

# UNDERSTANDING COMPANY LAW

22ND EDITION

PHILLIP LIPTON • ABE HERZBERG  
BENJAMIN B SAUNDERS • CATHERINE ROBINSON



Lawbook Co.

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# **Understanding company law**

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# Understanding company law

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to

Ilana, Evelyn, Rob, Natalie, Jack, Sam, Mattea, Sophia, Emma and Leo

Nan, Jessica, Adam and Quincy

Elizabeth, Amelia, Theodora, Rupert, Audrey and Augustin

Karl



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# Preface

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In this 22<sup>nd</sup> edition the original authors, Phillip Lipton and Abe Herzberg have been joined by Catherine Robinson and Benjamin B Saunders as fellow co-authors.

This edition includes the following changes:

- *Corporate Collective Investment Vehicle Framework and other Measures Act (2022)* introduced a Corporate Investment Vehicle (CCIV) as a new type of company limited by shares that is used for fund management. The features of a CCIV are discussed in Chapter 27.
- *Corporations Amendment (Meetings and Documents) Act 2022* makes permanent changes to the *Corporations Act* to permit virtual and hybrid meetings. The legislation also inserted Pt 1.2A into the *Corporations Act* to permit company documents to be executed electronically. The changes relating to execution of documents are discussed in Chapter 5 and the changes relating to meetings are discussed in Chapter 21.
- The *Treasury Laws Amendment (Modernising Business Communications and Other Measures) Act 2023* now enables all documents under the *Corporations Act* to be signed electronically and certain additional categories of documents can be sent electronically or in hard copy.

We would like to thank Vickie Ma, our publisher at Thomson Reuters, for her very efficient and convivial management of this edition. We also thank Janani who oversaw its editorial production.

10 October 2023





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# Chapter 1

## Regulatory framework

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### Key points

- A company is an abstract entity recognised by the law as a legal person with its own rights and liabilities that are separate and distinct from its “owners” (its shareholders or members) and managers (its directors and other officers).

- Company law is a combination of case law and legislation largely contained in the *Corporations Act 2001* (Cth) (*Corporations Act*). The *Corporations Act* scheme is administered and enforced by the Australian Securities and Investments Commission (ASIC).
- Companies vary greatly in the scale of their businesses, their purposes and their number of shareholders. Most of the largest companies in Australia choose to have their shares or other securities listed on the Australian Securities Exchange (ASX) which operates the largest Australian securities market in which shares of listed companies and other entities can be bought and sold. Listed entities must comply with detailed disclosure obligations and other requirements imposed by the ASX Listing Rules as well as by the *Corporations Act*.

## What is a company?

**[1.05]** A company is an abstract or fictitious entity recognised by the law as a legal person with its own rights and liabilities. The terms “company” and “corporation” are often used interchangeably but in some contexts they have different meanings. The *Corporations Act 2001* (Cth) (*Corporations Act*), s 9, definition of a company includes a company that is registered under the Act or its predecessors. A company is only one type of corporation: s 57A. A corporation also includes any body corporate formed under other legislation and those unincorporated bodies that may sue and be sued or hold property in the name of an office holder appointed for that purpose.

Companies are a very widely used form of business organisation. There are over 3 million companies registered in Australia and they vary greatly in the size of business they conduct and the number of shareholders they have. The overwhelming majority of companies operate small business enterprises and are typically controlled by an individual person or a family.

A company is a separate entity distinct from its shareholders, directors, officers and employees.

A fundamental characteristic of a company is that it has its own corporate personality and is a separate entity distinct from its shareholders, its directors who control its management and its officers and employees. The fact that a company is regarded as an entity separate from its shareholders, directors and others means that the company may own property, make contracts, and sue and be sued in its own name.

A consequence of separate legal personality is that a company has a lifespan that is potentially unlimited. Its directors and shareholders may change over time but this does not affect the company's continuing existence as a legal person. Even though a company is in a sense a fictitious entity, it has the same legal capacity and powers as a human being. It is therefore able to engage in any business or activity and may acquire and exercise legal rights in the same way as an individual.

Limited liability of shareholders is another important characteristic of nearly all companies and is often one of the main reasons why people choose to form a company to conduct their businesses.

Limited liability is an important characteristic of companies.

Limited liability means that shareholders are not personally liable for their company's debts. The shareholders' liability is limited to paying the issue price of the shares that they own which includes any unpaid amount on partly paid shares. The implications of a company being a separate legal entity and its shareholders having limited liability are discussed at [2.15]–[2.35]. Chapter 2 also contains comparisons of a company with a partnership and a trust, the other most common forms of business organisations: see [2.285]–[2.345].

The transferability of shares is another feature that distinguishes a company from a partnership. As a general rule, and subject to the company's constitution, shareholders are able to transfer or sell their shares free of any restrictions and free transferability of shares is a requirement for listing on a stock exchange. Shareholders of listed public companies who wish to sell their shares do not need to obtain approval from other shareholders or the company's directors. Free transferability of shares facilitates stock exchange share trading. Most unlisted and closely held companies, which have few shareholders, restrict the transfer of their shares by provisions in their constitutions which require approval of the directors before shares can be transferred. The proprietary company replaceable rule in s 1072G is an example of such a provision.

Some companies, particularly those that operate large businesses, frequently organise their affairs in a corporate group structure with a holding company controlling one or more subsidiary companies. Each company in a corporate group is a legal entity separate from other members of the group. This is discussed further at [2.80].

Company formation (also referred to as "registration" or "incorporation") is a relatively simple process that involves filing an application for registration with ASIC and paying the prescribed fee. Once ASIC registers the company it comes into existence as a legal entity and can operate anywhere in Australia. The procedures for registering a company are further discussed at [2.350] onwards.

The *Corporations Act* makes a formal distinction between ownership and control of companies. Companies are required to have members (also called "shareholders") who, in a non-legal sense, are regarded as the owners of the company. The shareholders contribute capital by paying the issue price on their shares and may receive dividends if the company makes sufficient profits so that its assets exceed its liabilities and the excess is sufficient for payment of the dividend. Share capital and dividends are discussed in Chapters 8 and 10, respectively.

|                                                                            |
|----------------------------------------------------------------------------|
| Shareholders contribute capital by paying the issue price on their shares. |
|----------------------------------------------------------------------------|

The *Corporations Act* and company constitutions give shareholders significant rights. For example, they have the right to receive the company's audited financial reports and in the case of public companies, the right to attend, speak and vote at the company's annual general meetings. Financial reporting and auditors are discussed in Chapters 22 and 23. Shareholders' meetings are discussed in Chapter 21.

|                                                             |
|-------------------------------------------------------------|
| Directors control the management of the company's business. |
|-------------------------------------------------------------|

Every company must also have directors who are collectively referred to as a "board". Company constitutions usually give directors the exclusive power to control management of the company's business. Because directors control the management of the company, they are subject to strict fiduciary and statutory duties. For example, directors are required to exercise their powers in the best interests of the company and its shareholders, rather

than in their own interests. Directors' fiduciary and statutory duties are discussed in Chapters 13–20.

As discussed at [3.40], the *Corporations Act* draws a distinction between public and proprietary companies.

#### Public and proprietary companies.

A company must be one or the other. There are far more proprietary companies than public companies. The regulation of proprietary companies is designed to suit the needs of companies with small numbers of shareholders. One-person proprietary companies are permitted. Proprietary companies are divided into two subcategories: small and large proprietary companies. The distinction is based on the scale of the proprietary company's business. Most proprietary companies are small and are subject to minimal financial disclosure and audit requirements. The legislation imposes more onerous obligations and greater public transparency on public companies because they are permitted to raise capital from the public and usually operate large-scale businesses with large numbers of shareholders. The fundraising rules are discussed in Chapter 7.

#### ASX listed companies.

The largest companies generally choose to list their shares on the Australian Securities Exchange (ASX), which operates the main Australian securities market where shares of listed companies can be traded. There are about 2,200 companies and other entities whose shares and other securities are listed on the ASX.

Listed companies must comply with detailed disclosure obligations imposed by the ASX Listing Rules as well as the *Corporations Act*. The ASX Listing Rules provide greater shareholder protection mechanisms than the *Corporations Act*. Despite the more detailed regulatory requirements imposed on listed companies, there are significant advantages to being listed for both listed companies and their shareholders. An active market for listed entities enables investors to easily trade their shares and listed companies are able to raise large amounts of capital.

