's attention; whether there has been proper and comprehensive disclosure of the details of the scheme to the members; that there is no evidence of oppression of minority members of the company or that any third parties will be adversely affected; that the scheme does not offend against public policy.

Summary—Arrangements and reconstructions

Companies can enter a scheme of arrangement via **s 411**

There are creditors' schemes and members' schemes

A creditors' scheme involves a compromise or other arrangement for payment

Court approval is required for both types of schemes—**s 411(4)(b)**

Creditors' schemes have lost popularity since voluntary administration was introduced

Members' schemes, for instance in a friendly takeover, reorganise members' rights

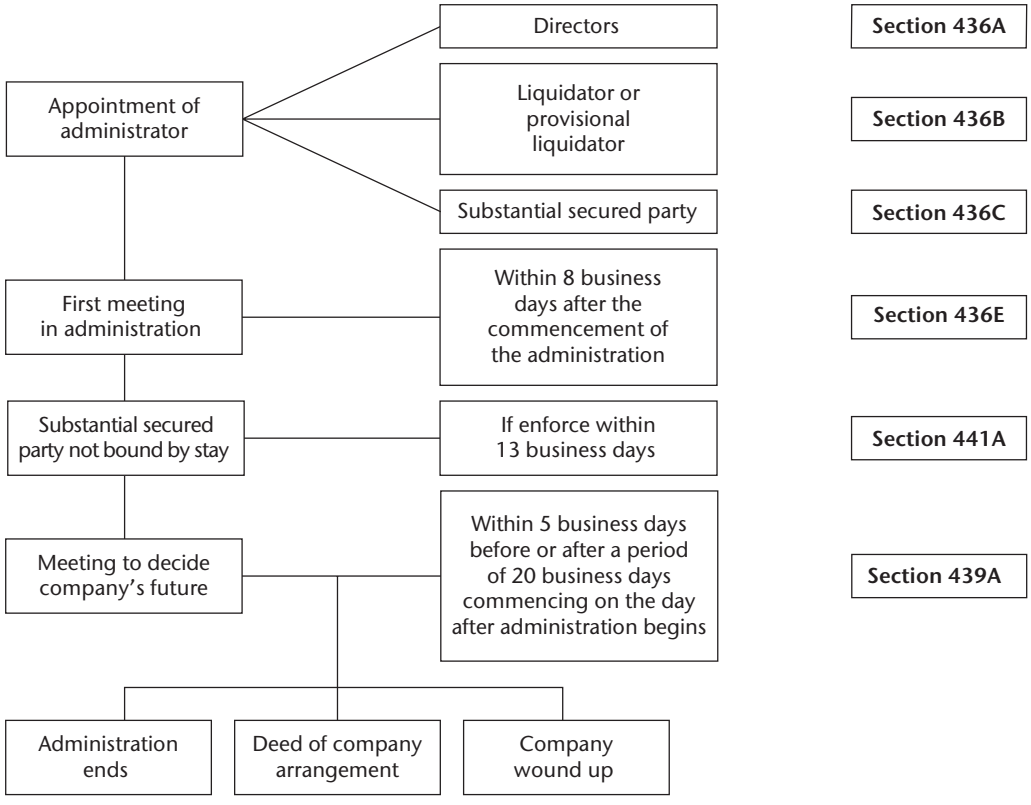
Members' schemes can achieve a merger of companies

31
Voluntary Administration

[31.10] Voluntary administration does not last for a long time (generally about a month). It is a means to quickly assess the company's position and then leave the decision as to its future to the creditors.

Schedule of administration

[31.20]

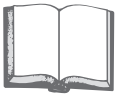


Commencement and effect of administration

Basis and aims

[31.30] Voluntary administration is designed to halt a company's slide into liquidation by providing a quick-to-implement alternative that does not involve court intervention

or substantial formality. There is of course the general applicability of the *Corporations Act 2001* (Cth), however, the court has merely a supervisory role and is not involved in the appointment of an administrator. The inability of restructuring mechanisms in the past to provide attractive alternatives to liquidation has meant that both the business of a company, and its function as a source of income for its employees, was lost. Voluntary administration provides a value-based view of insolvency by aiming to save the business and preserve employment. The following journal article extract sets out some of the benefits of rehabilitating struggling companies.



[Herzberg A, Bender M and Gordon-Brown L, "Does the voluntary administration scheme satisfy its legislative objectives? An exploratory analysis" (2010) 18 *Insolvency Law Journal* 181 at 182.]

> Facilitating the rehabilitation and continued existence of a financially distressed company or its business has obvious benefits for its creditors and shareholders. Successful rehabilitation means pre-VA creditors are either repaid in full or willingly accept a lesser amount as a compromise. They may also be prepared to continue doing business with the company after it is rehabilitated. The continued survival of viable companies or their businesses also produces positive benefits for other corporate stakeholders [as] well as the wider economy. For example, a company that is rehabilitated and emerges from a reorganisation plan to survive as a going concern benefits its employees by providing ongoing employment. Its customers derive ongoing benefits because they are able to maintain a continuing supply of the business' products and services. The surviving business pays tax on its income.

Appointment of an administrator

[31.40] An administrator can be appointed by the board of directors (**s 436A**), a liquidator or provisional liquidator (**s 436B**) or by a secured party who is entitled to enforce a security interest in the whole, or substantially the whole, of the company's property (**s 436C**). The directors' ability to appoint an administrator is important in that in may be a defence (**s 588H**) to an insolvent trading action and thereby protect them from personal liability. It is a condition of **s 436A** that the directors must be of the opinion that the company is insolvent or is likely to become insolvent before they resolve to appoint an administrator. Pursuant to **s 436B**, a liquidator must not appoint themselves as administrator without leave of the court or a resolution by the company's creditors approving the appointment.

Effect of the administration

[31.50] Creditors' claims are stayed (held up), however, there are some exceptions for substantial secured creditors. Basically the aims of voluntary administration could not be achieved if creditors were able to constantly bombard the company (specifically in this situation, the administrator) with claims, or to seek execution of their judgments.

This would severely limit the ability of the administrator to assess the company's true position. However, not all creditors are equal and the more important creditors may be less likely to advance credit to companies if they were to be restricted from enforcing their rights. This would have a negative effect on entrepreneurship. Accordingly, there are exceptions to the stay as follows (note that if receivers have been appointed to the company their rights are also protected in the following sections):

- In **s 441A**, a secured party with a security interest in the whole, or substantially the whole, of the property of the company that enforces within "the decision period" is not bound by the stay. The "decision period" is defined in **s 9** and is the period beginning on the day when notice of the appointment of the administrator is given (if required) to a secured party under **s 450A(3)** or the day administration begins; the period ends on the 13th business day thereafter.
- In **s 441B**, a secured party that enforces their security interest, such as entering into possession or assuming control of property of the company, prior to the appointment of the administrator, is not bound;
- In **s 441C**, a secured party that has a security interest over perishable property is not bound.

In each of the above instances, it is necessary for the secured party to have "perfected" the security within the meaning of the *Personal Property Securities Act 2009* (Cth) (see Ch 17). Obviously, the extent to which a company under administration has its funds depleted by secured parties exercising their rights under **ss 441A**, **441B** or **441C** will affect the possibility of a successful restructure. Creditors may reject a restructure if their return is insufficient.

The first meeting in administration

[31.60] The timetable for an administration is tight. The first committee of inspection meeting is to take place within eight business days after the commencement of administration (**s 436E**). The committee is appointed by the creditors by resolution (vote), also by single creditors or employees owed large amounts (**Sch 2**). Pursuant to **s 436E(3)**, the administrator convenes the meeting by giving written notice to the creditors and by publishing notice of the meeting in a national, or relevant State, newspaper at least five business days before the meeting. Note that **s 600G** provides that where notice is required or authorised under certain provisions of the *Corporations Act*, including **s 436E**, and the recipient of the notice (such as a creditor) nominates a fax number or electronic address then notice is validly given if sent to that fax or electronic address.

The functions of the committee of inspection will include assisting and giving directions to the external administrator and monitoring the administration. A committee of inspection can request that the administrator provide a report or produce documents.

How the company is run under administration

Powers of the administrator

[31.70] The administrator takes control of the company and has wide powers of investigation. The role of an administrator is set out in **s 437A** and includes exercising all of the functions that the company or any of its officers could perform. The administrator will be the company's agent for the carrying out of its business (**s 437B**). The creditors will rely on the administrator to provide a clear picture of the company's position and prospects to enable them to make an informed decision as to its future. Accordingly, the administrator's obligation to investigate in **s 438A** is essential to the success of voluntary administration. Even though an administrator's powers as set out in the *Corporations Act* are wide, it has been held that an administrator cannot destroy property rights that arose before the administration except where expressly authorised by statute (*Osborne Computer Corp Pty Ltd v Airroad Distribution Pty Ltd* (1995) 37 NSWLR 382; 17 ACSR 614).

Liability of administrator

[31.80] Administrators owe fiduciary duties to the company. They will also be subject to various statutory duties as pursuant to **s 9** they are defined as "officers" of the company for the purposes of the *Corporations Act* (many of the duties in **Pt 2D.1** apply to officers, such as the duty in **s 181** to act in good faith for a proper purpose). The administrator is also liable for debts arising during the administration in relation to services rendered to the company, goods brought or property hired, leased or used by the company (**s 443A**). This liability is crucial to ensure that creditors remain confident to deal with the company during administration. The administrator can avoid personal liability in relation to leased property pursuant to **s 443B** if within five business days after the beginning of administration the lessor is given notice that the company does not propose to exercise its rights to the property. Taking this action does not affect the liability of the company. The point of an administration is that a company in trouble is stabilised for a short period and assessed. If creditors cease normal trading, the company's precarious position may worsen making a positive outcome less likely. Note that pursuant to **s 443D** the administrator has a right of indemnity from the company's property in relation to any liability under **s 443A** and in relation to other debts and liabilities incurred in good faith and without negligence in the performance of their functions or powers as administrator.

In some cases, the creditors may doubt certain aspects of the carrying out of an administration and seek an independent assessment of its details and progress. In this regard, the creditors (as well as ASIC, or, the company itself if it is being wound up under a members voluntary winding up) may appoint a registered liquidator to review the external administration of the company. The review can cover a broad range of matters, including whether the remuneration of the external administrator is reasonable and whether costs and expenses have been properly incurred.

Effect on directors

[31.90] During an administration, the company falls under the control of the administrator and only the administrator can deal with the company's property. Any transaction or dealing will be void unless: it was entered into by the administrator on behalf of the company or; the administrator consented to the transaction in writing before it was entered into or; an order of the court permits entry into the transaction (**s 437D**). Directors, other officers and employees who breach these provisions may be ordered to pay compensation where the court is satisfied that the company or another person has suffered loss or damage because of the act or omission constituting the offence (**s 437E**). The point of an administration is to stabilise a company that has fallen into financial difficulty to allow the creditors to decide how best to recoup outstanding debts. Often the management of the company is a relevant issue. In this regard, **s 198G** of the *Corporations Act* sets out that it is an offence if an officer of a company under an external administration performs a function or power of that office unless that person has the approval of the administrator or the court.

The qualifications and requirements of an administrator

[31.100] A person appointed as an administrator must be a registered liquidator (**s 448B**). The requirements for registration by ASIC as a liquidator are set out in **Sch 2** of the *Corporations Act* (the Insolvency Practice Schedule), together with the Insolvency Practice Rules. The requirements include: sufficient experience at a senior level of relevant employment; evidence of honesty and financial ability (for instance within the previous 10 years no dishonesty offences, or personal insolvencies); appropriate insurance and; that the applicant has completed the academic requirements for the award of a tertiary qualification that includes at least three years of full-time study (or its equivalent) in commercial law and accounting. The object is to ensure that a registered liquidator has the appropriate level of expertise, behaves ethically, and maintains sufficient insurance to cover liabilities. Registration may be subject to conditions and will require periodic renewal (every three years). An administrator may be disqualified if a connection between the company and the administrator exists in the manner set out in **s 448C**. The section sets out that a person must not seek or consent to be appointed as an administrator where that person owes the company, or the company owes that person, an amount exceeding $5,000; where the person is a director or employee of the company; or where the person is an auditor, or a partner or employee of an auditor, of the company. If there is doubt as to the validity of the appointment of an administrator, the person so appointed or any of the company's creditors may apply to the court for a declaratory order (**s 447C**).

Where registered liquidators (administrators) fail to carry out their duties appropriately, ASIC can suspend or cancel their registration. ASIC can also give a registered liquidator notice to show cause why registration should continue and where not satisfied with the response ASIC can refer the matter to a committee. A committee pursuant to **Sch 2 Div 40** must consist of ASIC, an (independent) registered liquidator and a person appointed by the relevant Minister. **Sch 2** also covers the issue of external

administrator remuneration. **Sch 2 Div 60** enables the court to review remuneration upon an application by: ASIC; a person with a financial interest in the process of external administration such as a creditor; or an officer of the company.

The following ASIC Media Release is an example of circumstances that have led to disciplinary proceedings, although in this instance the outcome was a reprimand and the payment of costs, rather than cancellation of registration. Note that ASIC now deals directly with disciplining liquidators, and the role is removed from the functions of CALDB (which retains its role regarding auditors and has been renamed Companies Auditors Disciplinary Board (CALD)).

ASIC Media and Information Release

05-209 Adelaide liquidator reprimanded

An Adelaide insolvency practitioner has been severely reprimanded in his role as a registered liquidator by the Companies Auditors and Liquidators Disciplinary Board (CALDB) following an application by the Australian Securities and Investments Commission (ASIC). It was found that the liquidator failed to adequately and properly carry out the duties of a liquidator in relation to the administration of Southscape Civil Pty Ltd (Southscape), in that: he provided services to Southscape before it was placed into voluntary administration with a view to charging a fee for that work after he was appointed as the voluntary administrator; his investigation of the company was inadequate; and his report to creditors was inadequate.

The liquidator was appointed as voluntary administrator of Southscape, formerly Civil Works Group Pty Ltd, on 2 August. Southscape carried on a civil engineering business, earthmoving for the construction industry and structural concrete construction for the private and public sector. The liquidator had commenced his investigations into the company prior to his appointment and had obtained a court order abridging the time for holding the second meeting of creditors.

ASIC was concerned that the liquidator investigation was inadequate and that his report to creditors did not provide sufficient information to enable creditors to make an informed decision on whether to accept a proposed deed of company arrangement.

The liquidator resigned as administrator at the first meeting of creditors on 9 August 2004. The company has since been placed into liquidation.

As well as being reprimanded by the CALDB, the liquidator has given undertakings to the CALDB and was ordered to pay ASIC's costs of the proceedings.

'Creditors depend on registered liquidators to investigate the affairs of companies properly and, especially in voluntary administrations, to provide creditors with sufficient information to enable them to make good assessments about the company's position before deciding on its future. ASIC will continue to bring to account liquidators who fail in their duties by ensuring they are referred for disciplinary action where appropriate', ASIC's Deputy Executive Director of Enforcement, Mr Mark Steward said.

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The outcome of administration

Meeting to decide company's future

[31.110] This meeting signals the termination of administration and is particularly important as it is where the creditors consider the report of the administrator and vote on the company's future. Pursuant to s **439A** the meeting is to be held within five business days before, or within five business days after, the end of the convening period. The "convening period" is the period of 20 business days beginning on the day after the administration begins, or if that day is not a business day, the next business day (**s 439A(5)**). The convening period is extended at Christmas and Easter. If the day after the administration begins is in December, or is fewer than 25 business days before Good Friday, the convening period becomes 25 business days. The court can approve an extension of the convening period (**s 439A(6)**) in a situation where to do so fulfils the objects set out in **s 435A** of maximising the chances of the company continuing in business or resulting in a better return for creditors. Matters such as prejudice to creditors and pending litigation would be relevant to whether an extension is granted. In *Re Pan Pharmaceuticals* (2003) 46 ACSR 77; [2003] FCA 598, a 75-day extension was granted.

The *Insolvency Practice Rules (Corporations) 2016* (Cth) made under the *Corporations Act* regulate insolvency process together with the provisions of **Sch 2**. The relevant part of the *Insolvency Practice Rules* that concerns meetings during administration is **Div 75.** Adjournment of the meeting to decide the company's future (**r 75-140**) can take place by resolution of the meeting or by the person presiding at the meeting (external administrator). In this case, the meeting must not be adjourned to a day that is more than 45 business days after the first day on which the original meeting was held.

The creditors must be given written notice of the meeting, including the purpose for which the meeting is being convened. However, it has been held that the content of the notice may, particularly where the company has a large number of shareholders, set out that details concerning the meeting may be obtained from a website (*Re Ansett Australia Ltd and Mentha [No 2]* (2002) 115 FCR 395; 40 ACSR 419; [2002] FCA 2). Note that **s 600G** authorises the giving of electronic notice in certain circumstances.

Creditors' choices

[31.120] At the meeting to decide the company's future the administrator must present the creditors with a report concerning the business, property, affairs and financial circumstances of the company. It will be important for the administrator to address the issue of whether the choice made by the creditors would be in their interests and this requires providing information material to that decision. If the administrator's report suggests that the company has some chances of revival, the creditors may decide that allowing it to continue to trade will provide maximum returns. Accordingly, a deed of company arrangement will be entered into. This results in a restructure and is the desired outcome of voluntary administration. However, the

administrator may not be able to provide much hope for creditors if the company is insolvent and by choosing to wind up the company, the creditors will be placing the administrator (now the liquidator) in a position to pursue directors for insolvent trading under **s 588G** and perhaps recoup funds by that means.

A further matter that may be relevant to the creditors' consideration includes whether there are any transactions that appear to be voidable transactions in respect of which money, property or other benefits may be recoverable by a liquidator (if appointed) under **Pt 5.7B** of the *Corporations Act*.

At the **s 439A** meeting, the creditors may resolve, pursuant to **s 439C**, one of the following:

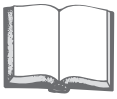
- that the company execute a deed of company arrangement (even if it differs from the proposed deed which accompanied any notice of the meeting);
- that the administration should end;
- that the company be wound up.

Accordingly, with the benefit of the administrator's report the creditors will decide the company's future, that is they will decide between: entering a deed of company arrangement; merely ending the administration without any further action by the administrator; or voting that the company be wound up. A resolution put to the vote at a meeting will be decided either by a poll if requested or "on the voices" (this is where the creditors are asked to call out their vote to the questions "those in favour" or "those against"; it is similar to a "show of hands" where raising of a hand signifies a vote: see *Insolvency Practice Rules*, **r 75-110** and **s 250J**). A resolution will be passed at the meeting if a majority of the creditors, in number and value, voting in person, by attorney or by proxy, vote in favour of the resolution.

Deed of company arrangement

[31.130] The aim of saving the business of the company and preserving employment is achieved if the creditors resolve that the company enter into a deed of company arrangement. All creditors are bound by the deed, however, a secured creditor is not prohibited from enforcing or otherwise dealing with its security, subject to certain matters set out in **s 444D**. The effect of **s 444D** is that a secured creditor will not be bound by the terms of a deed of company arrangement unless they have either voted in favour of the deed at the meeting to decide the company's future, or the court has made an order restricting the realisation (enforcement) of their security. The scope of **s 444D** was considered in *Lehman Brothers Holdings Inc v City of Swan* (2010) 240 CLR 509. In that matter, negotiations in relation to a deed of company arrangement involved the offer of support by Lehman Brothers, but on the condition of third party releases (that is, Lehman Brothers wanted to avoid being sued by creditors of the company who alleged their involvement stemmed from inadequate advice from Lehman Brothers). The deed was initially approved but after a challenge by certain creditors the Full Federal Court held the deed invalid and that the deed of company

arrangement provisions in the *Corporations Act* could not include third party releases as the binding provisions in the *Act* only related to rights that creditors had against the company in administration. However in some cases third party releases may produce a better result for the creditors.



[Harris J, "Adjusting creditor rights against third parties during debt restructuring" (2011) 19 *Insolvency Law Journal* 22 at 36.]

> Corporate insolvency law is not about making every creditor whole again, the economic fact of insolvency makes this impossible. Insolvency law aims to provide a more efficient distribution of corporate assets than would result from individual enforcement. The ability to resolve complex legal disputes by offering funds as part of an arrangement during insolvency may produce a faster and cheaper resolution than allowing creditors to have their day in court. Where related entities provide the funds for such arrangements they will usually require some form of release to ensure that their payment is not followed by more litigation at a later date. Provided that dissenting creditors have the safety net of court appeals to prevent oppressive conduct the use of third party releases can play an important role in producing a more efficient resolution of disputes in corporate insolvency situations.

Once a deed of arrangement is in place, and until it terminates, those bound by its terms cannot make an application to wind up the company or continue an application commenced prior to the deed, nor can they bring or continue proceedings or enforcement process against the company (**s 444E**). It should be noted that a deed of company arrangement not only binds the company but also its officers and members, and the deed's administrator (**s 444G**). The benefit of the creditors entering a deed of company arrangement is primarily that a restructure of the company, by providing the opportunity for it to trade out of its financial difficulties, is more likely to maximise a return in relation to their debt. Certainly this is a reason that a voluntary administrator would propose a deed of company arrangement.

Where the company has little hope of recovery and the administrator suspects insolvent trading may have occurred, the recommendation to the creditors may be to place the company into liquidation rather than enter a deed of company arrangement. Accordingly, directors of insolvent companies that are in administration often encourage the company's creditors to accept a deed as it avoids the liquidation of the company and the possibility that the liquidator (usually the person who was the administrator) will pursue them under **s 588G** for trading whilst insolvent (thereby lifting the corporate veil and making the directors personally liable for the company's debts). However, where a deed of company arrangement is entered into and is based on information, such as that provided by the directors, which was false or misleading and could reasonably be expected to have been material (important) to how the creditors voted, the court may make an order terminating the deed (**s 445D**).

The time limitations on an administration may make a full investigation by the administrator difficult. A means of securing more time (other than by seeking an

adjournment of the final creditors' meeting) is by the company entering a deed of company arrangement that does not deal with the distribution of property but simply extends the time an administrator has to negotiate and investigate for the purpose of securing a better outcome for creditors. This type of arrangement can be referred to as a holding deed of company arrangement (holding DOCA). However, it should be noted that this is not a legislative expression and that in *Mighty River International Ltd v Hughes* [2018] HCA 38, the expression "holding DOCA" was described by the Court as best avoided and that the description "purports to create an ill-defined sub-class of deed of company arrangement" (Kiefel CJ and Edelman J at [28]).

The definition of a creditor for the purposes of a deed of company arrangement is wide and can be interpreted in a similar fashion to the scope of **s 553**. That section concerns the winding up of a company, specifically debts or claims provable in a winding up. Creditors, having regard to **s 553** include persons with a claim that is present or future, certain or contingent, ascertained or sounding only in damages. The claims of creditors have traditionally taken priority over the claims of shareholders when a deed of company arrangement has been entered into. This hierarchy was briefly disturbed as the result of the judgment in *Sons of Gwalia Limited (Administrator Appointed) v Margaretic* (2007) 231 CLR 160; 81 ALJR 525; [2007] HCA 1. However, the relevant section, **s 563A**, was amended in 2010 and the status quo restored.

In some cases, companies enter deeds of company arrangement but, through various circumstances are not able to meet the terms of the deed. If this arises then, provided requisite notice is given, the creditors may, pursuant to **s 445E**, pass a resolution terminating the deed and resolving that the company be wound up. An example of where a deed of company arrangement was entered into but the company eventually wound up can be seen in the following newspaper article. It also provides examples of the kinds of financial factors that precede external administration. As can be seen from the article, the directors of the company, Nylex Ltd, appointed an administrator and thereafter secured creditors elected to appoint a receiver. While under administration and receivership, ways to restructure the company were considered. A deed of company arrangement was entered in October 2009. However, the terms of the deed were not able to be fulfilled and in 2011 a meeting of creditors resolved to wind up the company.

Nylex into administration and receivership after being swamped by debt

The financial crisis has finally broken the back of struggling manufacturer Nylex, which was initially placed in receivership and its shares suspended. McGrathNicol were appointed receivers and managers of the Nylex Group by a syndicate of secured lenders.

Nylex, which employed about 700 people throughout Australia, owed $60 million to the Westpac and ANZ banks and had debts of $100 million. A diversified company more than 60 years old, Nylex made some of Australia's most well-known products—Esky coolers, Ajax fasteners, rubbish bins and water tanks. It continued trading while in administration.

The receivers were appointed after directors placed Nylex in voluntary administration.

Nylex, based in Melbourne, had struggled for a decade and faced extensive restructuring.

When trading halted, its shares were worth 6.4¢, giving the company a market capitalisation of just $3.5 million. The financial crisis forced the banks to reassess their credit terms, and the slump in car sales has hit Nylex's automotive production. The company made plastic fuel tanks, carpet moulding and plastic components for cars.

Nylex said a default had arisen under its borrowing arrangements with the banks. The group had also been negotiating for a cash injection. Nylex made a loss of $21.3 million in the year after a profit of $10.9 million.

The company, a leading producer of water tanks, was badly hit by events in the tank market. The drought and a government rebate had stimulated demand for tanks, but there was a sudden flood of entrants to the market by local manufacturers, as barriers to entry were not high due to easily available technology. The oversupply pushed down prices, and when big rainfalls hit Queensland and NSW, demand for water tanks collapsed. Nylex had built its 2008 budget on expanding its tank operations.

The receivers said Nylex had faced a number of challenges over the years. "They have fought bravely, but the impact of the financial crisis has become too much. The company has a loyal and skilled workforce that produces good quality products. There is great value to be salvaged but the company could not stop the decline in trading".

Original source article by Philip Hopkins, *The Age*

***Corporations Act 2001* (Cth), s 436A**

Company may appoint administrator if board thinks it is or will become insolvent

(1) A company may, by writing, appoint an administrator of the company if the board has resolved to the effect that:
   (a) in the opinion of the directors voting for the resolution, the company is insolvent, or is likely to become insolvent at some future time; and
   (b) an administrator of the company should be appointed.
(2) Subsection (1) does not apply to a company if a person holds an appointment as liquidator, or provisional liquidator, of the company.

***Corporations Act 2001* (Cth), s 436E**

Purpose and timing of first meeting of creditors

(1) The administrator of a company under administration must convene a meeting of the company's creditors in order to determine:
   (a) whether to appoint a committee of inspection; and
   (b) if so, who are to be the committee's members.
(2) The meeting must be held within 8 business days after the administration begins.
(3) The administrator must convene the meeting by:
   (a) giving written notice of the meeting to as many of the company's creditors as reasonably practicable; and
   (b) causing a notice setting out the prescribed information about the meeting to be published in the prescribed manner:

   at least 5 business days before the meeting.

   Note: For electronic notification under paragraph (a), see section 600G.

(3A) A notice under paragraph (3)(b) that relates to a company may be combined with a notice under paragraph 450A(1)(b) that relates to the company.
(4) At the meeting, the company's creditors may also pass a resolution:
(a) removing the administrator from office; and
(b) appointing someone else as administrator of the company.

***Corporations Act 2001* (Cth), s 437A**

Role of administrator

(1) While a company is under administration, the administrator:
(a) has control of the company's business, property and affairs; and
(b) may carry on that business and manage that property and those affairs; and
(c) may terminate or dispose of all or part of that business, and may dispose of any of that property; and
(d) may perform any function, and exercise any power, that the company or any of its officers could perform or exercise if the company were not under administration.
(2) Nothing in subsection (1) limits the generality of anything else in it.

Note: A PPSA security interest in property of a company that is unperfected (within the meaning of the *Personal Property Securities Act 2009*) immediately before an administrator of the company is appointed vests in the company at the time of appointment, subject to certain exceptions (see section 267 of that Act).

***Corporations Act 2001* (Cth), s 439A**

Administrator to convene meeting and inform creditors

(1) The administrator of a company under administration must convene a meeting of the company's creditors within the convening period as fixed by subsection (5) or extended under subsection (6).

Note: For body corporate representatives' powers at a meeting of the company's creditors, see section 250D.

(2) The meeting must be held within 5 business days before, or within 5 business days after, the end of the convening period.
(5) The convening period is:
(a) if the day after the administration begins is in December, or is less than 25 business days before Good Friday—the period of 25 business days beginning on:
(i) that day; or
(ii) if that day is not a business day—the next business day; or
(b) otherwise—the period of 20 business days beginning on:
(i) the day after the administration begins; or
(ii) if that day is not a business day—the next business day.

(6) The Court may extend the convening period on an application made during or after the period referred to in paragraph (5)(a) or (b), as the case requires.
(7) If an application is made under subsection (6) after the period referred to in paragraph (5)(a) or (b), as the case may be, the Court may only extend the convening period if the Court is satisfied that it would be in the best interests of the creditors if the convening period were extended in accordance with the application.
(8) If an application is made under subsection (6) after the period referred to in paragraph (5)(a) or (b), as the case may be, then, in making an order about the costs of the application, the Court must have regard to:
(a) the fact that the application was made after that period; and
(b) any other conduct engaged in by the administrator; and
(c) any other relevant matters.

***Corporations Act 2001* (Cth), s 439C**

What creditors may decide
At a meeting convened under section 439A, the creditors may resolve:

(a) that the company execute a deed of company arrangement specified in the resolution (even if it differs from the proposed deed (if any) details of which accompanied any notice of meeting); or
(b) that the administration should end; or
(c) that the company be wound up.

Role of the court in voluntary administration

[31.140] Although an administrator can be appointed without seeking the court's approval, and generally the effectiveness of administration as a restructuring mechanism is aided by the absence of court intervention, it is nonetheless important that the court maintain an overriding supervisory role to ensure the processes of administration are undertaken equitably. **Section 447A** sets out the general power of the court to make orders it thinks appropriate including that the administration of a company should come to an end in circumstances where the company is found to be solvent, or where the provisions of that part of the *Corporations Act* dealing with voluntary administration (**Pt 5.3A**) are being abused. An application can be brought under **s 447A** by several parties including the company, a creditor or ASIC. The section has been widely used. In *Re National Express Group Australia (Bayside Trains)* (2003) 46 ACSR 674; [2003] FCA 764, an order was made under **s 447A** appointing a new administrator. The section was also used to cure a defective appointment (*Panasystems Pty Ltd v Voodoo Tech Pty Ltd* (2003) 21 ACLC 642; [2003] FCA 428) to vary a deed of company arrangement (*Re Pasminco Ltd (No 2)* (2004) 22 ACLC 774; 49 ACSR 470; [2004] FCA 656) and to vary the timetable for meetings during administration (*Australasian Memory Pty Ltd v Brien* (2000) 200 CLR 270; [2000] HCA 30—this case

established that **s 447A** should be interpreted broadly). The court can also make orders to protect creditors during the administration (**s 447B**). Note that together with the court's power to make orders in relation to an administration, the Insolvency Practice Schedule (**Sch 2**) includes procedures and requirements relevant to the supervision of administrators (registered liquidators).