#### Sources of rules that regulate companies.

There are three main sources of rules that regulate companies:

- legislation, particularly the *Corporations Act* which applies throughout Australia. Also important is the *Australian Securities and Investments Commission Act 2001* (Cth) (*ASIC Act*), which established ASIC as the main government authority responsible for administering the *Corporations Act* and enforcing its compliance;
- case law; and
- the constitution of each company, which sets out the rules that regulate their internal management. Company constitutions are discussed at [4.40]–[4.60].

# History of company law

## Earliest companies

**[1.10]** Companies or corporations which had their own legal personalities existed long before they were regulated by legislation. In medieval times, companies were created in England by Royal Charter or Act of Parliament to carry on public benefit activities such as local government, universities, and associations of skilled tradesmen and merchants known as guilds. From the 16th century, this legal form was adapted and came to be used by monopolies engaged in international trade to conduct large-scale business enterprises in which many investors could contribute capital to the business. The best known of these early corporations, known as “joint stock companies”, was the East India Company which had many of the characteristics of the modern company. Its business was conducted by a board of directors who were appointed by the shareholders. The shareholders had limited liability, met regularly at meetings, were paid dividends and were able to trade their shares on stock exchanges.

During the early 18th century, private companies were formed that did not have charters, but under their constitutions they adopted main characteristics of chartered companies, including governance structures and tradable shares. This resulted in a complex legal arrangement where both incorporated and unincorporated joint stock companies were used to raise capital and carry on business enterprises. Unincorporated companies were adapted from partnerships and were considered a form of partnership but partnership law did not properly accommodate business enterprises with large numbers of shareholders. This created legal uncertainty on matters such as limited liability and the ability to sue and be sued.

## Early companies legislation

**[1.15]** A series of Acts was passed in England between 1844 and 1856 which remain the foundation of modern UK and Australian company law. This reforming legislation sought to reduce the complexities of company law to better protect investors, simplify the process of incorporation and encourage the formation of companies.

|                           |
|---------------------------|
| The first Companies Acts. |
|---------------------------|

These Acts made a clear distinction between companies and partnerships by providing that all undertakings of more than 20 persons were required to incorporate as companies. It was open for any enterprise that met the statutory requirements to incorporate and be registered as a company. One requirement was that there be a minimum of seven shareholders. Limited liability was permitted after legislation was passed in 1855 and 1856. The various statutes dealing with companies were consolidated in the English *Companies Act 1862* (UK). This legislation established all registered companies as separate legal entities distinct from their shareholders. By the late 19th century many family businesses and partnerships used the companies legislation mainly to gain the advantage of limited liability. These businesses were usually conducted by an individual or a small



number of partners with family members, friends or employees making up the required minimum number of shareholders. The famous case of *Salomon v A Salomon & Co Ltd* [1897] AC 22, discussed at [2.50], confirmed that the separate legal entity principle extended to what were in reality one-person companies.

The Australian colonies soon passed legislation closely modelled on the English *Companies Act 1862*. In Victoria, the no liability company was introduced for mining companies in 1871 in order to encourage investment in the mining industry. This type of company is described at [3.30]. Victoria also introduced a number of investor protection reforms in 1896 when a distinction was made between public and proprietary companies with greater financial disclosure requirements imposed on public companies. Proprietary companies were seen to be most suited to small businesses which had relatively few shareholders and which operated in a similar way to sole traders or partnerships. Such companies were not required to have their financial affairs audited, nor were they required to disclose their financial statements.

## Case law and legislation

[1.20] The result of the history and development of company law both in England and Australia has been the interaction and interdependence of case and statute law. It is necessary for the study of company law to understand the interrelationship between cases and the *Corporations Act*, for each presumes the existence of the other. Over a long period of time the courts have been asked to interpret and define many aspects of the legislation. In turn, the Parliaments have amended the legislation over the years assuming the existence of common law principles that evolved from the cases. Thus the *Corporations Act* does not purport to be a comprehensive code covering all aspects of company law. Rather, the sections of the *Corporations Act* must be read in conjunction with case law, which gives the legislation more precise meaning. This situation is to be contrasted with the law of contract, for example, where the legal principles largely come from cases through the doctrine of precedent with statute law regulating particular types of contracts.

## Development of Australian company law

### Constitutional position

[1.25] During the first half of the 20th century, Australian company law was characterised by a lack of uniformity from State to State because the *Australian Constitution* did not give the Commonwealth Parliament a clear power by the to make laws with respect to all companies and so the regulation of companies remained the responsibility of the States.

*Australian Constitution*, s 51(xx).

The closest such power is s 51(xx) of the *Constitution*, which gives the Commonwealth the power to make laws with respect to “foreign corporations, and trading and financial corporations formed within the limits of the Commonwealth”.

In the early years of the 20th century, the High Court adopted a narrow interpretation of the power in s 51(xx) so as to deny the Commonwealth the power to make laws with respect to the formation of companies: *Huddart Parker & Co Pty Ltd v Moorehead* (1909) 8 CLR 330 (*Huddart Parker*). This conclusion was based on the strict interpretation of the word “formed”, meaning already in existence. It was also regarded as questionable whether mining, investment and charitable companies were “trading or financial corporations”.

The result of this interpretation was that the Commonwealth had limited jurisdiction under the *Constitution* to make laws with respect to the incorporation and regulation of companies and this remained largely a State matter. The narrow *Huddart Parker* interpretation of s 51(xx) was followed many years later by the High Court in *New South Wales v Commonwealth* (1990) 169 CLR 482. This case concerned a challenge by several States to the constitutional validity of certain sections of the *Commonwealth Corporations Act 1989* (Cth) which provided, among other things, for the incorporation of trading and financial corporations. The High Court held that s 51(xx) of the *Constitution* did not give the Commonwealth constitutional power to make laws with respect to the formation of trading and financial corporations and consequently, provisions that related to company formation were invalid. The basis of the majority judgment concerned the phrase “formed within the limits of the Commonwealth” in s 51(xx). The High Court followed the *Huddart Parker* case, interpreting this phrase as referring to corporations that had already been created in Australia and excluded the process of formation itself. In order to overcome the difficulties arising from these constitutional limitations, from the 1960s onwards the Commonwealth and States entered into various agreements aimed at achieving greater uniformity in the regulation of companies throughout Australia.

## The road to national regulation

**[1.30]** Company law remained regulated and administered by each State and Territory until the 1960s. During the next 40 years, there were a series of changes that moved towards the establishment of national scheme.

The Uniform Companies Acts passed by all Australian States in 1961 and 1962 largely achieved its aim of attaining uniform companies legislation throughout Australia. It was then possible to speak of a particular section and generally this was identical in the Companies Acts of each State.

The co-operative scheme came into effect in 1981. It established both uniform government administration of the law and importantly it established the National Companies and Securities Commission (NCSC), a predecessor of ASIC, with policy, administration and enforcement responsibilities throughout Australia.

The Commonwealth unsuccessfully tried to takeover companies and securities regulation in 1989. After this failed, it was clear that the Commonwealth required the co-operation of the States and a new arrangement was negotiated that established the *Corporations Law* scheme. It was a complex legislative framework of Commonwealth legislation applied as State law which had the characteristics of, and was treated for all practical purposes as if it was Commonwealth law. The constitutional validity of the *Corporations Law* scheme was successfully challenged in a number of High Court cases,

creating legal uncertainty around the basis of the scheme. This led to another overhaul of the regulatory scheme after the States and the Northern Territory agreed to refer to the Commonwealth, under s 51(xxxvii) of the *Constitution*, their constitutional powers to make and amend laws dealing with companies and securities.

## Corporations Act 2001

[1.62] As a result of the enactment of the referral legislation by the States, the Commonwealth passed the *Corporations Act* and the *ASIC Act* which operate to the present. The *ASIC Act* is discussed at [1.65].

The *Corporations Act* now applies Australia-wide and is administered and enforced on a national basis by ASIC and other Commonwealth bodies.

## Australian Securities and Investments Commission

[1.65] ASIC is the main Commonwealth authority responsible for administering the *Corporations Act* and regulating Australia's companies, financial markets and financial services, as well as service providers who deal and advise in investments and financial products. Prior to 1998, ASIC was called the ASC. As well as a change in name, ASIC was given additional functions dealing with the consumer protection and market integrity aspects of insurance and superannuation regulation. These additional functions are outside the scope of this book.