Summary—Voluntary administration

The aim of voluntary administration is the restructure of a company in financial difficulty

Can be commenced quickly and the final decision as to its outcome is left to the creditors

Can be initiated by the directors (**s 436A**) or secured creditors (**s 436C**)

Creditors' claims are stayed during administration giving a better chance of a restructure

Exceptions to the stay arise for important creditors, such as those with a security interest (**s 441A**)

The administrator, not the board, runs the company in administration

The company's future is decided by creditors at the final creditors' meeting

The administrator advises the creditors and makes recommendations

Administration will end following the creditors' decision at the final meeting

Creditors' choices: winding up; deed of company arrangement; no action

Deed of company arrangement will enable a restructure

Examples of cases: *Pan Pharmaceuticals*; *Lehman Brothers Holdings*

32
Receivership

Appointment of receivers

[32.10] There are two main ways receivers are appointed: (i) by the court or (ii) by a creditor. A receiver will generally have wide powers of management and **s 416** sets out that for the purposes of **Pt 5.2** (the Part of the *Corporations Act 2001* (Cth) dealing with powers and duties of receivers and other controllers) a receiver will include a receiver and manager. Receivers will owe a duty to the company to act in good faith and are included in the definition of an "officer" in **s 9**. **Section 1323** provides for a receiver to be appointed by the court in order to protect various interests in relation to liability, damages or compensation. The grounds of appointment in **s 1323** include where an investigation is being carried out by ASIC as concerns a breach of the *Corporations Act*. Another instance where the court may appoint a receiver is pursuant to **s 233**. Where a shareholder succeeds in an action for oppression (**s 232**), the court may make an order under **s 233** appointing a receiver, or a receiver and manager, of any or all of the company's property. Pursuant to **s 418**, a person appointed as a receiver must be a registered liquidator. That section also sets out those persons who cannot be appointed and these include auditors, directors, secretaries, senior managers or employees of the company.

Most receivers are appointed privately (rather than by the court) by secured creditors pursuant to a debenture or other security document. When a creditor provides funds or credit to a company, they will often consider it important to secure their interests. The rights of security interest holders are governed by a combination of the *Personal Property Securities Act 2009* (Cth) (see Ch 17) and the *Corporations Act*. The debenture deed will have various conditions and will set out the remedies available to the secured party in the event of a default. An important remedy, or right, is the appointment of a receiver to take control of the company for the purpose of protecting the secured party's interests. The privately appointed receiver's primary duty is to the secured party who has appointed them. The board of directors remain in place, but certain directors' powers are superseded or modified. Powers such as those relating to financial reports are not affected. The appointment of a privately appointed receiver does not alter the legal personality of the company. As most receivers are appointed by creditors, receivership is not regarded as a restructuring mechanism in the same way as voluntary administration. The secured creditor is seeking to recoup its debt. However, if a receiver is able to find sufficient funds to satisfy the secured party's claim, he or she will remove themselves from the company. At this stage, the company may have no assets and quickly slip into liquidation but it is also possible that beneficial market conditions or new business may allow it to continue

to trade provided its restructured financial position (that is, how it has been left after receivership) enables it to.

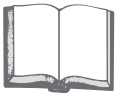
Powers of receivers

[32.20] Privately appointed receivers derive their powers from the debentures or security agreements under which they were appointed. A court appointed receiver's powers will generally be set out by the court. However, both types of receiver also derive powers under the *Corporations Act*. **Section 420** sets out the powers of receivers to include the ability to:

- enter into possession and take control of the company's property;
- carry on the business of the company;
- execute documents or to bring proceedings; and
- engage or discharge employees.

Further powers are outlined in **ss 429**, **430** and **431** (which sets out the power to inspect the books of the company relevant to the property that forms the subject of the receivership). The wide powers set out in **s 420** have been held to enable a receiver to assign a cause of action belonging to the company. In *Hawke v Daniel Efrat Consulting Services Pty Ltd* (1999) 91 FCR 154; 17 ACLC 733, the receiver of a printing company, upon advice, sought to bring an action on the company's behalf against another printing company in relation to unpaid commissions and other matters. The receiver did not have access to sufficient company funds to begin proceedings and sought approval to assign the cause of action to another party (an insurance company that would take as its fee a share of the proceeds of the action). The Federal Court held that the receiver had the requisite power to assign the cause of action and made a direction to that effect pursuant to **s 424(1)**.

A goal of receivership is to ensure that access is available to as much of the company's assets as possible and that the disposal of those assets provides the maximum return to the company. The powers of a receiver, particularly in **s 420**, are relevant to this goal. In a similar way, the level of the assets, and opportunities, that can be presented to creditors in a voluntary administration will determine whether the company can be successfully restructured or not. As insolvent companies do not generally provide much by way of return to creditors, especially unsecured creditors, alternative approaches to maximising returns have been considered. The following journal article extract looks at the use of "pre-pack" transactions.



[Poulos E and McCunn A, "Pre-pack transactions in Australia" (2011) 19 *Insolvency Law Journal* 235.]

A "pre-pack" transaction is the sale of the business or assets of a financially distressed or insolvent company that is commenced, and in most cases substantially

progressed, prior to any formal insolvency appointment. Negotiations for the transaction between the company and the prospective purchaser occur before the formal appointment is made. Major creditors of the company will be involved in the negotiations prior to the formal appointment and completion of the transaction, as their support, and in the case of secured creditors, their consent, is crucial to ensuring the sale is completed. In Australia, a traditional pre-pack sale can be completed by a receiver under s 420(2)(b) of the *Corporations Act* or, less frequently, by an administrator exercising the power under s 437A(1)(c) of the *Act*. Also, a practice has developed, commonly referred to as a "pre-pack DOCA" (or pre-pack deed of company arrangement) which involves a sale by a deed administrator under a Deed of Company Arrangement (DOCA). Whilst the pre-pack DOCA can be distinguished from the traditional pre-pack sale in that it does not involve an immediate sale upon appointment, it does share the essential characteristics of a pre-pack in that the desired outcome is agreed by key stakeholders prior to the appointment of the insolvency practitioner who is to give effect to the transaction.

Duties of receivers

[32.30] Receivers are subject to various statutory duties. They have a general liability following their appointment as set out in **s 419**. Further liability exists in **s 419A** and specifically under **s 420A** where the receiver is under a duty of care to sell company property at market value or otherwise at the best price that is reasonably obtainable having regard to the circumstances existing when the property is sold. This is to avoid the practices of receivers who ignore the company's interests and focus on their appointer's (the secured party's) interests solely. If a receiver were to sell at below market value, the company's remaining equity in the property would be reduced, thereby hampering its chances to resurrect its business following receivership.

The application of **s 420A** takes into account the various circumstances that may impact upon receivers in the course of valuing and selling company property. In *Florgale Uniforms Pty Ltd v Orders* (2004) 187 FLR 142; [2004] VSC 65, the company had conducted a business of manufacturing specialised apparel, linen and corporate uniforms. It had been financed, on debenture security, by a bank, which, on default, appointed a receiver. The company claimed relief against the receiver for alleged breaches of duty under **s 420A(1)** in selling stock at auction rather than to existing customers, and in failing to accept a prospective purchaser's advantageous offer made before the auction, albeit at short notice. The facts of the case revealed that the receiver had attempted, unsuccessfully, to sell the business as a going concern; had permitted trading to continue for over a week after deciding to close the business; and had encouraged the sale of items at above the estimated auction value before the auction was held. After considering the facts, the Court was not satisfied that the receiver's strategies were formulated on other than reasonable grounds, or that there was any obligation on him to produce a documented exploration and investigation of the feasibility of removing certain items of stock from auction, the cost of so doing, and any likely increase in price at auction that might have resulted.

Florgale Uniforms Pty Ltd v Orders (2004) 187 FLR 142; [2004] VSC 65 (Dodds-Streeton J)

Extract from Judgment

At [364], [418], [442], [443], [447]

The guarantors and third party mortgagors in this case argue that, but for a breach of duty by the receiver in realising the Florgale Group's stock, sufficient funds would have been realised from its sale fully to satisfy the liabilities to the debenture holder, without recourse to the guarantees and third party mortgages.

The property was originally to be auctioned on 30 August 2001. Signboarding was erected, advertisements were placed in national newspapers and a mail out to over 500 potential purchasers was conducted. Information memoranda and copies of the contract were sent to relevant inquirers. The defendant mortgagee was a corporation of which two solicitors, father and son, were directors and shareholders. Following the mortgagor's default, the father received offers for the property, including offers for $7 million and $9 million. The auction of the property was postponed to 13 September 2001. While the father was absent overseas his son handled the auction but was unaware of the prior offers. Despite the advice of the agent handling the auction, no additional advertising of the property took place. The signboards were not updated to show the new auction date and time. Shortly before the auction, a potential purchaser expressed a "serious" interest in buying the property, but the mortgagee took steps that had the inevitable consequence of keeping the potential purchaser away from the auction.

The expert evidence establishes that the exercise of all reasonable care by a receiver would entail a process of selecting the method of realising the highest net return, by considering the different available means of sale and weighing the prices likely to be achieved against the likely costs and expenses entailed and the relative risks of the various methods in all the circumstances. The process is informed by the objective of securing the best possible return for the secured creditor, subject to the obligations imposed by general law doctrines and s 420A. It necessarily involves the exercise of judgment, taking into account all the relevant variables and circumstances of the particular case. It does not depend on matters of price or revenue alone, or any single factor in isolation.

In my opinion, the process of evaluating and balancing the competing costs and benefits and the associated risks of various methods of sale will not, in every case, require a formal comparative analysis or documented calculations. All will depend on the circumstances of the individual case, including the scale of the receivership, the value and nature of the property involved, the receiver's expertise in relation to the type of property, relevant expert advice, the advice or input of proprietors and staff, the trading history and marketing of the company, including during the receivership, and other relevant variables in a realistic commercial context.

In my opinion, the plaintiffs have not established that the receiver breached his duty by failing to take all reasonable care in relation to the analytical process or the selection of the mode of realisation of the Florgale Group stock.

As well as being an "officer" as defined in **s 9**, a receiver is also an "officer" under **s 179** thereby exposing them to liability pursuant to various sections in **Pt 2D.1**. Accordingly, a receiver must act with due care and diligence (**s 180**) and in good faith in the best interests of the company and for a proper purpose (**s 181**). Action may be taken by ASIC, and the court may make orders as it sees fit, where a receiver has not faithfully performed their functions pursuant to the *Corporations Act*, under any court order or under the instrument by which they took control of the company's property.

Summary—Receivership

Appointed by the court (**ss 1323** and **233**) or by a secured creditor (private appointment)

Most receivers are privately appointed where companies default under security arrangements

If appointed by a secured creditor the receiver will owe duties to that creditor

Receivers' powers derive from the debentures or security agreements appointing them

The *Corporations Act* also contains powers of receivers (**s 420**)

Receivers are "officers" (**ss 9** and **179**) and have duties under the *Corporations Act*

Examples of duty: to sell company property at market value **s 420A**; act in good faith **s 181**

33
Liquidation

[33.10] Where restructuring is not successful, or not attempted, the law provides a final mechanism to deal with companies in financial difficulty. This is liquidation. Once a company is in liquidation (wound up), it ceases to exist as it did before and comes under the control of the liquidator whose job it is to finalise any outstanding matters, identify assets and accumulate and convert them so that creditors receive a proportionate return on the amount they are owed. Companies can be wound up voluntarily by its members or creditors, or compulsorily by the court.

Voluntary winding up

[33.20] There are two types of voluntary winding up:

- Members voluntary: Provided the company passes a special resolution (75%) (**s 491**) and the directors make a written declaration that the company will be able to pay its debts in full within 12 months of the commencement of winding up (a declaration of solvency **s 494**), the company will go into voluntary liquidation and a liquidator will be appointed under **s 495**.
- Creditors voluntary: If the company is not solvent (it is insolvent), then the voluntary winding up can still proceed with the approval of the creditors. An example of this is where at the final meeting of creditors under a voluntary administration (the meeting to decide the company's future) the creditors vote (pursuant to **s 439C**) to wind the company up.

Compulsory winding up

[33.30] A company can be wound up compulsorily by the court under **s 461** on grounds other than insolvency or under **s 459A** on the ground that it is insolvent. Note also that ASIC is given a specific power to apply for a winding up in connection with an investigation under the *ASIC Act 2001* (Cth) (**s 464**).

Winding up by the court on the ground of insolvency

[33.40] **Section 459A** sets out that pursuant to an application by one or more of the parties listed in **s 459P**, the court may order that an insolvent company be wound up. **Section 95A** sets out that a person is solvent if they can pay all of their debts as and when they become due and payable. Accordingly, insolvency is when a person cannot do so. A decision as to a company's insolvency should take into account its financial

position in its entirety and matters such as a temporary lack of liquidity should not be decisive. For example, in *Hamilton v BHP Steel Pty Ltd* (1995) 13 ACLC 1,548, the court recognised the business reality of delaying payment of debts in its consideration of a company's solvency. In a general sense, a company may be considered solvent, where it can utilise the resources realistically available to it through the use of assets, or other means, to meet its debts as they fall due. If a company is insolvent, its creditors are at risk and, because a company is an artificial legal entity, it may be the vehicle through which business is done yet have no assets from which creditors could seek repayment. Commercially, an insolvent company has a negative impact on creditor confidence. In these circumstances, there is a commercial justification in withdrawing such companies from the market, that is, placing the company into liquidation. Of course, restructuring the company may avoid the likelihood of liquidation, and in this regard, voluntary administration (see Ch 31) is an important alternative for companies in financial difficulty.

Although each company's situation will be different, there are a number of common indicators of insolvency. In *Austin Australia Pty Ltd v De Martin & Gasparini Pty Ltd* [2007] NSWSC 1238, certain factors were singled out as relevant. These included: a history of dishonoured cheques; suppliers requiring COD; issuing post-dated cheques; negotiating special arrangements with creditors; failure to prepare, or delay in, financial accounts; unpaid group or payroll tax; failure to pay required premiums or superannuation contributions; receipt of bank demands; receipt of letters of demand and legal proceedings for debts owed.

An application under **s 459A** that a company be wound up in insolvency can be made by several parties including the company, a creditor, a contributory (member), a director, a liquidator, or ASIC. Unless the applicant is the company or a liquidator, the leave of the court must be sought. Pursuant to **s 459P(3)**, leave will be given, where the court is satisfied that there is a prima facie case that the company is insolvent. Where a creditor seeks to wind up a company under **s 459A** based upon service of a statutory demand (**s 459E**), there are three main elements of which a court must be satisfied. The applicant for the order must prove: insolvency; that the amount outstanding exceeds the statutory minimum ($2,000 or other prescribed amount); and that the court has jurisdiction (ie, the company is one to which the *Corporations Act 2001* (Cth) applies).

A company is insolvent if it cannot pay its debts as they fall due. A creditor can rely on certain presumptions in **s 459C** to establish insolvency. These include that a receiver has been appointed under a power contained in an instrument relating to a circulating security, or that execution of, or other process issued in relation to, a judgment in favour of a creditor of the company has been returned unsatisfied (this means that a sheriff's officer has not been able to collect a judgment debt). However, the most common presumption used is found in **s 459C(2)(a)**. This sets out that the court must presume that the company is insolvent if, during or after the three months ending on the day when the application for winding up was made, the company failed to comply with a statutory demand. Accordingly, for a creditor to be able to establish insolvency as the result of non-compliance with a statutory demand, that

non-compliance must have occurred within the three months before the application to wind up was filed/commenced, or after that date.