The *ASIC Act* was enacted at the same time as the *Corporations Act* and largely re-enacted the previous package of ASIC legislation as a single Commonwealth law that operates in every State that referred its powers to the Commonwealth as well as the Australian Capital Territory and Northern Territory.

ASIC is a body corporate with between three and eight government-appointed commissioners headed by a chairperson: *ASIC Act*, ss 8–10. ASIC has offices headed by a Regional Commissioner in each referring State and Territory: ss 95 and 96. ASIC has also established other offices and business centres in most large Australian cities. These were set up so that ASIC could better serve the needs of the business communities in the various referring States and Territories. ASIC's website (<http://www.asic.gov.au>) sets out vast amounts of valuable information and is linked to the Understanding Company Law website at <http://www.uclaw.com.au/asic/>.

## Objectives of ASIC

[1.70] In performing its functions and exercising its powers, s 1(2) of the *ASIC Act* directs ASIC to strive to:

- maintain, facilitate and improve the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy;
- promote the confident and informed participation of investors and consumers in the financial system;

- administer the laws that confer functions and powers on it effectively and with a minimum of procedural requirements;
- receive, process and store, efficiently and quickly, the information given to the Commission under the laws that confer functions and powers on it;
- ensure that information is available as soon as practicable for access by the public; and
- take whatever action it can take, and is necessary, in order to enforce and give effect to the laws that confer functions and powers on it.

## Functions and powers of ASIC

**[1.75]** Section 11(1) of the *ASIC Act* provides that ASIC has such functions and powers as are conferred on it by or under the *ASIC Act* and the *Corporations Act*. These include the power to:

- register companies;
- grant Australian financial services licences;
- register auditors and liquidators;
- grant relief from compliance with various provisions of the *Corporations Act*;
- maintain publicly accessible registers of information about companies and financial services licensees;
- investigate suspected breaches of the law including requiring the production of books and answering questions at an examination;
- advise the responsible Minister with regard to any changes to the corporations legislation that are needed to overcome problems of which ASIC has become aware;
- ban people from providing financial services; and
- seek civil penalties from the courts.

ASIC is responsible to the Commonwealth Treasurer and therefore ultimately to the Commonwealth Parliament. The Treasurer may give written directions to ASIC about the policies it should pursue and the priorities it should follow: s 12. Before giving ASIC a direction, the Minister must provide the ASIC chairman the opportunity to discuss a proposed direction. To maintain the independence of ASIC from the executive arm of government, the Minister is not permitted to issue directions about particular cases.

### *Registering companies*

**[1.80]** ASIC is the government authority that registers companies. As discussed at [2.410], any person who wishes to form a company must lodge an application for registration with ASIC and pay the appropriate fee. ASIC registers the company and issues a certificate of registration. Once registered, a company comes into existence and is permitted to operate in every Australian State or Territory.

### *Registering business names*

**[1.82]** ASIC maintains a single national online business names register in which anyone who carries on a business in a name other than their own is obliged to register the business name and provide prescribed information such as the name of the owner of the

business name. The register may be searched online enabling the public to easily discover who owns a particular business name.

## *National database*

**[1.85]** ASIC provides publicly accessible information on all Australian companies through its national companies database. ASIC's national database contains public information about:

- corporations, including their names, registered offices, particulars of directors and principal activities;
- fundraising offer documents;
- licensed financial service providers (for example, stockbrokers and financial advisers); and
- registered auditors and liquidators.

Anyone can search the national database to obtain publicly accessible information about companies. Any written material that purports to have been prepared by ASIC from information contained in the national database is admissible as prima facie evidence, in the absence of evidence to the contrary, as proof of the information contained in it and is admissible in court proceedings as evidence without formal certification of its accuracy: s 1274B.

## *Regulation of financial services and markets*

**[1.90]** ASIC is the main authority responsible for regulating financial products, financial services and financial markets. For example, under Pt 7.2 of the *Corporations Act*, operators of a financial market such as the ASX must be licensed by ASIC. ASIC is also given the power to direct a market licensee to suspend dealings in particular securities on the ASX and to enforce compliance with the ASX's Listing Rules: ss 793C and 794D. Under Pt 7.6, financial service providers such as stockbrokers and financial advisers must be licensed by ASIC. ASIC also has broad powers to regulate fundraising by the issue of securities. For example, Ch 6D requires a disclosure document in relation to offers or issues of securities to be lodged with ASIC before they are issued to potential investors. Section 741 gives ASIC wide power to grant exemptions in relation to the fundraising provisions.

ASIC is solely responsible for the supervision and enforcement of laws dealing with misconduct of participants in relation to financial markets. This is further discussed at [26.40].

## *Takeovers*

**[1.95]** ASIC has an important role in regulating company takeovers. As discussed at [25.85], under Pt 6.5 of the *Corporations Act*, takeover bidders must lodge a bidder's statement and offer document with ASIC containing prescribed information before an offer is sent to a target company's shareholders. In addition, takeover target companies are also required to lodge with ASIC a target's statement containing prescribed information: see [25.90]. The purpose of the bidder's and target's statements is to ensure that shareholders of target companies receive adequate information so as to enable them to assess the merits of takeover offers. ASIC is also given broad powers to grant exemptions from, or modify

the application of, the takeover provisions. To ensure both the spirit and the letter of the takeover provisions are complied with, Pt 6.10, Div 2 enables ASIC or any person (including the bidder or target) whose interests are affected by a decision of ASIC or by unacceptable circumstances to apply to the Takeovers Panel for an order affecting a decision of ASIC or for a declaration that unacceptable circumstances have occurred in relation to an acquisition of shares.

### *Powers of investigation*

**[1.100]** ASIC has the responsibility of ensuring compliance with the provisions of the *Corporations Act*. To this end, Pt 3 of the *ASIC Act* provides ASIC with wide investigatory and information-gathering powers where it has reason to suspect that a contravention of a national scheme law may have been committed. For example, s 19 gives ASIC the power to require any person to give reasonable assistance and answer questions on oath where it conducts an investigation. Under ss 28–39 it can compel persons to produce books and records in a wide range of circumstances. ASIC's investigations and information-gathering powers are further discussed in Chapter 28.

### *Enforcement powers*

**[1.105]** ASIC has the power to initiate civil proceedings against a person where as a result of an investigation or examination it forms the opinion that it is in the public interest to do so: *ASIC Act*, s 50. The proceedings may, for example, be brought in the name of a company against its directors for the recovery of damages for fraud, negligence, default, breach of duty, or other misconduct. Section 50 also enables ASIC to initiate class actions for the recovery of damages on behalf of shareholders or other persons. ASIC has the power under s 1324 to apply to the court for an injunction where a person has engaged in conduct that constitutes a contravention of the *Corporations Act* and to intervene under s 1330 in any legal proceedings initiated by others relating to a matter arising under the *Corporations Act*.

ASIC may also bring a criminal prosecution where, as a result of an investigation, it forms the opinion that a person has committed an offence against the corporations legislation and ought to be prosecuted: *ASIC Act*, s 49. ASIC's powers to begin criminal prosecutions overlap with similar powers granted to the Commonwealth Director of Public Prosecutions (DPP). Because this overlap caused past tension between ASIC and the DPP, guidelines were established that require senior officers of ASIC and the DPP to meet regularly and review all investigations and prosecutions in which ASIC and the DPP have common interests. The guidelines also require ASIC to consult with the DPP before taking civil enforcement action in any case where criminal proceedings may also be available.

### *Education role*

**[1.110]** ASIC performs an important educative function. It releases regulatory guides, consultation papers, information sheets and media releases so that both the public at large and the business community can more easily understand the operation of the *Corporations Act* and ASIC's interpretation of its provisions.

## Consumer protection

[1.115] ASIC's website has a consumer webpage called "Moneysmart" that provides guidance in financial dealings and investing and warnings of dishonest financial schemes. ASIC established the Consumer Advisory Panel to advise on consumer protection issues and to give feedback on ASIC policies and activities.

## Financial Regulator Assessment Authority

[1.117] The *Financial Regulator Assessment Act 2021* (Cth) established the Financial Regulator Assessment Authority (FRAA) to assess the effectiveness and capability of ASIC and APRA, the supervisory body of banks and other financial institutions. In order to maintain the operational independence of ASIC and APRA, the FRAA does not have the power to direct or interfere with the regulators' individual decisions or functions. The authority's key functions are to assess and report to the Minister on ASIC's effectiveness and capability every two years and whenever requested by the Minister.