A statutory demand is a document prepared by the creditor (usually its solicitor), which sets out the details of the debt and that if the debt is not satisfied within 21 days of the service of the demand, then the company is presumed insolvent pursuant to **s 459C**. Service of the demand is by pre-paid post to the registered office of the company as set out in the ASIC records. Unless the debt referred to in the statutory demand is a judgment debt, the demand must be accompanied by an affidavit verifying that the amount claimed is due and payable. A company that has an offsetting claim in relation to the debt or for some other reason disputes the statutory demand has 21 days after service of the demand to apply to the court to set it aside (**s 459G**). The courts have interpreted the application of the 21 day period strictly (*Chief Commissioner of State Revenue (NSW) v Boss Constructions (NSW)* [2018] NSWCA 270). In *Design & Construct Pty Ltd v Golden Plantation Pty Ltd* [2011] NSWCA 7, Spigelman CJ described the statutory demand process as constituting "a carefully formulated series of interlocked steps which have substantial consequences and the objects of which require precise compliance for their attainment" (at 29). There is an onus on the company seeking to set aside a statutory demand to clearly outline the area of dispute in accordance with the grounds set out in **ss 459H** and **459J**. In *Graywinter Properties Pty Ltd v Gas & Fuel Corp Superannuation Fund* (1996) 70 FCR 452; 21 ACSR 581, it was established that a mere assertion of a genuine dispute, or a bare claim that the debt was disputed, were both insufficient for the purposes of **s 459G**.

If there is non-compliance with the statutory demand, the creditor can file an application to wind up the company in either the Federal Court of Australia or a State Supreme Court. Prior to the matter being heard, the creditor must place a notice, including the date and place of the hearing, on the ASIC insolvency notices website. This allows other creditors of the company access to the details of the application and the opportunity to attend the hearing. If at the hearing the creditor can satisfy the court of all relevant matters (and provided no application to set aside has been made by the company), then an order that the company be wound up will be made and a liquidator appointed.

***Corporations Act 2001* (Cth), s 459C**

Presumptions to be made in certain proceedings

(1) This section has effect for the purposes of:
  (a) an application under section 234, 459P, 462 or 464; or
  (b) an application for leave to make an application under section 459P.
(2) The Court must presume that the company is insolvent if, during or after the 3 months ending on the day when the application was made:
  (a) the company failed (as defined by section 459F) to comply with a statutory demand; or

(b) execution or other process issued on a judgment, decree or order of an Australian court in favour of a creditor of the company was returned wholly or partly unsatisfied; or
(c) a receiver, or receiver and manager, of property of the company was appointed under a power contained in an instrument relating to a circulating security interest in such property; or
(d) an order was made for the appointment of such a receiver, or receiver and manager, for the purpose of enforcing such a security interest; or
(e) a person entered into possession, or assumed control, of such property for such a purpose; or
(f) a person was appointed so to enter into possession or assume control (whether as agent for the secured party or for the company).

(3) A presumption for which this section provides operates except so far as the contrary is proved for the purposes of the application.

***Corporations Act 2001* (Cth), s 459E**

Creditor may serve statutory demand on company

(1) A person may serve on a company a demand relating to:
(a) a single debt that the company owes to the person, that is due and payable and whose amount is at least the statutory minimum; or
(b) 2 or more debts that the company owes to the person, that are due and payable and whose amounts total at least the statutory minimum.

(2) The demand:
(a) if it relates to a single debt—must specify the debt and its amount; and
(b) if it relates to 2 or more debts—must specify the total of the amounts of the debts; and
(c) must require the company to pay the amount of the debt, or the total of the amounts of the debts, or to secure or compound for that amount or total to the creditor's reasonable satisfaction, within 21 days after the demand is served on the company; and
(d) must be in writing; and
(e) must be in the prescribed form (if any); and
(f) must be signed by or on behalf of the creditor.

(3) Unless the debt, or each of the debts, is a judgment debt, the demand must be accompanied by an affidavit that:
(a) verifies that the debt, or the total of the amounts of the debts, is due and payable by the company; and
(b) complies with the rules.

In *ASIC v Radisson Maine Property Group (Australia) Pty Ltd* (2004) 51 ACSR 420; [2004] NSWSC 949, ASIC sought that Radisson Maine Property Group and another company,

Ran Holdings International, be wound up in insolvency pursuant to **ss 459A**, **459B**, **464** and **472** of the *Corporations Act* and alternatively on the just and equitable ground under **s 461(1)(k)**. The Court held that where it is required to determine the issue of insolvency, it must do so by considering the company's financial position in its entirety, based on commercial reality. The question was whether, at the relevant time, the company could pay its debts as they fell due.

ASIC v Radisson Maine Property Group (Australia) Pty Ltd [2004] NSWSC 949 (Pearlman AJ)

Extract from Judgment

At [50]-[52]

I am satisfied, on the balance of probabilities, that the defendants are each insolvent.

My reasons for reaching that conclusion are as follows. First, although not determinative, I place weight upon Mr Lombe's (provisional liquidator) opinion, expressed in his primary report and repeated several times in cross-examination, that neither of the defendants has assets, cash flow or capacity to pay its debts as and when they became payable. Secondly, although again not determinative, I place weight upon the fact that the defendants have in effect admitted insolvency. They have not produced any evidence to the contrary of the matters dealt with by Mr Lombe, but have approached ASIC's application for winding up on the basis that their negative financial position can be cured by the appointment of (a new director) and a cash injection from (current shareholders). Thirdly, I have had regard, as a matter of commercial reality, to the whole of the financial position of the defendants set out in the evidence. Each of the defendants has significant liabilities. The (companies/defendants have) significantly negative cash flow. Neither of the defendants has available any realistic amount of cash to meet debts as they fall due. Nor do they have available any material net assets against which borrowings by way of further funding could be secured. The cross-examination of Mr Lombe did not change these facts. Whilst as a theoretical matter the position of the defendants could improve, that is not the present reality. Further, the defendants have failed to comply with statutory requirements as to the furnishing of returns, and significant amounts are owing for tax and employee liabilities. Fifthly, nothing has been put to the Court to demonstrate that the level of activity of the business of the defendants will increase so as to improve their financial position any substantial way.

The approach taken by the defendants is one of fervent hope for the future. But the issue is not whether they would be able in the future to trade profitably and thereby meet debts as they became due; the issue is whether they are presently able to do so with the assets available to them. However, even if the Court was to look to the future, the defendants have proffered nothing but speculation. The new director to be appointed has no experience as a company director, nor any demonstrated experience in the running of a business such as that of the companies. His business plan, while no doubt produced in good faith, seems hopeful rather than realistic.

Winding up by the court on grounds other than insolvency

[33.50] Where insolvency is not the basis of an application to wind up, the *Corporations Act* provides alternative means in **s 461**. The parties that can apply to the court to wind up a company under **s 461** include the company, a creditor, a contributory (member) and ASIC. Where the application is based on the just and equitable ground in **s 461(1)(k)**, the court must be satisfied of a justifiable lack of confidence in the conduct and management of the company.

***Corporations Act 2001* (Cth), s 461**

General grounds on which company may be wound up by Court

(1) The Court may order the winding up of a company if:
- (a) the company has by special resolution resolved that it be wound up by the Court; or
- (c) the company does not commence business within one year from its incorporation or suspends its business for a whole year; or
- (d) the company has no members; or
- (e) directors have acted in affairs of the company in their own interests rather than in the interests of the members as a whole, or in any other manner whatsoever that appears to be unfair or unjust to other members; or
- (f) affairs of the company are being conducted in a manner that is oppressive or unfairly prejudicial to, or unfairly discriminatory against, a member or members or in a manner that is contrary to the interests of the members as a whole; or
- (g) an act or omission, or a proposed act or omission, by or on behalf of the company, or a resolution, or a proposed resolution, of a class of members of the company, was or would be oppressive or unfairly prejudicial to, or unfairly discriminatory against, a member or members or was or would be contrary to the interests of the members as a whole; or
- (h) ASIC has stated in a report prepared under Division 1 of Part 3 of the *ASIC Act* that, in its opinion:
  - (i) the company cannot pay its debts and should be wound up; or
  - (ii) it is in the interests of the public, of the members, or of the creditors, that the company should be wound up; or
- (k) the Court is of opinion that it is just and equitable that the company be wound up.

(2) A company must lodge a copy of a special resolution referred to in paragraph (1)(a) with ASIC within 14 days after the resolution is passed.

Matters that arise following the appointment of a liquidator

[33.60] Once appointed, a liquidator will control the company and take all of the powers of the board and the directors will cease to perform any functions or powers (**s 198G**). The company's property will vest in the liquidator and the creditors cannot

bring any proceedings against the company or enforce any judgment. The creditors must deal with the liquidator following winding up and advise the liquidator of their claims. The liquidator has various powers arising from **s 477** including running the company, bringing proceedings in the company's name or selling the company's property.

The liquidator will be the company's agent and, because of the role undertaken, will have fiduciary obligations to the company similar to those applying to directors. As an "officer" pursuant to **ss 9** and **179**, the liquidator will be subject to various statutory duties such as those relating to officers in **Pt 2D.1**. For example, a liquidator cannot improperly use their position to gain advantage (**s 182**). The liquidator's role involves identification, collection and distribution of the company's assets. The liquidator may need to examine (question in court) the directors of the company or other relevant parties to assist in the identification of assets. The liquidator will also meet with the creditors and keep them informed of the progress of the liquidation.

Following the processes of collection, the liquidator will be in a position to distribute funds. Before any distribution under the priorities in the *Corporations Act* occurs, the secured creditors are entitled to enforce their security. There are some exceptions to the secured creditors' rights, such as in **s 561**, where a secured party with a circulating security interest will lose their priority if the funds available for distribution are insufficient to pay all employee claims. After the secured creditors have enforced their claims, the remainder of the funds is distributed pursuant to the priorities in **s 556**. The order of priority in **s 556** includes:

- the cost of preserving the company's business and realising its property;
- the costs of the winding up (including solicitors costs);
- other costs necessary to winding up such as those of administrators or liquidators;
- wages (employee directors are subject to a limit in the amount claimed);
- compensation for injury;
- holiday or sick pay entitlements (directors subject to a limit);
- retrenchment; and
- non-priority creditors ranked equally pursuant to **s 555**.

Following the application of the priorities in **s 556**, the non-priority creditors, which include unsecured creditors, will share the funds available proportionately. The principle of equality of distribution set out in **s 555** is referred to as the *pari passu* rule and reflects that the basis of the process of liquidation is designed to benefit the creditors generally. However, because most companies in liquidation have limited funds for distribution, it is not unusual for non-priority unsecured creditors to receive only a proportion of their entitlement. Lastly, and only if there is a surplus after all creditors have received their full entitlement, the company's members will receive a distribution. When the winding up is complete, the company will be deregistered (**s 601AC**).

The liquidator's power to recoup funds

[33.70] If all a liquidator could use to repay creditors was the amount existing in the company's accounts or the value of the company's capital assets at the time of winding up, there would rarely be much to distribute. Companies wound up by the court usually have little property available to satisfy creditors. Accordingly, the *Corporations Act* gives the liquidator various powers that allow a wider view to be taken as to what property may be targeted for the purposes of the collection of a fund from which creditors' claims may be satisfied.

One way the *Corporations Act* facilitates the liquidator's task of identifying and calling in company assets is to enable the liquidator to look back at company transactions that occurred prior to the filing/presentation of the application to wind up. Proceedings can be commenced in either the Federal Court of Australia or a State Supreme Court. The liquidator is then able to use the provisions of **Pt 5.7B** to claim that certain property dealt with in that prior period (generally by the directors) can be recouped (and usually, auctioned) for the purposes of distribution to the creditors of the company in liquidation. Another means by which a liquidator can recoup funds is where directors are in breach of the insolvent trading provisions in **s 588G**. Rather than being focused on company assets, as the voidable transaction provisions are, an application pursuant to **s 588G** targets directors' personal assets.

Together with proceedings under the *Corporations Act*, the liquidator, being in control of the company and its management, can use remedies available generally to the company against its officers.

As directors are fiduciaries, they owe duties to the company and if loss results to the company they are personally liable. The liquidator can enforce these duties on behalf of the company. For example, in *Paul A Davies (Aust) Pty Ltd v Davies* [1983] 1 NSWLR 440; (1983) 1 ACLC 1091, the company had been placed into liquidation. The liquidator targeted a director for breach of fiduciary duty and succeeded in recouping the total benefit gained by the director as a result of the breach.

With large company failures becoming a more normal occurrence and the possibility of recouping funds dependant on complex investigations, liquidators often need the assistance of the creditors in the funding of their investigations and the carrying out of examinations of directors and other relevant parties. Together with creditor funding, liquidators often seek independent funding from established litigation funders. The following newspaper article sets out an example of a successful request to creditors and notes that further funding is to be provided by IMF. IMF Bentham Ltd is a public listed company providing funding of legal claims. Without this type of funding, recovery action by liquidators in complex liquidations (and by shareholders in class actions) would be limited.

Fighting fund set up to probe directors' actions

In a step rarely seen in corporate Australia, the creditors have joined forces and raised $300,000 of their own money to create a fighting fund to investigate the actions of Babcock's directors and senior management. The reason? They want heads on sticks. Now, in liquidation and

with sufficient funds to complete a detailed investigation, the noteholders will expect a full and final reckoning of director and banking consortium actions.

The fighting fund will be used to fund public examinations of the directors and other relevant parties to investigate how Australia's second-largest investment bank lost $5 billion in a financial year. The aim is to start these examinations within two months.

At the same time, litigation funder IMF will be invited to wade into the mess, which to date has barely rated a word from the corporate watchdog ASIC. ASIC's silence has been nothing short of breathtaking given the explosive report Babcock & Brown's administrators published in August, which included claims that directors may have breached their duties and the corporations law by operating the investment bank while it was insolvent.

Original source article by Adele Ferguson, *The Australian*

Voidable transactions

[33.80] Upon the liquidation of a company, the liquidator will use whatever funds or assets the company has, or that can be collected, to attempt to satisfy creditors' claims. Where a company's assets have been divested or diminished prior to liquidation, the liquidator's task is made more difficult and the level of creditor dissatisfaction increases. If the company's assets have been depleted in a way that prejudices its creditors, the liquidator is able to target certain transactions. This results in a retrospective alteration of rights and can only occur if the transaction falls within the scope of one of the voidable transactions in **Pt 5.7B**.

There are two major criteria that must be addressed before the liquidator can succeed in calling in, or collecting, assets pursuant to the voidable transactions provisions. The first is the issue of the company's insolvency at the time of the transaction, and the second is when the transaction took place. The liquidator can look for past transactions over varying periods depending on the type of transaction. The period that can be examined is called the relation-back period. The period in each case will commence on the "relation-back day". The identification of the appropriate relation-back day in the several circumstances in which a company can be placed into liquidation depends on factors such as whether the company was in voluntary administration at the time of liquidation, whether a deed of company arrangement had been entered, whether the liquidation was voluntary or compulsory. **Schedule 2** of the *Corporations Act* (Insolvency Law Schedule) sets out the meaning of the "relation-back day". Broadly, if a company was under administration immediately prior to it being wound up, then the "relation-back day" may be the date that the administration commenced, or in certain circumstances, it may be the date that the application to wind up the company was filed. In situations where the winding up of a company is taken to have commenced on the day the order to wind up was made (this includes where a creditor has applied to the court to wind up the company) the "relation-back day" will be the date of the filing of the application to wind up (see **ss 513A-513D**). Accordingly, where creditors wind up insolvent companies compulsorily (ie, court-ordered liquidation) the date from which the liquidator, once appointed by the court, can take as the start date (the relation-back day) from which to measure the time periods applicable to the

voidable transactions will be the date that the creditor who brought the proceedings initiated those proceedings (ie, the filing of the application to wind up).

Types of voidable transactions

[33.90] Recovering property or compensation for the benefit of creditors of an insolvent company is dealt with in **Pt 5.7B** of the *Corporations Act* and that Part contains the law relevant to voidable transactions. Basically, the liquidator can look at certain transactions for the purposes of recouping funds. There are several types of transactions set out in **s 588FE**. Of these, four require a finding that the company was either insolvent at the time of the transaction or became insolvent as a result of the transaction. These four are an unfair preference (**s 588FA**—relation-back period six months); an uncommercial transaction (**s 588FB**—relation-back two years); a transaction with a related party (relation-back four years); and a transaction to defeat creditors (relation-back 10 years). The other two types of transactions referred to in **s 588FE** do not require a finding that the company was insolvent at the time of the transaction. These are an unfair loan (unlimited relation-back period) and an unreasonable director-related transaction (relation-back four years). Once the criteria relevant to the particular transaction have been satisfied (ie, the relation-back and insolvency issues), then the liquidator can treat the transaction as voidable and use the provisions of the *Corporations Act* for the purposes of recouping funds. The liquidator claims the benefit derived from the transaction from the other party. For example, a creditor who has received an unfair preference must pay to the liquidator (for the benefit of the company), the amount received. The orders that can be sought by the liquidator are set out in **s 588FF** and include: an order directing a person to pay to the company an amount equal to some or all of the money that the company has paid under the transaction; an order directing a person to transfer to the company property that the company has transferred under the transaction.

However, before any order under **s 588FF** can be made in favour of the liquidator in relation to a voidable transaction, the availability of any defences against the liquidator's claim must be considered. **Section 588FG** sets out that transactions are not voidable as against certain persons in a number of circumstances. These include if the person received no benefit, or, if a benefit was received, it was in good faith and the person had no reasonable grounds, nor would a reasonable person have had grounds, for suspecting the insolvency of the company. In certain circumstances, a benefit gained from a continuing business relationship, for example, a running account, will not be seen as an unfair preference. **Section 588FA(3)** sets out that where a transaction is, for commercial purposes, an integral part of a continuing business relationship between a company and a creditor and in the course of the relationship the level of the company's net indebtedness to the creditor is increased and reduced from time to time as the result of a series of transactions forming part of the relationship, then all of those transactions must form part of the assessment of whether a preference occurred. Courts will consider the purpose of payments when deciding whether an

unfair preference arises. In *Airservices Australia v Ferrier* (1996) 185 CLR 483, the court held that if a payment by a company is intended to induce a creditor to provide further goods or services as well as to discharge an existing indebtedness, the payment will only be a preference if it exceeds the value of the goods or services subsequently provided, even where the payment is made in respect of a particular debt. The payment will only be preferential, where in the circumstances, it results in a decrease in the net value of the assets available to meet the competing demands of the other creditors.

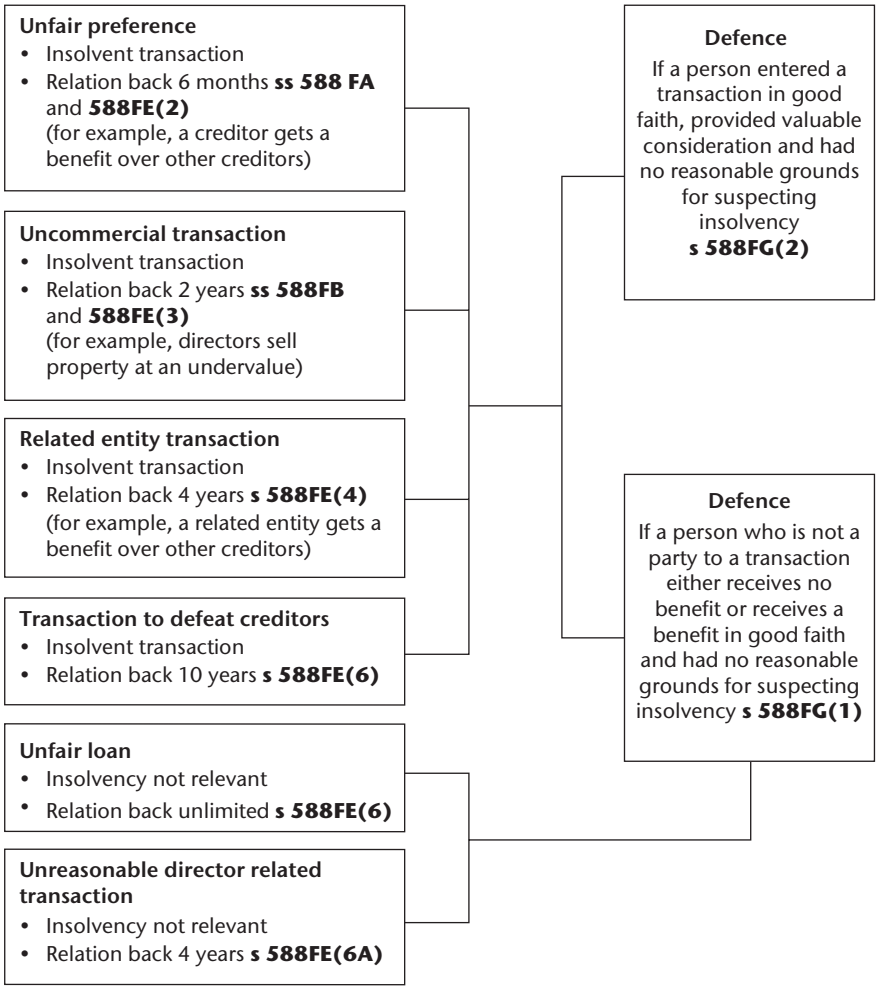
Section 588FE includes provisions relating to the situation when liquidation follows voluntary administration. **Section 588FE(2A)** and **(2B)** set out that if a company was in voluntary administration (**2A**) or under a deed of company arrangement (**2B**) immediately before winding up then a voidable transaction will arise if that transaction was either an uncommercial transaction, an unfair preference, an unfair loan or an unreasonable director related transaction and was not entered into by the administrator or deed administrator or with their authority. The relation-back period will commence on the relation-back day (which will be the date administration commenced) and end either: if the company was wound up by special resolution—on the day of the special resolution or; if the company was wound up by the court—on the day of the court order.

The liquidator can also target transactions that discharge a liability of guarantor related entities. Creditors often require directors to enter into personal guarantees in relation to company debts. When companies are insolvent or nearing insolvency directors will obviously want to discharge their personal liability under the guarantee and therefore are likely to repay the company's debt to the particular creditor that the guarantee relates to, prior to the payment of other debts. Such payment has the effect of a preference and the liquidator can recover the amount pursuant to **s 588FH**. Another practice adopted when a company is in financial difficulty is for companies to secure past debts by granting circulating security interests over their assets in favour of certain creditors. **Section 588FJ** addresses this situation by providing that a circulating security interest created during the six months ending on the relation-back day is void against the liquidator (ie, the liquidators rights override the rights of the circulating security interest holder) unless the company was solvent immediately after the security interest was created. Once the company is in liquidation, dispositions of company property not in accordance with the *Corporations Act* will be void (**s 468**).

When companies are insolvent or nearing, insolvency directors obviously have choices as to which creditors to pay. As referred to above, a preferential payment to a creditor will be voidable if the relevant conditions are met. Where the preferential payment is to the Commissioner of Taxation (eg, group tax owing) directors may be exposed to personal liability under **s 588FGA**. Where an order is made under **s 588FF** requiring a preference to the Commissioner of Taxation to be repaid to the company, then pursuant to **s 588FGA** that amount becomes a debt due to the Commonwealth by the directors (payable to the Commissioner). There are defences available to the directors in **s 588FGB**. These defences are in all material respects identical to the defences available under **s 588H** in relation to insolvent trading (see [33.120]).

Voidable transactions

[33.100]



***Corporations Act 2001* (Cth), s 588FA**

Unfair preferences

(1) A transaction is an unfair preference given by a company to a creditor of the company if, and only if:
   (a) the company and the creditor are parties to the transaction (even if someone else is also a party); and
   (b) the transaction results in the creditor receiving from the company, in respect of an unsecured debt that the company owes to the creditor, more than the

creditor would receive from the company in respect of the debt if the transaction were set aside and the creditor were to prove for the debt in a winding up of the company;

even if the transaction is entered into, is given effect to, or is required to be given effect to, because of an order of an Australian court or a direction by an agency.

(2) For the purposes of subsection (1), a secured debt is taken to be unsecured to the extent of so much of it (if any) as is not reflected in the value of the security.

(3) Where:

(a) a transaction is, for commercial purposes, an integral part of a continuing business relationship (for example, a running account) between a company and a creditor of the company (including such a relationship to which other persons are parties); and

(b) in the course of the relationship, the level of the company's net indebtedness to the creditor is increased and reduced from time to time as the result of a series of transactions forming part of the relationship; then:

(c) subsection (1) applies in relation to all the transactions forming part of the relationship as if they together constituted a single transaction; and

(d) the transaction referred to in paragraph (a) may only be taken to be an unfair preference given by the company to the creditor if, because of subsection (1) as applying because of paragraph (c) of this subsection, the single transaction referred to in the last-mentioned paragraph is taken to be such an unfair preference.

***Corporations Act 2001* (Cth), s 588FB**

Uncommercial transactions

(1) A transaction of a company is an uncommercial transaction of the company if, and only if, it may be expected that a reasonable person in the company's circumstances would not have entered into the transaction, having regard to:

(a) the benefits (if any) to the company of entering into the transaction; and

(b) the detriment to the company of entering into the transaction; and

(c) the respective benefits to other parties to the transaction of entering into it; and

(d) any other relevant matter.

(2) A transaction may be an uncommercial transaction of a company because of subsection (1):

(a) whether or not a creditor of the company is a party to the transaction; and

(b) even if the transaction is given effect to, or is required to be given effect to, because of an order of an Australian court or a direction by an agency.

***Corporations Act 2001* (Cth), s 588FC**

Insolvent transactions

A transaction of a company is an insolvent transaction of the company if, and only if, it is an unfair preference given by the company, or an uncommercial transaction of the company, and:

(a) any of the following happens at a time when the company is insolvent:
  (i) the transaction is entered into; or
  (ii) an act is done, or an omission is made, for the purpose of giving effect to the transaction; or
(b) the company becomes insolvent because of, or because of matters including:
  (i) entering into the transaction; or
  (ii) a person doing an act, or making an omission, for the purpose of giving effect to the transaction.

***Corporations Act 2001* (Cth), s 588FE**

Voidable transactions

(1) If a company is being wound up:
  (a) a transaction of the company may be voidable because of any one or more of subsections (2) to (6) if the transaction was entered into on or after 23 June 1993; and
  (b) not reproduced.
(2) The transaction is voidable if:
  (a) it is an insolvent transaction of the company; and
  (b) it was entered into, or an act was done for the purpose of giving effect to it:
    (i) during the 6 months ending on the relation-back day; or
    (ii) after that day but on or before the day when the winding up began.
(2A) The transaction is voidable if:
  (a) the transaction is:
    (i) an uncommercial transaction of the company; or
    (ii) an unfair preference given by the company to a creditor of the company; or
    (iii) an unfair loan to the company; or
    (iv) an unreasonable director-related transaction of the company; and
  (b) the company was under administration immediately before:
    (i) the company resolved by special resolution that it be wound up voluntarily; or
    (ii) the Court ordered that the company be wound up; and
  (c) the transaction was entered into, or an act was done for the purpose of giving effect to it, during the period beginning at the start of the relation back day and ending:
    (i) when the company made the special resolution that it be wound up voluntarily; or
    (ii) when the Court made the order that the company be wound up; and

(d) the transaction, or the act done for the purpose of giving effect to it, was not entered into, or done, on behalf of the company by, or under the authority of, the administrator of the company.

(2B) The transaction is voidable if:

(a) the transaction is:

(i) an uncommercial transaction of the company; or

(ii) an unfair preference given by the company to a creditor of the company; or

(iii) an unfair loan to the company; or

(iv) an unreasonable director-related transaction of the company; and

(b) the company was subject to a deed of company arrangement immediately before:

(i) the company resolved by special resolution that it be wound up voluntarily; or

(ii) the Court ordered that the company be wound up; and

(c) the transaction was entered into, or an act was done for the purpose of giving effect to it, during the period beginning at the start of the relation back day and ending:

(i) when the company made the special resolution that it be wound up voluntarily; or

(ii) when the Court made the order that the company be wound up; and

(d) the transaction, or the act done for the purpose of giving effect to it, was not entered into, or done, on behalf of the company by, or under the authority of:

(i) the administrator of the deed; or

(ii) the administrator of the company.

(3) The transaction is voidable if:

(a) it is an insolvent transaction, and also an uncommercial transaction, of the company; and

(b) it was entered into, or an act was done for the purpose of giving effect to it, during the 2 years ending on the relation-back day.

(4) The transaction is voidable if:

(a) it is an insolvent transaction of the company; and

(b) a related entity of the company is a party to it; and

(c) it was entered into, or an act was done for the purpose of giving effect to it, during the 4 years ending on the relation-back day.

(5) The transaction is voidable if:

(a) it is an insolvent transaction of the company; and

(b) the company became a party to the transaction for the purpose, or for purposes including the purpose, of defeating, delaying, or interfering with, the rights of any or all of its creditors on a winding up of the company; and

(c) the transaction was entered into, or an act done was for the purpose of giving effect to the transaction, during the 10 years ending on the relation-back day.

(6) The transaction is voidable if it is an unfair loan to the company made at any time on or before the day when the winding up began.

(6A) The transaction is voidable if:

(a) it is an unreasonable director-related transaction of the company; and

(b) it was entered into, or an act was done for the purposes of giving effect to it:

(i) during the 4 years ending on the relation-back day; or

(ii) after that day but on or before the day when the winding up began.

Insolvent trading

[33.110] When making management decisions, directors must bear in mind their *Corporations Act* obligations but also the underlying reason for their election as directors, which is their ability to increase the profitability of the company. Various factors impact on a company's financial position. If a company is insolvent, directors should not compound the situation by incurring debt. **Section 588G** makes directors personally liable in such a situation and **s 588M** enables the liquidator to bring proceedings. Accordingly, what was originally a company debt becomes the personal responsibility of the director. The corporate veil is lifted. Note that **s 588G** is also a civil penalty section allowing ASIC to pursue actions against directors. Civil penalty orders and compensation can be sought.

The purpose of the liquidator using **s 588G** is to recoup funds to meet amounts owing to creditors by the company. The amounts collected by the liquidator from directors under **s 588G** are placed into the general fund for distribution.

There is a breach of **s 588G** if a company incurs a debt and at the time (or by the incurring of the debt) a director is aware of insolvency or there are reasonable grounds for a person in the director's circumstances to suspect that the company is (or would become) insolvent. The test of whether **s 588G** has been breached is an objective one, much like the test in relation to **s 180** (see also **s 588E** as to certain presumptions of insolvency). If the directors should have suspected that the company was insolvent then by incurring liability they are putting all creditors at risk. A temporary lack of liquidity is not necessarily insolvency and there are various factors such as the relationship between when a company must pay its creditors, and when a company is entitled to sue its debtors, that may influence a court's decision. It is not necessary to establish that a director is actually aware of the company's insolvency (although it would obviously help in proving a breach). The test is objective and based on what a reasonable person would suspect. In *Metropolitan Fire Systems Pty Ltd v Miller* (1997) 23 ACSR 699, the court considered that the company was insolvent having regard to the following factors: creditors were pursuing legal action; amounts owed to creditors were large and well overdue; any assets the company had could not be quickly realised; and funds to pay its current debts were not available at the time or in the near future.