## The ASX

[1.120] ASX Ltd, formerly called the Australian Stock Exchange, operates Australia's main financial markets for equities including shares, derivatives and fixed interest securities. The ASX was formed in 1987 with the amalgamation of a number of independent exchanges, each of which operated in the various State capitals. In 1998, the ASX became a public company listed on its own market.

The ASX operates Australia's main financial markets for shares and derivatives.

In 2010, the ASX transferred its responsibility to supervise trading on financial markets to ASIC which now has the power to supervise financial markets and make and enforce rules with respect to trading. The role of the ASX in the regulation of financial markets is discussed at [26.45]–[26.60].

The major role of the ASX is to ensure the integrity of their financial markets so that they operate in a fair, orderly and transparent manner.

The major responsibilities of the ASX include:

- having adequate arrangements in place for operating their markets;
- admitting entities to its official list;
- supervising listed entities; and
- monitoring and enforcing compliance with the market's operating rules including its listing rules.

In carrying out these responsibilities, the ASX plays an important role in keeping the market informed and requiring disclosure of corporate governance practices. The continuous disclosure regime incorporates both legislative regulation and ASX Listing



Rule requirements. Under the continuous disclosure obligations, listed entities must inform the ASX of any information concerning the company of which it becomes aware, which is not generally available and which a reasonable person would expect to have a material effect on the price of the company's securities. The continuous disclosure requirements play a key role in promoting an informed and transparent market. These requirements are discussed at [22.135]–[22.144].

The ASX formed a Corporate Governance Council comprising 21 interested organisations which issued its *Principles of Good Corporate Governance and Best Practice Recommendations* in 2003 setting out recommended best practices which listed companies must either follow or explain to the market why they have not done so. The current version, *Corporate Governance Principles and Recommendations* (4th ed), was issued in 2019. This is discussed in Chapter 14.

The ASX website contains useful information about the stock market and ASX listed companies and is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## Takeovers Panel

**[1.125]** The Takeovers Panel replaced the courts as the main forum for resolving disputes about takeovers while a takeover bid is on foot. The Panel was set up to ensure such disputes could be resolved quickly by a specialist body and to prevent the various parties involved in a takeover from slowing the takeover process by initiating court litigation as a strategy. A person cannot commence court proceedings about a takeover bid until after the end of a takeover bid period. ASIC has the power to commence court proceedings before the end of the bid period: s 659B.

The Takeovers Panel is a peer review body with members appointed by the government based on their knowledge or experience in areas such as business, financial markets, law and economics. This was done so that a specialist body composed of takeover experts, attuned to the commercial realities and aware of market practices could best resolve takeover disputes.

The *Corporations Act* gives the Panel broad powers in relation to takeovers. It can declare circumstances in relation to a takeover, or to the control of a company, to be unacceptable circumstances: s 657A. Under s 657D the Panel can make a wide range of remedial orders to protect the rights of any person affected by the circumstances to ensure that a takeover bid proceeds the way that it would have proceeded if the unacceptable circumstances had not occurred. The Takeovers Panel also has the power to review certain decisions of ASIC to grant exemptions or modifications during the life of a takeover: s 656A.

The role of the Takeovers Panel is discussed further at [25.240]. The Panel's website (<http://www.takeovers.gov.au>) contains the Panel's guidance notes, media releases, decisions and rules and is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.



## Financial reporting system

**[1.130]** The institutional arrangements of the financial reporting system are set out in Pt 12 of the *ASIC Act*.

The main objects of the financial reporting system as set out in s 224 include:

- the development of accounting standards and auditing and assurance standards; and
- the maintenance of investor confidence in the Australian economy (including its capital markets).

### Financial Reporting Council

**[1.135]** The Financial Reporting Council (FRC) operates as a single oversight body for the key elements of the financial reporting system. The FRC aims to ensure that oversight is coherent and effective and in alignment with a common policy direction. Under s 225(1) of the *ASIC Act*, the FRC's functions include:

- providing broad oversight of the processes for setting accounting and auditing standards in Australia;
- monitoring the effectiveness of and advising on auditor independence requirements;
- giving reports and advice to the Minister; and
- establishing appropriate consultative mechanisms.

The FRC also provides the responsible Minister and professional accounting bodies with strategic policy advice and reports in relation to the quality of audits conducted by Australian auditors.

The FRC's functions and powers were designed to ensure that while it had broad oversight over the standards-setting process, it is not able to determine the content of particular standards. For example, the FRC does not have any direct influence over technical deliberations of the Australian Accounting Standards Board (AASB) or the Auditing and Assurance Standards Board (AuASB) and cannot veto any standard made by the AASB or the AuASB.

The FRC appoints the members of the AASB and AuASB, other than the chair, and has responsibility to approve and monitor the AASB's and the AuASB's priorities, business plans and budgets. The FRC website (<http://www.frc.gov.au>), which is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/> sets out FRC's strategic plan, reports, rules of operations and media releases.

### Australian Accounting Standards Board

**[1.140]** The AASB was established under s 226 of the *ASIC Act* as the body that sets accounting standards. Its broad strategic plan and priorities are subject to FRC approval. In recent years its activities have included the implementation of the FRC directive that Australia should adopt International Accounting Standards and Interpretations.

Under s 227(1) the functions of the AASB include:

- developing a conceptual framework for the purpose of evaluating proposed accounting standards and international standards;
- making and formulating accounting standards; and
- participating in the development of a single set of accounting standards for worldwide use.

In performing its functions, the AASB must follow the FRC's broad strategic and general policy directions: s 232. It must also take into account the advice and feedback on matters of general policy given by the FRC. However, the FRC does not have the power to direct the AASB in relation to the development or making of a particular standard, nor does it have the power to veto standards formulated and recommended by the AASB: s 225(5) and (6).

The AASB is a body corporate whose members, apart from the chairman who is appointed by the Minister, are appointed by the FRC: s 236B. The AASB website (<http://www.aasb.gov.au>), which contains information about the AASB, its standards, pronouncements, work in progress, publications and latest news, is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## Auditing and Assurance Standards Board

**[1.145]** The Auditing and Assurance Standards Board (AuASB) was established under s 227A of the *ASIC Act*. Its functions and powers largely mirror those of the AASB. The main function of the AuASB is to make the auditing standards which are given legal effect by s 336 of the *Corporations Act*.

Registered company auditors, irrespective of whether they are members of the accounting professional bodies, must use auditing standards when performing auditing work in accordance with the *Corporations Act*. Auditing standards are discussed at [23.90].

The AuASB is required to follow the broad strategic and general policy directions determined by the FRC and take into account the advice and feedback on matters of general policy given by the FRC: *ASIC Act*, s 234C. The FRC does not have the power to give directions on the development or making of or to veto a particular auditing standard: s 225(7) and (8).

As with the AASB, meetings of the AuASB which are concerned with the contents of auditing standards or international auditing standards must be held in public: s 236E(2). The chair of the AuASB is appointed by the Minister and all other members are appointed by the FRC: s 236F.

The AuASB website (<http://www.auasb.gov.au>), which is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/> sets out AuASB standards, pronouncements, work in progress, news and publications.

## Companies Auditors Disciplinary Board

**[1.155]** The Companies Auditors Disciplinary Board (CADB) is established and governed under Pt 11 of the *ASIC Act*. It is a disciplinary body which can only act upon applications made to it by ASIC or the Australian Prudential Regulation Authority (APRA) for a registered auditor to be dealt with by the Board under s 1292. Its members are selected by the government. CADB hearings are conducted by panels consisting of a majority of non-accountants to ensure there is sufficient independence from the professional accounting bodies.

Under s 1292 of the *Corporations Act* the CADB may cancel or suspend the registration of a person as an auditor if, after conducting a hearing, it is satisfied that the person has failed to carry out adequately and properly their duties or is otherwise not a fit and proper person to remain registered. The CADB also has the power to impose monetary penalties as an alternative to cancellation or suspension of registration.

## Corporations and Markets Advisory Committee

**[1.160]** Corporations and Markets Advisory Committee (CAMAC) (once called the Companies and Securities Advisory Committee (CASAC)) was the main corporate law reform advisory body of the *Corporations Act* scheme. CAMAC's primary function was to advise and make recommendations to the government on any matter connected with the operation, administration and reform of the corporations legislation as well as proposals dealing with financial markets, products and services. It ceased operation in 2014.