A breach of **s 588G** enables the liquidator to sue the directors for compensation. **Section 588M** sets out that where a director has contravened **s 588G**, a creditor is owed a debt and the company is being wound up, then whether or not the director has been convicted of an offence or been the subject of a civil penalty order the liquidator may recover the loss or damage as an amount due to the company. Note that it is also possible for a creditor of a company that is being wound up, but only with the written consent of the company's liquidator, to begin proceedings under **s 588M** in relation to the incurring by the company of a debt that is owed to the creditor.

Section 588G is also a civil penalty section. Accordingly, pursuant to **s 1317G**, breach may result in a director being subject to one or a combination of the following orders: a pecuniary penalty order being the greater of (a) 5,000 penalty units and

(b) if a court can determine the benefit derived and detriment avoided because of the contravention then that amount multiplied by 3; a relinquishment order requiring a person to pay to the Commonwealth an amount equal to the benefit derived and detriment avoided because of the contravention (**s 1317GAB**); a refund order where an ongoing fee has been received after termination of the fee arrangement in contravention of **s 962P** (**s 1317GA**); an order to pay compensation to the company (**s 1317H**); and disqualification from managing a corporation (**s 206C**). Note that pursuant to **s 1317J**, an order for compensation under **s 1317H** may be sought not only by ASIC but also by the corporation and compensation may be ordered whether or not a declaration of contravention under **s 1317E** has been made. If the failure to prevent the company incurring the debt was dishonest, **s 588G(3)** indicates that an offence is committed and the penalty for an individual (2,000 penalty units, five years' imprisonment, or both) is set out in **Sch 3**.

An example of insolvent trading can be found in *Elliott v ASIC* (2004) 48 ACSR 621 in which the Victorian Supreme Court of Appeal substantially affirmed the decision of the Mandie J in *ASIC v Plymin* (2003) 46 ACSR 126; [2003] VSC 123. The facts of the matter involved two companies, Water Wheel Holdings Ltd and Water Wheels Mills Pty Ltd that were placed into voluntary administration by their directors. ASIC brought proceedings under **s 588G** against three of the directors including Mr Elliott, a non-executive director. The Court considered that although Elliott had substantial business experience and should have obtained the relevant financial information about the company from management, he failed to do so and in fact ignored the company's liquidity crisis. The Court of Appeal held that it was not necessary in proving a breach of **s 588G(2)** that ASIC establish that the director (Elliott) was under a duty to take any particular step which would have prevented the company incurring the debt. In essence, a failure by a director to prevent a company from incurring a debt is a failure by that director to take all reasonable steps within his power to prevent such debt. As a result of the finding that he breached the insolvent trading provisions, Elliott was fined, ordered to pay compensation to the companies and disqualified from managing a corporation.

Note that in *Morley v Statewide Tobacco Services Ltd* [1993] 1 VR 423; 8 ACSR 305, it was suggested that where a director is aware that the company may be insolvent and cannot prevent the incurrence of a debt he has a duty to either take steps to have the company wound up, or resign.

Companies in liquidation have often had debt and insolvency problems for a number of years. Restructuring mechanisms such as voluntary administration may provide some hope for failing companies; however, they will not necessarily insulate directors' exposure to actions for insolvent trading, particularly in circumstances as outlined in the following ASIC Media Release concerning whitegoods distributor Kleenmaid. The company had been placed into voluntary administration and at the meeting to decide the company's future the creditors voted to wind up pursuant to **s 439C**. This then exposed the directors to insolvent trading actions. Pursuant to **s 588G**, criminal proceedings may be brought if the provisions of **s 588G(3)** apply.

This provides for criminal liability where the company incurs a debt and a director suspected that at that time the company was insolvent, or would become insolvent by incurring the debt, and acts dishonestly in failing to prevent the company incurring the debt. To ground criminal liability, the onus requires proof that a suspicion was present. Note that this is unlike the civil liability test in **s 588G(1)** and **(2)**, which only requires that there were reasonable grounds for suspecting.

ASIC Media Release

12-27AD ASIC brings criminal charges against former Kleenmaid directors

Three former directors of national whitegoods distributor Kleenmaid faced court today accused of 20 criminal charges including a $13 million fraud and insolvent trading, following an ASIC investigation.

They have been charged with 18 counts of criminal insolvent trading of debts totalling more than $4 million and a $13 million fraud committed on Westpac Bank. The focus of ASIC's investigation centred on the solvency of the Kleenmaid Group and a corporate restructure undertaken by the Kleenmaid directors in September 2007. ASIC alleges the Kleenmaid Group continued to trade despite becoming insolvent from March 2008.

Each of the criminal insolvent trading charges under section 588G(3) of the *Corporations Act 2001* carries a maximum penalty as set out in Sch 3 of the *Corporations Act*.

Based on Queensland's sunshine coast and employing about 200 staff, the Kleenmaid group of companies operated the Kleenmaid brand of kitchen appliances and was an importer and distributor of whitegoods, operating 22 outlets Australia-wide including 15 franchise stores and 7 company-owned stores.

The former directors appointed voluntary administrators on 9 April 2009 with liquidators reporting Kleenmaid Group had consolidated debts of $97 million, including $26 million in customer deposits.

Following a three week committal hearing taking place in November 2013 and March 2014 the directors were committed to stand trial at a date to be fixed.

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One director pleaded guilty to fraud and criminal insolvent trading charges and was sentenced in 2015 to seven years' imprisonment. Another of the directors was found guilty at trial in August 2016 and was sentenced to nine years' imprisonment for fraud and three and a half years' imprisonment for the criminal insolvent trading charges. Each will be eligible for parole after a requisite period. [ASIC Media Release 16-257MR]

Defences to insolvent trading

[33.120] Proceedings brought under **s 588G** are the most common way that the court lifts the corporate veil and makes individuals liable for company debts. The targeting

of insolvent trading in **s 588G** is a warning to directors to take care when the company is in a precarious financial position. However, the decision as to whether, and when, to incur a debt on behalf of the company, may often be a difficult one and many factors may be relevant to consider. Accordingly, the *Corporations Act* provides defences for directors in **s 588H** and **s 588GA**.

It should be noted that the substance of the defences available to a director under **s 588H** are also relevant where the Commissioner of Taxation must repay a preference received from an insolvent company resulting in that amount becoming a debt owing by the director to the Commissioner (**s 588FGA**). The defences available to the directors under **s 588FGB** are based on the same principles as those in **s 588H** and are in all material respects the same.

Sections 588H(2) provides a defence, where the director had reasonable grounds to expect solvency and did expect that when the debt was incurred the company was solvent and would remain solvent. Note that the prohibition of insolvent trading in **s 588G** relies on the establishment of a reasonable suspicion of insolvency, whereas the defence in **s 588H(2)** requires an expectation of solvency, which is a more substantial evidential matter to establish (a suspicion needs less factual evidence than an expectation).

In *ASIC v Plymin* (2003) 46 ACSR 126; [2003] VSC 123, the court rejected a defence based on **s 588H(2)** advanced by Mr Elliott, a director, on the grounds that he failed to obtain from those managing the company essential matters including a list of the amounts owing to creditors and regular profit and loss and cash-flow statements. Another example of the court rejecting a defence based on **s 588H(2)**, and also **s 588H(4)**, can be seen in *Tourprint International Pty Ltd v Bott* (1999) 32 ACSR 201, where the director failed to inquire as to the company's position from the accountant or other directors and did not inspect the company's books. In this case, it was held that the deceptive conduct of a fellow director could not be regarded as appropriate grounds for a director to argue that they had not taken part in the management of a company for the purposes of the defence set out in **s 588H(4)**. This was so where the director had not shown a proper degree of commitment to involvement in the financial management of the company by not being involved in the financial management at all. The court considered the appropriate response would have been for the director to have confronted his fellow director and insisted upon proper involvement in the company's affairs. As regards the defence available under **s 588H(2)**, it was held that this requires an actual expectation that the company was and would continue to be solvent, and that the grounds for so expecting are reasonable. The court explained that expectation means a higher degree of certainty than "mere hope or possibility" or "suspecting". A director cannot rely on complete ignorance or a neglect of duty; nor can a director hide behind ignorance of the company's affairs which is of her or his own making or, if not entirely of her or his own making, has been contributed to by her or his own failure to make necessary inquiries.

Section 588H(3) (and **s 588FGB(4)**) provides for a defence, where there is reliance on reasonable grounds that a competent and reliable person, who was responsible

for providing information regarding the company's solvency, indicated that the company was solvent. Obviously, the occupation of the person who is relied upon, their qualifications and experience as well as many other factors, will be relevant to determining whether this defence is available. In *Metropolitan Fire Systems Pty Ltd v Miller* (1997) 23 ACSR 699, the fact that the directors should have been suspicious of the company's financial circumstances and accordingly should have made further inquiries of the person alleged to be competent and upon whom they relied meant that the defence in **s 588H** was not available.

The defence in **s 588H(3)** raises an important factor in the management of companies in financial difficulty, namely, that directors should be aware of when specialist advice is required to protect the company's position and be willing to seek such advice. However, to establish a defence in **s 588H(3)**, it must be shown that at the time the debt was incurred the director not only had reasonable grounds to believe, but did in fact believe, that the person relied upon was fulfilling their responsibilities. A competent and reliable person for the purposes of **s 588H(3)** will not be able to fulfil their responsibilities where a director's instructions as to the company's circumstances are unclear, and a director will not be able to take the benefit of the section where the person relied upon is not given sufficient information to perform their task (*Manpac Industries Pty Ltd v Ceccattini* (2002) 91 NSWLR 786; [2002] NSWSC 330).

Section 588H(4) (and **s 588FGB(5)**) provides a defence, where illness or "other good reason" results in a director not taking part in the management of the company. Managing the company is the directors' responsibility and this responsibility cannot be easily avoided. However, in some instances, directors have been appointed for regulatory formalities only and play no effective part in management (referred to as a "sleeping director"). This presents a risk, particularly in relation to the duty of care and diligence. However, the need for the appointment of a second director for the sole purpose of satisfying regulatory requirements only, is no longer necessary since the introduction of one-person companies into Australia (*First Corporate Law Simplification Act 1995* (Cth)). In *Deputy Commissioner of Taxation v Clark* (2003) 57 NSWLR 113; [2003] NSWCA 91, a case which dealt with the issue of "sleeping directors" and absence from management, the Court of Appeal considered the defence of a director based on the ground that they did not play a part in management for a "good reason". In that case, the respondent director argued that the "good reason" for absence from management was that she trusted that all management functions in the company could be ably taken care of by the other director (her husband).

Deputy Commissioner of Taxation v Clark [2003] NSWCA 91

Extract from Judgment

Spigelman J at [164]-[167]

The recognition of complete abdication of responsibilities as a director as a "good reason", for purposes of the statutory defences, carries with it the risk of reinforcing gender stereotypes and undermining the confidence with which potential creditors

> will deal with small companies in which women participate with their husbands. Maintaining a firm position on the duties of directors will encourage the use of single director corporate structures for small business. In my opinion, it is desirable to promote coherence between appearance and reality in corporate practice.
>
> It is by no means clear what will prove to be the long term effect of the abolition of the requirement of two directors. Instinctively one would expect the number of small companies with a second sleeping director to decline. However, in the context of family companies there remain possible advantages in the form of income splitting for tax purposes or as a protection for the assets of the family, including the husband.
>
> The change in the policy of the *Corporations Act* to permit single director companies abolished a requirement which had, as a practical matter, resulted in many small businesses having sleeping directors, often spouses. Although this change acknowledged the fact that some directors did not participate in management in the past, it does not, in my opinion, alter the basic requirement of the law that directors should participate.
>
> In my opinion, there is no justification for a doctrine which would hold sleeping directors to be "de facto non-directors", who should be relieved of their liabilities. Although, as a practical matter, the conduct of such directors may never meet the requisite standard of participation in management, such conduct should not be excused as a "good reason" in law.
>
> Accordingly, the Respondent's total reliance on her husband in the management of SCI (the relevant company) is not a "good reason", within the meaning of s 588FGB(5), for her non-participation in the management of the company at the time when payments were made to the Appellant. The Respondent cannot, on that basis, resist her liability under s 588FGA as a director of SCI.
>
> The appeal should be allowed with costs.
>
> **Hodgson JA** at [174], [175]
>
> A director's non-participation in the management of the company will usually involve a breach of that duty, whether the director is aware of this or not. In my opinion, a director's non-participation in the management of a company at a particular time will be "because of illness or for some other good reason" within s 588FGB(5) of the *Corporations Act* only if the illness or other good reason is of this character, that is, such as to make the non-participation reasonable (on the appropriate standard) and thus not a breach of the director's duty to exercise reasonable care and diligence.

If a director took reasonable steps to prevent the company incurring the debt a defence will be available in s 588H(5). Merely voicing concerns with other directors as to the company's inability to meet its commitments will not suffice for the purposes of **s 588H(5)** (see *Byron v Southern Star Group Pty Ltd* (1997) 136 FLR 267). In fact, directors who find themselves in a situation, where they foresee insolvent trading may need to consider the decision in *Morley v Statewide Tobacco Services Ltd* [1993] 1 VR 423; 8 ACSR 305 and resign. Where directors recognise that their company is in a position of impending insolvency, they may be wise to utilise the processes of voluntary administration. Taking action with a view to appointing an administrator

is specifically included in **s 588H(6)** as evidence of whether directors have taken reasonable steps as required in **s 588H(5)**.

The following newspaper article looks at the relationship between directors intentions and the notion of insolvency, and raises issues that may be relevant to directors making use of the defences in **s 588H** (and the similar defences in **s 588FGB**) concerning an expectation of solvency. The matter referred to in the article is *Re Locktronic Systems Pty Ltd (in liq) (receivers appointed)* [2008] VSC 626 in which the liquidators of the company sought orders that certain alleged preferential payments to the Commissioner of Taxation pursuant to **s 588FA** were in fact insolvent transactions and thereby voidable by the liquidators pursuant to **s 588FF** (see "The liquidator's power to recoup funds" at [33.70]). The defence that is available to the directors is based on the directors having reasonable grounds to expect, and expecting, that the company was solvent and would remain so.

The newspaper article and the journal extract which follows, raise the difficulties directors may encounter in decision-making, particularly forecasting outcomes of negotiations, during periods of financial difficulty. It was these difficulties and the reforms that addressed them initiated through the Federal Government's National Innovation and Science Agenda (NISA) that lead to the *Treasury Laws Amendment (2017 Enterprise Incentives No 2) Act 2017* (Cth) that introduced the protections for directors found in **s 588GA**.

Reform insolvency laws for honest directors, judge urges

A Victorian Supreme Court judge has made a highly unusual call for changes to the law that might ease the burden on directors who honestly try to salvage an insolvent company. The judge's comments appear in line with the submissions the Law Council of Australia has proposed introducing a "business judgment" defence for directors, so that if they act honestly and diligently and have a reasonable belief that the company would come out of the restructuring in a better shape for creditors, despite incurring further debts that cannot be repaid immediately, then the directors should be shielded from liability.

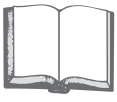
Justice Robson was speaking in a minor costs hearing in a case where three directors paid instalments to the Tax Office when their company, Locktronic Systems, was close to collapse. Locktronic's liquidators clawed back the $400,000 or more of tax payments from the Commonwealth as a preferential payment, arguing the company was clearly insolvent when the tax was paid.

Justice Robson believed the three directors were "honest men" who believed Locktronic would be recapitalised by some Malaysian investors and that it was in line for a big payment from the Hawaiian Government. Both fell through.

But the judge noted the prospect of recapitalising the company "does not appear to be sufficient [to shield directors] under our present law". "The law is not that the directors have a reasonable expectation that the debts would be paid in full, but that the company was solvent and would remain solvent even if the payment was made—and that is a very difficult burden to satisfy when you've got what is expected to be temporary illiquidity," he said.

Original source article by Leonie Wood, *The Age*

An issue raised by the above newspaper article was that if the standard applied to a breach of **s 588G** is similar to the standard relevant to **s 180**, that is, applying an objective, reasonable person test, then a defence, based on the requirements of the business judgment rule in **s 180**, should also apply to **s 588G**. The following journal article extract also sets out some reasons why a defence along the lines of the business judgment rule may be applicable to **s 588G**. However, this has not eventuated. **Section 588GA**, although it does provide protection for directors, does not include a business judgement rule defence for insolvent trading. The following extract is, nonetheless, useful for the issues it raises regarding the role of directors in insolvent companies. It is the type of issues raised in the following article extract, of directors lacking incentive to pursue ideas to attempt to reverse the company's fortunes, that **s 588GA** addresses.



[Whitechurch L, "Should the law on insolvent trading be reformed by introducing a defence akin to the business judgment rule?" (2009) 17 *Insolvency Law Journal* 25 at 27, 28.]

> But the strongest argument in favour of extension of the BJR has been that directors need to engage in risk-taking and entrepreneurialism. In particular, in difficult financial times, such risk-taking may encourage a company to restructure or trade out of possible insolvency which is, after all, in everyone's interests, including shareholders and creditors. However, the fear of personal liability—hanging above "like a sword of Damocles"—overshadows the desire to attempt to do so and therefore, (responsible) directors will instead hasten to put the company into voluntary administration rather than risk personal liability. Indeed, the Act encourages such action. Although it may benefit creditors, the impact of voluntary administration can be severe on a company's brand and reputation and hasten its demise. In such circumstances, like a captain steering a sinking ship, a director is between a rock and hard place—risking the ire of the passengers (ie shareholders) by "cowardly" jumping ship prematurely (placing the company into administration), or the ire of creditors (personal liability and potentially, criminal proceedings) if his or her valiant attempts to ride out the storm end in shipwreck. The choice also puts the directors in an unenviable conflict, as the reasons for placing a company into voluntary administration do not actually include protecting one's own interests as a director; therefore by placing the company into administration, directors may be breaching their *other* duties.

Section 588GA meets the problems raised in the above articles by enabling directors of companies heading for insolvency to appoint an appropriately experienced and qualified restructuring adviser to undertake a gatekeeper role. The foundation for change was the proposition that overly formal insolvent trading laws not only discourage start-up investors but also restrict the chances of maximising creditor returns from failing companies, as directors, wary of the personal liability that insolvent trading brings, may take a very conservative approach to a company's financial difficulties, usually placing the company into voluntary administration and as a result avoiding

more ambitious solutions, outside of the formal insolvency mechanisms, to work the company through (turnaround) its financial difficulties.

Section 588GA establishes a safe harbour for directors of an insolvent company to protect them against personal liability for contraventions of the insolvent trading provisions under **s 588G(2)**. This safe harbour protection in **s 588GA** is aimed at facilitating more successful company restructures outside of formal insolvency processes. It is also aimed at driving a cultural change among company directors who encounter uncertainty over a company's solvency and provides an alternative to proceeding to the immediate appointment of an administrator or liquidator. The safe harbour will protect a director in relation to debts that a company incurs directly or indirectly in connection with developing and taking a course of action that is reasonably likely to lead to a better outcome. The term "better outcome" is defined in the section as an outcome that is better for the company than the immediate appointment of an administrator, or liquidator, of the company.

The safe harbour will start to apply from the time the person (director), after beginning to suspect that the company may become insolvent, starts developing one or more courses of action, and one of those courses of action is reasonably likely to lead to a better outcome for the company. The sort of things needed to be shown by directors include: properly informing themselves; preventing officer or employee misconduct; keeping proper records; getting advice from an "appropriately qualified entity"; developing or implementing a restructuring plan. Probably the most obvious course of action that may be taken to gain the benefit of the safe harbour provisions is for the director to obtain advice from an appropriately qualified entity who was given sufficient information to give the advice. "Appropriately qualified" in this context is used in the sense of "fit for purpose" and is not limited merely to the possession of particular qualifications (however, accountants, lawyers, and insolvency practitioners will be common).

***Corporations Act 2001* (Cth), s 588G**

Director's duty to prevent insolvent trading by company

(1) This section applies if:
  (a) a person is a director of a company at the time when the company incurs a debt; and
  (b) the company is insolvent at that time, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt; and
  (c) at that time, there are reasonable grounds for suspecting that the company is insolvent, or would so become insolvent, as the case may be; and
  (d) that time is at or after the commencement of this Act.

(1A) [Not reproduced]

(2) By failing to prevent the company from incurring the debt, the person contravenes this section if:
  (a) the person is aware at that time that there are such grounds for so suspecting; or

(b) a reasonable person in a like position in a company in the company's circumstances would be so aware.

Note: This subsection is a civil penalty provision (see subsection 1317E(1)).

(3) A person commits an offence if:
(a) a company incurs a debt at a particular time; and
(aa) at that time, a person is a director of the company; and
(b) the company is insolvent at that time, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt; and
(c) the person suspected at the time when the company incurred the debt that the company was insolvent or would become insolvent as a result of incurring that debt or other debts (as in paragraph (1)(b)); and
(d) the person's failure to prevent the company incurring the debt was dishonest.

***Corporations Act 2001* (Cth), s 588H**

Defences

(1) This section has effect for the purposes of proceedings for a contravention of subsection 588G(2) in relation to the incurring of a debt (including proceedings under section 588M in relation to the incurring of the debt).
(2) It is a defence if it is proved that, at the time when the debt was incurred, the person had reasonable grounds to expect, and did expect, that the company was solvent at that time and would remain solvent even if it incurred that debt and any other debts that it incurred at that time.
(3) Without limiting the generality of subsection (2), it is a defence if it is proved that, at the time when the debt was incurred, the person:
(a) had reasonable grounds to believe, and did believe:
(i) that a competent and reliable person (the other person) was responsible for providing to the first-mentioned person adequate information about whether the company was solvent; and
(ii) that the other person was fulfilling that responsibility; and
(b) expected, on the basis of information provided to the first-mentioned person by the other person, that the company was solvent at that time and would remain solvent even if it incurred that debt and any other debts that it incurred at that time.
(4) If the person was a director of the company at the time when the debt was incurred, it is a defence if it is proved that, because of illness or for some other good reason, he or she did not take part at that time in the management of the company.
(5) It is a defence if it is proved that the person took all reasonable steps to prevent the company from incurring the debt.
(6) In determining whether a defence under subsection (5) has been proved, the matters to which regard is to be had include, but are not limited to:
(a) any action the person took with a view to appointing an administrator of the company; and
(b) when that action was taken; and
(c) the results of that action.

Regulating liquidators' conduct

[33.130] Once a company is in voluntary administration, receivership or liquidation, the task of implementing the provisions of the *Corporations Act*, and the task of managing (to varying degrees) the company, falls to either an administrator, receiver or liquidator respectively, all of whom are required to be registered liquidators (note though, **s 532(4)** regarding a members voluntary winding up of a proprietary company). ASIC must establish and maintain a Register of Liquidators. An individual may apply to be registered as a liquidator. The application is referred to a committee, which will assess the applicant's qualifications and experience. Registration is for a period of three years and is able to be renewed at the end of that period. In certain cases, registration may be subject to conditions.

Further, ASIC must be satisfied that the applicant is capable of performing the requisite duties and is a fit and proper person to be registered as a liquidator.

The liquidator will be an agent of the company. Where a liquidator is appointed as a result of a compulsory winding up, the wide powers set out in **s 477** will apply. Included in those powers will be the ability to: carry on the business of the company; pay any class of creditors in full (subject to the priorities in **s 556**); enter into any compromise or arrangement with creditors (subject to **s 477(2A)**); and bring or defend any legal proceedings. The liquidator must use his or her own discretion in the management of affairs and property of the company and distribution of its property.

Pursuant to **s 532**, a person must not, without leave of the court, seek to be appointed or act as a liquidator where that person owes the company, or the company owes that person, an amount exceeding $5,000; where the person is a director or employee of the company; or where the person is an auditor, or a partner or employee of an auditor, of the company.

In *ASIC v Edge* (2007) 211 FLR 137; [2007] VSC 170, the Supreme Court of Victoria considered the conduct of the defendant, an official liquidator, in relation to a number of companies in administration and liquidation, including matters such as the drawing of remuneration without valid approval. The *Corporations Act* provides for the investigation of any misfeasance, neglect or omission on the part of the liquidator and enables the court to make good any loss that the estate of the company has sustained and make such other orders as it thinks fit. ASIC sought orders in relation to the defendant's alleged misconduct as the voluntary administrator or deed administrator of three companies in voluntary administration or under a deed of company arrangement pursuant to **Pt 5.3A**. The court held that the defendant be removed as liquidator of a number of companies and prohibited from accepting appointment as a liquidator, administrator or receiver for a period of 10 years. The defendant was also ordered to disgorge funds drawn as remuneration without valid approval.

Liquidators are given various powers for the purposes of maximising the funds available for creditors. Because the provisions of the *Corporations Act* that enable the liquidator to target pre-liquidation transactions often involve complex fact situations, the evidence needed is sometimes difficult to accumulate, especially in

the circumstances of the company's insolvency. Of particular, relevance is the cost of proceedings brought by the liquidator in order to recoup funds. Complex corporate insolvencies require substantial input of both funds and expertise. However, because creditors of a company in liquidation often have little precise knowledge of the steps involved in the process, it is important that both administrators and liquidators conduct themselves, and levy fees, in accordance with their *Corporations Act* obligations.

ASIC has the overall responsibility for registering and disciplining liquidators (**Sch 2** of the *Corporations Act*). It may direct a registered liquidator to comply with a requirement to lodge a document, or correct incomplete, inaccurate documents, or convene a meeting. If the liquidator fails to comply, ASIC can direct that the liquidator accept no further appointments or seek a court order directing the liquidator to comply. ASIC may suspend or cancel registration if the liquidator is a person who is disqualified from managing corporations under **Pt 2D.6** of the *Corporations Act*. **Schedule 2** also provides for disciplinary action by a committee. ASIC may give to the registered liquidator a show-cause notice requiring explanation as to why registration should continue. The matter will then be determined by the committee and the decision given effect by ASIC.

In more complex matters, ASIC will make an application to the court. In *ASIC v Ariff* [2009] NSWSC 829, ASIC made an application to the Supreme Court of NSW under a number of sections of the *Corporations Act*, which set out that where it appears to the Court or ASIC that a liquidator has not faithfully performed her or his duties the Court may take such action as it thinks fit. The matter was settled on terms including that the liquidator be disqualified for life and pay compensation to certain companies that were under his control as liquidator or administrator. The breaches of the liquidator's obligations were considered serious and in the course of the judgment Bergin CJ commented (at [34]):

> The conduct the subject of the admitted facts is conduct that is quite appalling. A liquidator is an officer of the Court. That is why the Court has power to supervise liquidators. The community expects the highest standard of conduct from liquidators. For whatever reason, which remains unexplained I am afraid, the defendant has, sadly, failed the community and the Court.

Further proceedings were brought against the liquidator including for a breach of **s 1308(2)**, which sets out that a person who makes or authorises the making of a statement submitted to ASIC that to the person's knowledge is false or misleading in a material particular is guilty of an offence. In 2011, the liquidator was found guilty by the NSW District Court of breaching **s 1308(2)** and together with other breaches of the *Crimes Act 1900* (NSW) was sentenced to a period of imprisonment. In ASIC Media Release 11-308MR, the ASIC Deputy Chairman noted that the decision to pursue criminal charges against the liquidator was a clear demonstration of ASIC's commitment to deterring misconduct by gatekeepers such as insolvency practitioners.

Pooling

[33.140] To streamline the liquidation process, where several companies are being wound up and are related, **s 571** enables the liquidator(s) to make a pooling determination provided the consent of the unsecured creditors is obtained. This situation would arise, where several companies that are part of a group structure are in liquidation. In these circumstances, **s 571(2)** sets out that each company in the group is taken to be jointly and severally liable for each debt payable by, and each claim against, each other company in the group. Pooling thereby addresses the problem creditors have traditionally faced, that the corporate veil between companies meant that creditors of one company in the group could not access other group companies' assets. Where a pooling determination is made, a copy of the determination must be lodged by the liquidator(s) with ASIC within seven days (**s 573**). A pooling determination may be varied or terminated by the court (**s 579A**). Where creditors do not consent to a pooling determination, the court may make a pooling order on the application of the liquidator or liquidators of the companies as a group (**s 579E**). Before a pooling order is made, the court must be satisfied as to a number of things including: that it is just and equitable to do so having regard to matters such as the extent to which companies, or officers, in the group were involved in the management or operations of other companies in the group, and the extent to which creditors of any companies in the group may be advantaged or disadvantaged by the making of an order.

Deregistration

[33.150] A company ceases to exist on deregistration and all of the company's property (other than held on trust) vests in ASIC (**s 601AD**). A company can be deregistered in the following ways: voluntarily where, among other things, all the members agree (**s 601AA**); by ASIC where there is an ongoing failure to lodge required documentation (**s 601AB**); or following winding up. **Section 601AB(2)** enables ASIC to deregister a company in a number of circumstances, including, where the company is being wound up and ASIC has reason to believe that the liquidator has ceased acting in the role of liquidator. ASIC also has an obligation to deregister a company where the court orders deregistration upon the specific grounds set out in **s 601AC**.

Insolvency notices

[33.160] At the hearing of an application to wind up a company, evidence is required of a number of matters. The applicant must show insolvency, jurisdiction, and that the debt owed by the company is still outstanding and is above the statutory minimum. Importantly, and to ensure that all of the company's creditors have the opportunity to be represented in the winding up, the applicant is required to advertise the particulars of the application to wind up including details of the hearing. Notices to this effect, and in relation to other aspects of external administration of companies

are lodged electronically on the ASIC insolvency notices website. The notices were previously published in national and State newspapers and in the Business *Gazette*. The notices are required to be in a format as specified in the *Corporations Act* and the *Corporations Regulations 2001* (Cth). The insolvency and deregistration notices lodged with ASIC provide examples of the application of the provisions of the *Corporations Act* in relation to liquidation, receivership and administration. Following are modified examples from the ASIC website.

Corporations Act 2001
Paragraph 465A(c)
Regulation 5.4.01A

NOTICE OF APPLICATION FOR WINDING UP ORDER

Company details

Company:	Blix Properties (SA) Pty Ltd
ACN:	114 397 291

An application for the winding up of Blix Properties (SA) Pty Ltd was commenced by the plaintiff Lancaster Gate Apartments Ltd on 1/5/2019 and will be heard as set out below.

Hearing details

The details of the hearing are:

Court:	Supreme
District/State:	Victoria
Place:	Court 5 Ground Floor Supreme Court of Victoria 436 Lonsdale Street Melbourne VIC 3000
Date and time:	10:30AM, 14 June 2019
Action number:	S CI 2014 1406

Copies of documents filed may be obtained from the plaintiff's address for service.