CAMAC and its predecessor, CASAC, produced many reports and discussion papers dealing with a variety of topics that can still be accessed on the CAMAC website. The Understanding Company Law website at <http://www.uclaw.com.au/resources/> has links to these reports.

## Parliamentary Joint Committee on Corporations and Financial Services

**[1.165]** Part 14 of the *ASIC Act* provides for the appointment of a Parliamentary Joint Committee on Corporations and Financial Services (PJC) at the commencement of the first session of each Parliament. The PJC consists of 10 members of the Commonwealth Parliament, five of whom are senators appointed by the Senate and five who are members of the House of Representatives appointed by that House. The purpose of the PJC is to add an additional level of parliamentary supervision over the *Corporations Act* scheme. According to s 243 of the *ASIC Act*, the duties of the PJC are to inquire and report into the operation of the corporations legislation generally, ASIC and the Takeovers Panel. The PJC website contains information about its role, current inquiries and recent reports and is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## New developments

[1.170] Since the previous edition, the following significant legislation has been introduced.

*Corporate Collective Investment Vehicle Framework and other Measures Act 2022* (Cth) introduced a Corporate Investment Vehicle (CCIV) as a new type of company limited by shares that is used for fund management. A CCIV is an umbrella vehicle that comprising of one or more sub-funds operated by a single corporate director. According to the Explanatory Memorandum a key policy objective of the legislation is increase the competitiveness of Australia's managed funds industry internationally to attract offshore investment. The features of a CCIV are discussed in Chapter 27. While the legislation also introduced a new tax framework specifically for CCIV's, tax is outside the scope of this book.

*Corporations Amendment (Meetings and Documents) Act 2022* (Cth) makes permanent changes to the *Corporations Act* to permit virtual and hybrid meetings. The legislation also inserted Pt 1.2A into the *Corporations Act* to permit company documents to be executed electronically. The changes relating to execution of documents are discussed in Chapter 5 and the changes relating to meetings are discussed in Chapter 21.

The *Treasury Laws Amendment (Modernising Business Communications and Other Measures) Act 2023* (Cth) expands the scope of the technology neutral reforms in the *Corporations Amendment (Meetings and Documents) Act 2022* so that all documents under the *Corporations Act* can be signed electronically and certain additional categories of documents can be sent electronically or in hard copy.

## Tutorial questions

The following questions dealing with the legislative framework of the corporations legislation may best be answered by reading this chapter and considering the internet resources linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/> and the Legislative Framework Pathway at <http://www.uclaw.com.au/pathways/>.

1. Go to ASIC's website and look up its most recent Annual Report:
  - (a) What did the ASIC chair identify as the main achievements of the year?
  - (b) What were the main strategies and priorities implemented by ASIC during the year?
2. Outline some current areas of interest and concern to ASIC as indicated by recent speeches given by ASIC Commissioners and senior officers. Choose one of these speeches from the ASIC website (under Newsroom) and describe the issues raised in it.
3. Describe a recent matter that came before the Takeovers Panel and the decision of the Panel. Go to the Takeover Panel's website for information on this.
4. Select a CAMAC report or discussion paper and briefly describe the main issues raised in it. Go to the CAMAC website to find its reports.

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.
- For further corporations law links and material please refer to the Understanding Company Law website at <http://www.uclaw.com.au>.

## Chapter 2

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# Registration and its effects

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## Key points

- Upon registration a company is regarded as a legal entity that is separate and distinct from its members/shareholders and directors. This is sometimes referred to as the “veil of incorporation”. Even a one-person company is regarded as a separate legal entity distinct from that person.
- The fact that a company is a separate legal entity means that it may sue and be sued in its own name. Company property belongs to the company, not its shareholders. A company continues to exist until it is deregistered, even if its shareholders die.
- Limited liability is an important characteristic of nearly all companies and their shareholders. Most companies are registered on the basis that the liability of shareholders is limited to the amount unpaid (if any) on the issue price of their shares. This encourages shareholder investment because the risk of the company’s insolvency is largely transferred from its shareholders to its creditors.



- Occasionally, both the *Corporations Act* and case law lift the corporate veil to either disregard the fact that a company is a separate legal entity or remove the privilege of limited liability.
- The procedure for setting up a company involves lodging an application for registration with ASIC. This application must contain prescribed information. The *Corporations Act* imposes a number of post-registration requirements, such as the establishment of registers, financial records and minute books, which must be carried out soon after a company is registered.

## Characteristics of a company

**[2.05]** Companies are legal persons recognised by the law with rights and liabilities separate from their members (also usually referred to as shareholders). This chapter discusses the legal consequences and implications that flow from this definition. Companies are used for a wide range of purposes and differ considerably in terms of size of business, purpose, number of shareholders, spread of shareholdings, nature of activities and value of assets held. Despite this diversity, the fundamental consequences of registration are the same for all companies.

**[2.10]** A company comes into existence with its own legal personality, on the day on which it is registered with the name specified in its certificate of registration: s 119. A company is separate from its members or shareholders, so the assets of the company are not the assets of its members or shareholders and contracts entered into by the company will create rights and liabilities that vest in the company and not in its members or shareholders.

## Effects of registration

**[2.15]** The rights, powers and liabilities of a company stem from its creation as a distinct legal entity which is separate from the shareholders it may have from time to time.

A company has the legal capacity and powers of an individual and a body corporate.

The legal capacity and powers of a company include the capacity and powers of an individual and a body corporate: s 124. Powers of an individual applicable to companies include the power to acquire and dispose of property and the right to sue.

Powers of a company as a body corporate are listed in s 124(1) and include the powers to:

- issue and cancel shares (a company limited by guarantee does not have a share capital and so does not have power to issue shares);
- issue debentures;
- grant options over unissued shares;
- distribute the company's property among its members, in kind or otherwise;
- grant a security interest in uncalled capital; and
- grant a circulating security interest over the company's property.

A body corporate is an incorporated legal entity created and recognised by the law. It is an artificial legal person as opposed to individuals, who are known as natural persons. The various types of body corporate are discussed at [3.05]. Under the *Corporations Act*, a body corporate is regarded as one type of "corporation": s 57A. A company registered under the *Corporations Act* is the most common type of corporation.

A company may sue and be sued in its own name.

Because a company is a separate legal entity recognised by law, it follows that it may enforce its rights by suing and conversely it may incur liabilities and be sued by others.

As a general rule, shareholders or members cannot sue on behalf of their company to enforce a right of the company. However, Pt 2F.1A (ss 236–242) permits a member or officer to seek leave of the court to bring legal proceedings on behalf of the company in circumstances where the company is unwilling to do so. Such proceedings are referred to as “statutory derivative actions” and are discussed at [24.285]–[24.300]. The separate nature of a company is illustrated by the fact that a company may sue and be sued by its own members. This may be contrasted with the difficulties faced by unincorporated associations and their members seeking to enforce legal rights against each other.

Shareholders do not own the company’s property.

A further consequence of the fact that a company is a separate legal entity is that a company owns its property in its own right separate from the property of its shareholders or members.

This means that even though shareholders hold shares in the company, they do not have a proprietary interest in the assets of the company. This is illustrated by *Macaura v Northern Assurance Co Ltd* [1925] AC 619, discussed at [2.70]. The legal nature of shares is discussed at [8.10]. A change in shareholders of a company has no effect on the company’s ownership of its assets.

A company continues to exist until it is deregistered by ASIC: s 601AD(1). Its shareholders may change over time but this does not affect the continuing legal personality of the company. Even if all shareholders died at the one time, the company will still continue to exist. The deceased shareholders’ shares are transmitted to their personal representative, who will usually be the executor named in a deceased shareholder’s will.

Historically, one of the effects of registration was that a company could enter into a contract only if there was a contractual document bearing the impression of the company’s seal which served the purpose of representing the company’s signature. Section 126 now provides that the power of a company to make a contract may be exercised by an individual acting with the company’s express or implied authority and on behalf of the company. This power may be exercised with or without the use of a common seal. The validity of the exercise of power by an individual to act on behalf of a company is determined by the law of agency and the assumptions in s 129. This is discussed at [5.235] onwards.