Plaintiff's details

Plaintiff's address for service:

Place:	Globe and Shakespeare Solicitors Level 3, 555 Lonsdale Street Melbourne VIC 3000

Telephone:	(03) 8600 2007
Facsimile:	(03) 8666 1406

Any person intending to appear at the hearing must file a notice of appearance in accordance with the rules, together with any affidavit on which the person intends to rely, and serve a copy of the notice and any affidavit on the plaintiff at the plaintiff's address for service at least 3 days before the fixed date for the hearing.

Plaintiff or Plaintiff's legal practitioner:

Address:	Level 3, 555 Lonsdale Street, Melbourne VIC 3000
Contact person:	Antonio Rialto
Contact number:	(03) 8600 2017
Facsimile:	(03) 8666 1427
Email:	arialto@globeandshakespeare.com

This notice does not mean that the company was wound up. To check whether the company was wound up following publication of this notice, search the ASIC database using the ASIC Connect function on ASIC's website http://www.asic.gov.au

Corporations Act 2001
Paragraph 491(2)(b)
Regulation 5.5.01
NOTICE OF APPOINTMENT AS LIQUIDATOR

Company details

Company:	French News Finance Australia Limited
ACN:	040 833 696
Status:	In Liquidation
Appointment Date:	14 June 2019

Resolution

Notice is given that at a general meeting of the members of the Company held on 14 June 2019, it was resolved that the Company be wound up and that Dromio Ephesus be appointed liquidator(s).

Date of Notice:	28 June 2019
Dromio Ephesus	
Liquidator:	

Address:	Dromio Ephesus and Partners, GPO Box 564, Sydney NSW 2001
Contact person:	Dromio Ephesus
Contact number:	(02) 9339 2543
Facsimile:	(02) 9339 2007
Email:	dephesus@dromioephesusandpartners.com

Corporations Act 2001
Paragraph 439A(1)
Insolvency Practice Rules (Corporations) 2016 s 75-40(1)
NOTICE OF SECOND MEETING OF CREDITORS OF COMPANY UNDER ADMINISTRATION

Company details

Company:	Kensington Palace Gardens Pty Ltd (Administrators Appointed)
ACN:'	166 209 159
Status:	Administrators Appointed
Appointed:	22 May 2019

Meeting details

Notice is given that a second meeting of the creditors of the Company, or a second meeting for each of the Companies, (for multiple companies), will be held:

Location:	the offices of Oliver Martext & Co. Pty Ltd, 165 Fitzroy Street, St Kilda 3182
Meeting date:	12 June 2019
Meeting time:	10:00AM

(If multiple companies, see special instructions for meeting times)

Agenda

The purpose of the meeting(s) is:

1. to receive the report by the Administrator(s) about the business, property, affairs and financial circumstances of the Company(ies); and
2. to receive a statement of Administrator(s) opinion and reasons for the opinion:
   a. whether it would be in the creditors' interests for the Company(ies) to execute a deed of company arrangement;
   b. whether it would be in the creditors' interests for the administration to end;
   c. whether it would be in the creditors' interests for the company to be wound up;

3. to receive a statement of such other information known to the administrator as will enable the creditors to make an informed decision about the matters at paragraphs 2(a) – (c) above;
4. to receive details of any transactions that appear to the Administrator(s) to be a voidable transaction in respect of which money, property, or other benefits may be recoverable by a liquidator under part 5.7B of the Act
5. to receive details of any proposed deed of company arrangement; and
6. for the creditors of the Company(ies) to resolve that:
    a. the Company(ies) execute a deed of company arrangement; or
    b. the administration(s) should end; or
    c. the Company(ies) be wound up.

Other agenda items are:

1. to determine the remuneration of the administrator(s)
2. to determine the future remuneration of the administrator(s)
3. to determine the deed administrator(s) and or liquidator(s) future remuneration if appointed
4. if the company is wound up, to consider the appointment of a committee of inspection and, if so, who are to be the committee members
5. any other business

Proof of debt and proxies

Creditors wishing to attend are advised proofs and proxies should be submitted to the Administrator by:

Time:	05:00PM
Date:	11 June 2019
Date of Notice:	31 May 2019
Jaques De Bois	
Administrator	
Address:	165 Fitzroy Street, St Kilda VIC 3182
Contact person:	Jaques De Bois
Contact number:	(03) 8599 2087
Facsimile:	(03) 8590 2222
Email:	jdebois@olivermartextandco.com

Summary—Liquidation

Going into liquidation

There is no restructure with liquidation—the company is deregistered

Liquidation is either voluntary or compulsory (by court order)

Compulsory winding up usually begins with the serving of a statutory demand

The statutory demand is served on the registered office of the company

Application to set aside the statutory demand must be made within 21 days of service

Example of a case re setting aside: *Graywinter Properties Pty Ltd*

Company presumed insolvent if non-compliance with statutory demand

A key part of compulsory liquidation is finding the company is insolvent

Examples of sections re compulsory liquidation: **ss 459A, 459C, 459E**

Collection of assets

When a company is wound up a liquidator is appointed and takes control

Liquidator collects assets and distributes according to **ss 555** and **556**

Secured creditors are paid first, then priority creditors, then unsecured creditors

Wide powers exist to recoup ("claw back") funds

Liquidator examines prior transactions and targets those benefited

Sections dealing with the voidable transactions are **ss 588FA-588FG**

Examples: preference to a creditor; an uncommercial transaction

Defences include: good faith, no reasonable suspicion of insolvency

Purpose and effect of unfair preference (**s 588FA**) is relevant: *Airservices Australia*

Insolvent Trading

Liquidators can bring actions against directors for insolvent trading (**s 588G**)

The test is whether a reasonable director would suspect insolvency

Example of a case on insolvency: *Metropolitan Fire Systems Pty Ltd*

Insolvent trading is also a civil penalty provision enforceable by ASIC

Defences to **s 588G** actions are found in **s 588H** and **s 588GA**

Examples of defences: expect solvency; reliance; illness

Example of a case dealing with **s 588H**: *ASIC v Plymin*

34
Company Regulation in the Competition and Consumer Act

[34.10] The *Corporations Act 2001* (Cth) is the most important, but not the only, statutory regulation that impacts upon companies. The *Competition and Consumer Act 2010* (Cth), which includes in Sch 2 the *Australian Consumer Law*, is an important company regulator, particularly in relation to market practices. The *Australian Consumer Law* is enforced by all federal, State and Territory courts and tribunals and is administered by the relevant consumer protection agencies. The restrictive trade practices sections of the *Competition and Consumer Act* are enforced by the Australian Competition and Consumer Commission (ACCC) and the Australian Competition Tribunal reviews decisions of the ACCC. The *Competition and Consumer Act* deems conduct engaged in on behalf of a company by a director, servant or agent within that person's actual or apparent authority, to be the conduct of the company. Following are examples of some of the provisions of the *Competition and Consumer Act* (CCA) and the *Australian Consumer Law* (ACL) that deal with a company's conduct in the marketplace.

Protecting competition

[34.20] Section 45 (CCA) prohibits contracts, arrangements or understandings entered into by companies that contain a provision that has the purpose or effect of substantially lessening competition. The section targets competition in any market in which a corporation that is a party to the contract, arrangement or understanding or would be a party to the proposed contract, arrangement or understanding, or a body corporate related to such a corporation, supplies or acquires, or is likely to supply or acquire, goods or services or would, but for the provision, supply or acquire, or be likely to supply or acquire, goods or services. Contracts or clauses within contracts that breach s 45 (CCA) are not enforceable. An example of the type of conduct that will breach s 45 (CCA) can be found in *Trade Practices Commission v David Jones (Australia) Ltd* (1986) 13 FCR 446 in which certain supply companies and the respondent company agreed to raise prices in accordance with a list circulated at a meeting between them.

Cartel arrangements are regulated in s 45AD (CCA). That section sets out that provisions in contracts, arrangements or understandings that have the purpose or effect, directly or indirectly, of fixing, controlling or maintaining, or providing for fixing, controlling or maintaining, the price for, or a discount, allowance, rebate or credit in relation to, goods and services supplied or acquired, shall be cartel provisions. Where a contract is made containing a cartel provision, an offence is committed

pursuant to s 45AF (CCA). Another form of restrictive behaviour targeted by the *Competition and Consumer Act* is the practice of boycotts. For example, s 45DB (CCA) prohibits engaging in conduct with another to prevent or hinder a third person from engaging in trade or commerce involving the movement of goods between Australia and places outside of Australia.

The *Competition and Consumer Act* aims to create a fair and equitable market, where companies can compete on an equal standing. To this end, it provides that a corporation with a substantial degree of market power must not engage in conduct that has the purpose, or has or is likely to have the effect, of substantially lessening competition (s 46 of the CCA). For instance, a corporation shall not take advantage of such power by either eliminating or damaging competitors, preventing entry into the market or deterring or preventing competitive conduct. This misuse of market power will occur when a company with market power refuses to supply to a competitor or supplies only on restrictive terms. The ability to influence market behaviour increases as companies become larger. The takeover of Patrick Corporation Ltd by Toll Holdings Ltd in 2005-2006 provided an example of the important role of the ACCC in relation to the application of the principles inherent in the *Competition and Consumer Act*. Having regard to the large market entity that would be created as a result of a successful takeover, the ACCC considered several aspects of the operations of Toll Holdings Ltd, particularly the issues of competition relating to its shipping services to Tasmania, the control (of both Toll Holdings and Patrick Corporation) over automobile freight, the ability to dominate the supply of international container freight, and the rail joint venture with Patrick Corporation (Pacific National Pty Ltd). Toll Holdings provided a number of undertakings to the ACCC in relation to Pacific National's operations including the surrender of certain train paths and the limiting of its use of the North Dynon terminal in Melbourne. The *Competition and Consumer Act* protects competition and seeks to limit monopoly situations. Success by Toll Holdings in its takeover bid for Patrick Corporation may have created a large market entity and the ACCC's intervention was part of its regulatory role based on concerns that the outcome could affect competition and the ability of others to enter the market. The *Competition and Consumer Act* prohibits restrictive trade practices and the ACCC monitors the creation of entities that may have the ability to exercise a substantial degree of market power. Following its initial consideration of the bid, the ACCC did not take any further action and the takeover proceeded. In each takeover, where monopoly issues are relevant, there will be different circumstances for the ACCC to consider. The example of Toll Holdings raises the important matters of competition, control and the ability to dominate one or more levels of the market.

Section 47 (CCA) prohibits companies dealing (supplying or acquiring) in relation to goods or services on the condition that the other party will not deal with a competitor. This type of conduct, exclusive dealing, involves conditional supply or demand at different levels of the distribution chain. Section 47 will not apply to prohibit exclusive dealing unless the company's conduct has the effect of substantially lessening competition.

Together with the regulation of restrictive trade practices in the *Competition and Consumer Act*, companies are also prohibited under ss 20, 21 and 22 of the ACL from engaging in unconscionable conduct. Matters relevant will involve discrepancies in bargaining power, whether the company is acting in a consistent manner toward its consumers, issues of non-disclosure, and any relevant industry standards.

Australian Consumer Law, s 20

Unconscionable conduct within the meaning of the unwritten law

(1) A person must not, in trade or commerce, engage in conduct that is unconscionable, within the meaning of the unwritten law from time to time.

A pecuniary penalty may be imposed for a contravention of this subsection.

(2) This section does not apply to conduct that is prohibited by section 21.

Australian Consumer Law, s 21

Unconscionable conduct in connection with goods or services

(1) A person must not, in trade or commerce, in connection with:
(a) the supply or possible supply of goods or services to a person; or
(b) the acquisition or possible acquisition of goods or services from a person;
engage in conduct that is, in all the circumstances, unconscionable. …

Australian Consumer Law, s 22

Matters the court may have regard to for the purposes of section 21

(1) Without limiting the matters to which the court may have regard for the purpose of determining whether a person (the *supplier*) has contravened section 21 in connection with the supply or possible supply of goods or services to a person (the *customer*), the court may have regard to:
(a) the relative strengths of the bargaining positions of the supplier and the customer; and
(b) whether, as a result of conduct engaged in by the supplier, the customer was required to comply with conditions that were not reasonably necessary for the protection of the legitimate interests of the supplier; and
(c) whether the customer was able to understand any documents relating to the supply or possible supply of the goods or services; and
(d) whether any undue influence or pressure was exerted on, or any unfair tactics were used against, the customer or a person acting on behalf of the customer by the supplier or a person acting on behalf of the supplier in relation to the supply or possible supply of the goods or services; and

(e) the amount for which, and the circumstances under which, the customer could have acquired identical or equivalent goods or services from a person other than the supplier; and
(f) the extent to which the supplier's conduct towards the customer was consistent with the supplier's conduct in similar transactions between the supplier and other like customers; …

Misleading or deceptive conduct

[34.30] Perhaps the most widely known and used section of the consumer legislation is s 18 of the ACL, which sets out that a person (this includes a company) must not, in trade or commerce, engage in conduct that is misleading or deceptive or is likely to mislead or deceive. The section may be used not only by consumers but also by competitors of a company who allege that the manner in which the company is conducting its business is misleading or deceptive. Breach of s 18 of the ACL will not lead to a prosecution for an offence but will ground civil penalties such as injunctions or damages. Examples of when a company will breach s 18 include where it claims it has rights to assign property that it does not, or that its products have capacities they do not, or, where a company is selling its business and makes false allegations about the profitability of the business. Even the setting out by a company of its future conduct will breach s 18 if at the time the company did not intend to carry through with such conduct (*Hosmer Holdings Pty Ltd v CAJ Investments Pty Ltd* (1995) 57 FCR 45). Whereas s 18 has a broad scope, other sections of the Act prohibit conduct that is described more specifically. For example, s 29 of the ACL prohibits the company from making false representations about matters such as the origin of goods, sponsorships and affiliation.

Investors purchase shares on their perception of the worth of the company and will suffer loss, where the information available as to the company's finances and standing generally is misleading or deceptive, or likely to be. In *Sons of Gwalia Ltd v Margaretic* (2007) 231 CLR 160; [2007] HCA 1, a shareholder alleged that at the time of the purchase of his shares the company had engaged in conduct that was misleading or deceptive, under a section in previous legislation that was largely identical to s 18, by not disclosing to the market information that would have shown that the company was insolvent. In similar fashion, the *Corporations Act* targets misleading or deceptive conduct, or the likelihood thereof, as follows: **s 670A** regarding conduct during a takeover; **s 728** regarding the preparation of fundraising documents; **ss 953A** and **1022A** regarding disclosure documents; **s 1041H** in relation to a financial product or a financial service; **s 1308** concerning the prohibition on the company advertising or publishing misleading statements as to the amount of its capital. The *ASIC Act 2001* (Cth) identifies misleading representations in s 12BB and prohibits conduct that is misleading or deceptive in s 12DA.

Contravention of the ACL by a company can result in fines (the fines for companies are much larger than for individuals), injunctions (s 232), orders for damages (s 236) and various other ancillary orders such as variation or rescission of contracts (ss 237 and 243).

Summary—Company regulation in the *Competition and Consumer Act*

The *Competition and Consumer Act* regulates corporate markets and conduct

Provisions in the Act target anticompetitive conduct by companies

Boycotts, price fixing and misuse of market power are prohibited

The ACCC administers the restrictive practices sections of the Act and prosecutes contravention

Large takeovers may reduce competition and may require ACCC approval

Schedule 2 of the *Act* contains the *Australian Consumer Law* (ACL)

Misleading or deceptive conduct is prohibited by s 18 of the ACL

Unconscionable conduct is prohibited by ss 20, 21, 22 of the ACL

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