It is now optional for companies to have a common seal: s 123(1). Consequently, a company may execute a document without using a common seal: s 127(1) and (3).

If a company chooses to have a common seal, its name and Australian Company Number (ACN) or Australian Business Number (ABN) must be set out on the seal: s 123(1). If a company has an ABN issued for goods and services tax purposes, it may use its ABN in place of its ACN provided that the ABN includes its nine-digit ACN. It is a strict liability offence to use or authorise the use of a seal in non-compliance with these requirements: s 123(3).

## Limited liability

### *Economic benefits of limited liability in publicly traded companies*

[2.20] Limited liability of corporate shareholders is a feature of legal systems around the world. Limited liability is one of the main advantages of the corporate form over other forms of business organisation such as partnerships. Limited liability encourages shareholder investment by offering protection to shareholders and, as discussed at [2.340], it also facilitates efficient corporate fundraising and operation of stock exchanges.

Limited liability means that shareholders are not personally liable for their company's debts. The extent of a shareholder's liability depends on the type of company, as provided by s 112. These various types of companies are discussed at [3.10]–[3.35]. In any case, if a company has incurred obligations, it is primarily liable because its debts are separate from the debts of its shareholders. It is only when the company has insufficient assets to pay its debts that the issue of shareholder liability arises.

The liability of shareholders is limited to the amount unpaid on the issue price of their shares.

The liability of shareholders of a company limited by shares (by far the most common type of company) is limited to the amount, if any, unpaid on the issue price of their shares: s 516. Shareholders who own fully paid shares have no further liability to pay further amounts to the company.

The effect of limited liability is that the risk of company failure is largely transferred from the company's shareholders to its creditors. The arguments in favour of limited liability were stated by Companies and Securities Advisory Committee (CASAC) in para 1.52 of its *Corporate Groups Final Report* (May 2000):

Limited liability achieves various economic goals:

- **facilitating enterprise.** Limited liability facilitates investment and otherwise encourages economic activity by separating investment and management functions and shielding investors from any corporate loss in excess of their equity capital. This protection for investors reduces the costs of raising capital. Also, corporate controllers may be more willing to undertake entrepreneurial activity through their controlled companies, given that, as shareholders of those companies, they are shielded against unlimited liability for the debts of those companies
- **reducing monitoring.** Limited liability decreases the need for shareholders to monitor the managers of companies in which they invest. The risk to those shareholders of a company's failure is confined to the loss of the equity invested
- **promoting market efficiency.** Limited liability promotes the liquidity and efficient operation of securities markets, as the wealth of each shareholder of a public company is irrelevant to the trading price of its shares. This allows shares to be freely traded, as their price is set by factors other than their

owners' wealth. The free transfer of shares may in turn promote efficient management, given that shares in a poorly managed company may trade at a discount, creating the climate for a takeover and the replacement of incumbent management.

- **encouraging equity diversity.** Limited liability permits investors to acquire shares in a number of companies. This might not be possible for particular investors if the principle of unlimited liability applied and they could lose all or most of their personal wealth through failure of one company in which they held equity.

CASAC's *Corporate Groups Final Report* is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

### *Limited liability and closely held companies*

[2.25] The application of limited liability to closely held companies is problematic in a number of situations. Tort creditors of corporate groups may be adversely affected where a parent company seeks to limit liability to an under-capitalised subsidiary that is unable to fully meet its liabilities to tort creditors. This is discussed at [2.240]–[2.270]. Limited liability also enables shareholders of closely held companies to avoid liability to creditors by stripping the company of its valuable assets, putting it into liquidation and then conducting the company's business through a new company, described as a “phoenix” company, whose assets are outside the reach of the creditors. This is discussed at [18.55]–[18.80].

The arguments put forward in favour of limited liability at [2.20] have much less applicability in the case of closely held small companies and subsidiaries within corporate groups. These companies, usually registered as proprietary companies, do not generally separate the roles and functions of directors and shareholders, as they have small numbers of shareholders who typically also function as, or nominate, the directors and managers. Within corporate groups, some of the benefits of limited liability, such as the reduction in monitoring costs, are irrelevant as it is usual for a controlling company to monitor its controlled subsidiary companies.

Further, the benefit of promoting an efficient market for shares through limited liability is not applicable as closely held companies such as subsidiaries, cannot be listed. The application of limited liability to corporate groups may have an adverse outcome as it is more likely to encourage excessive risk-taking by parent companies, because the benefit of taking a business risk will accrue to the company, while if the risk fails, the burden falls on creditors.

Tax considerations are the main purpose behind the common practice of incorporating a company to act as trustee of a discretionary trust to operate a family business. Typically, such companies are established with a minimal paid up capital to operate businesses and incur debts on behalf of the beneficiaries of the trusts. Apart from their paid up share capital, company trustees usually do not have any significant assets of their own. If trust assets are insufficient to meet all of the creditors' claims, trust creditors cannot look to the personal assets of the trustee's shareholders. Trustee companies are discussed in [3.190]–[3.200].

## *Limited liability and contract creditors*

**[2.30]** The impact of limited liability on creditors depends on the type of creditor. The risks in dealing with limited liability companies are usually overcome by secured creditors such as banks and other financial institutions, as such lenders usually have strong bargaining power, they generally will not lend money to limited liability entities unless they receive adequate security for their loans.

The impact of limited liability on secured creditors.

The security may take the form of a debenture granting the lender a security interest over company assets. It may also consist of a mortgage over the real estate or other assets owned by the company. In the case of closely held companies, finance creditors commonly also insist on security in the form of personal guarantees from the directors and shareholders. As well as requiring security for loans, finance creditors often seek to further protect themselves from the risk of business failure by insisting on the inclusion in loan agreements of terms that restrict the borrowing company's dividend policy, investment decisions that alter the risk characteristics of the company's earnings and the ability of the company to raise further debt capital that may rank equally or have priority over existing debt.

Limited liability and trade creditors.

Trade creditors supply goods or services to a company on credit. Such creditors rarely insist on security before they supply on credit to a company. For this reason, suppliers generally bear a large part of the risk of a debtor company's insolvency.

Trade creditors may reduce their credit risk in a number of ways. They may factor in the risk of debtor insolvency by charging a higher price for the goods or services supplied. In some cases, trade creditors may take out insurance to protect themselves from bad debts. Further, because trade creditors are often creditors of more than one company, they may effectively diversify the risk that one of their corporate customers may become insolvent.

Limited liability and employees.

The employees of a company are a special category of unsecured creditors that may be adversely affected by limited liability.

Unlike finance or trade creditors, employees rarely obtain security or diversify the risk of their employer's insolvency. Further, most employees have little information about their employer's financial position. The *Corporations Act* to some extent recognises the particular hardships and difficulties that confront employees in the event of their employer's insolvency and provides some protection. Section 556 accords unpaid employee wages, holiday pay and long service leave preferential treatment in the event of the liquidation of a corporate employer: see [32.675]. Part 5.8A also protects

employees from agreements that have the purpose of defeating the recovery of their entitlements: see [32.625]–[32.635].

ASIC has published an information paper, INFO 26 *Dealing with Businesses and Companies*, on its website that suggests steps that should be taken to reduce risk when dealing with limited liability companies. This paper is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

### *Limited liability and tort creditors*

**[2.35]** While contract creditors bear some risk when they provide credit to a limited liability company, they generally enter into the contract voluntarily and so are able to make inquiries and assess how the risk can be managed. This is not the case for a company's tort creditors, who are generally involuntary creditors because they did not intend becoming tort victims or creditors.

#### Involuntary creditors.

Victims of torts such as negligence committed by a limited liability company bear an uncompensated and involuntary risk in the event of the company's insolvency, yet they are usually in a poor position to protect themselves against the risk of harm. This is especially so where a parent company acts negligently and thereby causes injury to employees or consumers and then seeks to quarantine tort liability in a subsidiary which has inadequate assets or negligence insurance cover to meet all tort claims. The parent company then seeks the protection of limited liability to prevent tort creditors recovering compensation from the parent or any other companies in the group. This problem is discussed at [2.240]–[2.270].

Several economic and ethical arguments have been put forward in favour of limiting the operation of limited liability in relation to tort claims against members of a corporate group:

- It is economically inefficient to leave involuntary tort creditors with the risk of uncompensated injuries because the party best able to take measures to avoid the risk, which is the holding company, should bear the liability so it has the greatest incentive to take the necessary steps to avoid harming others.
- Excessive risk-taking business behaviour is not deterred. One of the main objectives of tort law is to discourage unreasonably harmful behaviour by the imposition of compensation liability on the person who commits a tort. This objective is undermined if the wrongdoer can avoid having to meet claims against it through reliance on the principle of limited liability. This avoidance of liability is known as “externalising risk”.
- It is unethical for companies to profit from business activities which cause harm without bearing the costs arising from death and injury caused by these activities.
- There is little incentive for a limited liability entity to carry adequate negligence insurance since, in the event of insolvency, shareholders can only lose their investment. It is therefore not surprising that many professionals who may potentially incur tort liabilities, incorporate their practices as limited liability

companies to avoid potential liability for negligence. Even those professionals who are not permitted by professional rules to incorporate their practices in limited liability entities often shift their personal assets to limited liability companies or other related parties.

The operation of limited liability in corporate groups was considered in the *Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation* (2004). This inquiry, conducted by David Jackson QC, investigated the circumstances surrounding the restructuring of James Hardie Industries Limited. The Report includes a Discussion Paper by John Sheahan SC, *The Concept of Limited Liability – Existing Law and Rationale* by Counsel Assisting. This Discussion Paper recommended that the *Corporations Act* should be reformed so as to restrict the application of the limited liability principle in cases of liability for damages for personal injury or death caused by a company that is part of a corporate group. The benefit of limited liability should be confined to the members of the ultimate holding company. The Discussion Paper is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## Other reasons for incorporation

**[2.40]** As noted at [2.20] business enterprises with limited liability are a feature of developed legal systems around the world. Apart from the obvious advantages of limited liability, corporate law academics have suggested that there are a number of other reasons why companies are widely used.

|                   |
|-------------------|
| Entity shielding. |
|-------------------|

Henry Hansmann and Reinier Kraakman in “The Essential Role of Organizational Law” (2000) 110 *Yale Law Journal* 387 argued that the characteristic of limited liability which shields the assets of shareholders from the creditors of their company was not as important for the growth in popularity of companies as “affirmative asset partitioning” also referred to as “entity shielding”.

Creditors are more prepared to lend large amounts of money to companies because the company’s assets are partitioned and shielded from the personal creditors of the company’s shareholders. As a company is a separate legal entity, personal creditors of shareholders do not have recourse to the assets of the company. Hansmann and Kraakman’s article may be viewed on the Social Science Research Network website which is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

|                                                 |
|-------------------------------------------------|
| Locking in shareholders’ capital contributions. |
|-------------------------------------------------|

Margaret Blair in “Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century” (2003) 51 *UCLA Law Review* 387 argued that a reason why companies became so popular from the 19th century onwards was that the law permitted the enterprise to “lock in” the capital contributions of its shareholders



and restricted them from recovering their investments from the company except in very limited circumstances.

This feature was especially important for the growth of companies that invested in long-term highly specific investments such as railways and mining. Such enterprises needed large amounts of capital to establish infrastructure and took a long time to generate revenue and profits. Locking in shareholders' capital allowed companies to enter into long-term relationships with various outside parties and to develop complex organisational structures and intellectual capital that required long-term horizons. Laws regarding the locking in of capital apply in Australia. As discussed at [8.200] onwards, the share capital transactions provisions of the *Corporations Act* restrict the situations where a company may return capital to shareholders. Margaret Blair's article may be viewed on the Social Science Research Network website which is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources>.

## The company as a separate legal entity

[2.45] The various reasons for the historical development of companies are discussed at [1.10]–[1.15]. While the *Corporations Act* sets out the various characteristics described at [2.15] it is clear that the mid-19th century companies legislation was drafted primarily to meet the needs of large-scale businesses with large numbers of investors. The last few decades of the 19th century saw a rapid increase in incorporations of small partnerships and sole traders, but it still remained unresolved whether small private enterprises with few shareholders could incorporate as companies.

*Salomon's* case established that a company is a separate legal entity even where a single person controls it.

The famous case of *Salomon v A Salomon & Co Ltd* [1897] AC 22 established that if the necessary formalities of incorporation were satisfied, a new entity comes into existence that is separate and distinct from its directors and shareholders. This is so whether the company has many shareholders or, as in *Salomon's* case, it is a company managed and controlled by one person.

### *Salomon v A Salomon & Co Ltd* [1897] AC 22

[2.50] Salomon owned a successful business that he operated as a sole trader. Several of his sons worked in the business and he wished to give them each a share. For this reason he formed a company, which was duly incorporated under the applicable English *Companies Act*. The company was at all times intended to be what would now be a proprietary company. The initial shareholders were Salomon, his wife and five of his children. Each of them took up one share. Salomon and his two eldest sons were appointed directors. The company purchased Salomon's business for £39,000, which was an excessive price. The purchase price was paid as follows: 20,000 £1 fully paid shares and debentures worth £10,000 were issued to Salomon; £1,000 was paid in cash to Salomon and £8,000 went in discharge of the debts of the business.

After these transactions were completed, Salomon held 20,001 of the 20,007 issued shares in his company. Further, there was evidence that the other shareholders held their six shares as nominees for Salomon, so that A Salomon & Co Ltd was in reality a “one-man” company.

Many years after its incorporation, the company experienced financial difficulties. To maintain the company’s business, Salomon advanced it further funds secured by a debenture over all the company’s assets. When this proved insufficient he borrowed £5,000 from a lender, Broderip, which was then on-lent to the company. As security for Broderip’s loan, Salomon granted him a mortgage over his debentures and caused them to be reissued in Broderip’s name.

Despite this infusion of funds, the business soon after failed. The company defaulted on paying the interest due on the debentures and Broderip appointed a receiver to realise the security. The company was then compulsorily wound up due to its insolvency and a liquidator was appointed.

The liquidator found that the company’s realisable assets amounted to about £6,000. This was sufficient to repay Broderip’s claim of £5,000. The remaining £1,000 was claimed by Salomon as beneficial owner of the debentures. If these claims had been met, there would have been nothing left for payment to the unsecured creditors.

The liquidator initially resisted Broderip’s demand for repayment of the £5,000 and counterclaimed against Salomon seeking to have the original sale of business contract rescinded and the debentures cancelled. The liquidator argued that Salomon, as promoter of his company, had breached his fiduciary duties by selling his business to it for an excessive price. He also maintained that the formation of the company was a fraud on its unsecured creditors.

The case eventually was decided by the House of Lords in *Salomon v A Salomon & Co Ltd* [1897] AC 22. By the time the hearing commenced, the liquidator had met Broderip’s claim, so the case against Salomon was the sole question to be determined. The House of Lords unanimously decided in Salomon’s favour and reversed the earlier decisions.

It held that a person may sell a business to a limited liability company of which the person is virtually the only shareholder and director. The company was a separate legal entity distinct from its shareholders and directors. It therefore followed that a one-person company could borrow money on a secured basis from its controlling shareholder, thereby enabling the shareholder to rank as a creditor ahead of the company’s other unsecured creditors. Lord Macnaghten stated that “the company attains maturity on its birth. There is no period of minority ... no interval of incapacity”.

## *Application of Salomon’s case*

**[2.55]** *Salomon v A Salomon & Co Ltd* [1897] AC 22 is widely regarded as a landmark case because it was not until the House of Lords handed down its decision that a “one-person”

company was fully recognised as a separate legal entity. The *Corporations Act* now allows the formation of public or proprietary companies with a single shareholder: s 114.

The principle in *Salomon's* case has been applied in many contexts so that its operation has expanded to include many situations that the House of Lords judges would not have contemplated. This is particularly so in the case of corporate groups discussed at [2.80], which were rarely used at the time *Salomon's* case was decided.

A one-person company is a separate entity from its controller who may also be its sole employee.

### *Lee v Lee's Air Farming Ltd* [1961] AC 12

**[2.60]** Lee was a pilot who conducted an aerial top-dressing business. He formed a company to conduct the business. The capital of the company comprised 3,000 £1 shares, of which 2,999 were allotted to Lee. The remaining share was taken by his solicitor as nominee for Lee. Under the articles of association, Lee was governing director with very wide powers. Workers' compensation insurance was taken out, naming Lee as an employee.

Lee was killed when his plane crashed while engaged in aerial top-dressing. His widow made a claim for payment under the *Workers' Compensation Act 1922* (NZ). Her claim was initially rejected on the ground that as Lee had full control of his company he could not be a "worker" within the meaning of that Act. "Worker" was defined under the *Workers' Compensation Act 1922* as a person "who has entered into or works under a contract of service ... with an employer".

The Privy Council rejected this argument. It held that as the company was a separate legal entity distinct from its founder, Lee, it could enter into a contract of employment with him.

**[2.65]** The recognition of a company as a separate legal entity may, in some cases, work against the person responsible for the formation of the company.

The shareholder of a one-person company does not have a legal or equitable interest in the company's property.

### *Macaura v Northern Assurance Co Ltd* [1925] AC 619

**[2.70]** Macaura owned land on which stood timber. He sold the land and timber to a company he formed and received as consideration all the fully paid shares. The company carried on the business of felling and milling timber. A fire destroyed all the timber that had been felled. Macaura had earlier insured the timber against loss by fire in his own name. He had not transferred the insurance policy to the company.

When Macaura made a claim his insurers refused to pay, arguing that he had no insurable interest in the timber. Only persons with a legal or equitable interest in property are regarded as having an insurable interest in it. The House of Lords agreed that the insurers were not liable. It was only Macaura's company, as owner of the timber, which had the requisite insurable interest in it. Only the company, and not Macaura, could insure its property against loss or damage.

Shareholders, the court held, have no legal or equitable interest in their company's property. This is the case whether a company has only one or many shareholders.

Section 17 of the *Insurance Contracts Act 1984* (Cth) dispenses with the common law requirement of "insurable interest" and now overcomes the decision in *Macaura's* case. This provides that where an insured, under a general insurance contract, suffers a pecuniary or economic loss by reason of damage to or destruction of the insured property, the insurer is not relieved of liability just because the insured did not have a legal or equitable interest in the property.

This provision, however, raises the question whether a shareholder suffers a pecuniary or economic loss if the company's property is damaged. Most probably a shareholder in Macaura's position, holding all the shares in a company, would have a strong case for compensation by the insurer. The loss would arise by reason of the decline in the value of the shares because of the damage or destruction of the company's property. It is less clear whether there would be a quantifiable loss for the purposes of s 17 in the case of an insured who is a minority shareholder in respect of damage to property of the company, particularly where the property represents a relatively small proportion of the company's assets.

Can the shareholder of a one-shareholder company steal from the company?

**[2.75]** One consequence arising from the conclusion that shareholders have no legal or equitable interest in company property is that it is theoretically possible for a shareholder to be found guilty of stealing company property. This is the case even in one-person companies. In *MacLeod v The Queen* (2003) 214 CLR 230, the High Court held that a person who was the sole director and shareholder of a company could be convicted under s 173 of the *Crimes Act 1914* (Cth) of fraudulently applying property owned by the company for his own use. This type of situation usually arises where the company is insolvent or in financial difficulties and the conduct of the sole director and shareholder in reducing the value of the company's assets is detrimental to creditors. According to the High Court:

The self-interested "consent" of the shareholder, given in furtherance of a crime against the company, cannot be said to represent the consent of the company.

### *Salomon's principle and corporate groups*

**[2.80]** An important use of companies is the common practice of large listed companies establishing group structures that involve a large number of subsidiaries. Generally, the

larger the listed company, the more companies it tends to control in a group. In some cases a corporate group may comprise well over 100 controlled entities. In the majority of cases, subsidiaries of listed companies are wholly owned.

Purposes of corporate groups.

CASAC's *Corporate Groups Final Report* (May 2000) gave several reasons why corporate groups exist. These include:

- Reducing risk or maximising returns by diversifying an enterprise's activities into various businesses, each of which is operated by a separate group company.
- Acquiring existing companies to expand an enterprise or increase market power. The acquired companies may possess recognised brands or goodwill. It is often more advantageous to acquire a company as a going concern than to acquire its assets.
- Equity may be attracted into part of a company's overall business by establishing a partly owned subsidiary with a minority shareholder.
- High-risk liabilities may be confined to particular subsidiaries and remaining group assets are thereby isolated from potential risk.
- Better security may be required by a lender through a transfer of some group assets to a particular company and conferring a charge over those assets.

The CASAC report noted that large enterprises often operate through a corporate group structure and considered whether the law based on the principle in *Salomon's* case properly regulates such groups.

CASAC's *Corporate Groups Final Report* is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

Companies in a group are treated as separate legal entities even though they are part of a group.

The application of the principle in *Salomon's* case to corporate groups means that each company in a group is regarded as a separate legal entity distinct from other companies in the group. As a result of this, creditors of a company in a group can enforce their rights only against the debtor company. Shareholders of each company in the group have limited liability and therefore cannot be held liable for the debts of a company of which they are shareholders. Directors owe duties only to the particular companies of which they are directors and not to the group as a whole.

The application of *Salomon's* principle to corporate groups may in some cases lead to legal outcomes which are contrary to commercial practice norms and community expectations because parent companies have considerable scope to establish the boundaries of the group structure and allocate resources within the group and are invariably able to give directions to other companies in the group. Despite this usual high degree of control, the controlling company or other companies in the group will generally not be liable for the debts of another group company. This creates a particular

problem where assets are moved between companies and the unsecured creditors of one company cannot claim assets which have been transferred to another company in the group. As discussed at [2.190]–[2.270], in order to alleviate some of these difficulties, the corporate veil may, in some cases, be lifted so that the parent company may sometimes be liable for the debts of a subsidiary but this is the exception rather than the rule.

The following cases provide instances of situations where the court applied *Salomon's* principle to treat each company as a separate legal entity distinct from other group or associated companies.

Directors of a company that is a member of a group cannot act in the best interests of the group and disregard the interests of that company's shareholders and creditors.

*Walker v Wimborne* (1976) 137 CLR 1

**[2.85]** The High Court had to consider the liability of directors of several associated companies. The directors had moved funds between the companies to enable various debts to be paid and used assets of one company as security for loans obtained by others. The companies went into liquidation and the liquidator brought an action under the predecessor of s 598 (discussed at [32.460]) on the grounds that the directors had been guilty of fraud, negligence, default, breach of trust or breach of duty in relation to a corporation and the corporation had thereby suffered loss.

Mason J rejected the argument that where companies were associated in a group, directors could disregard their duties to individual companies in the group provided their actions were undertaken for the benefit of the group as a whole. He said:

The creditor of a company, whether it be a member of a “group” of companies in the accepted sense of that term or not, must look to that company for payment. His interests may be prejudiced by the movement of funds between companies in the event that the companies become insolvent.

In this case Mason J refused to recognise the group as a single entity and, for the purpose of determining the liability of directors, held that each company was a separate legal entity to each of which directors' duties were owed.

**[2.90]** In *Walker v Wimborne* (1976) 137 CLR 1, the companies could be described as “associated” companies rather than as a “group” of companies in the usual sense because there were no common or interlocking shareholdings. The association existed because each company had the same directors who administered the companies as an integrated group. They were not, however, related bodies corporate as defined in ss 46–50 (see [3.130]–[3.170]) because the companies did not hold shares in each other.

A holding company cannot declare a dividend from profits of a subsidiary.

*Industrial Equity Ltd v Blackburn* (1977) 137 CLR 567

**[2.95]** The consolidated accounts of a group of companies of which Industrial Equity was the holding company disclosed sufficient profits from which a dividend could be paid. These profits were actually made by the subsidiaries. Industrial Equity asserted that it could pay dividends to its own shareholders from the profits made by its subsidiaries notwithstanding that the subsidiaries had not paid dividends to the holding company. The High Court rejected this approach. It regarded each company within the group as a separate legal entity. A subsidiary's profits could not be regarded as the profits of its holding company available for payment of the holding company's dividend. The High Court held that merely because the group accounting requirements treated the group as a single entity to ensure that sufficient information of the group's financial position was provided, this did not mean that the corporate veil could be lifted for other purposes such as payment of a dividend.

Holding company and subsidiary are separate contracting parties.

*Pioneer Concrete Services Ltd v Yelnah Pty Ltd* (1987) 5 ACLC 467

**[2.100]** A complex marketing agreement between three independent parties involved the manufacture and supply of readymix concrete. One of the parties was a subsidiary company. Under the agreement, the subsidiary company gave an undertaking that it would always act in the best interests of the other companies associated in the business, nor would it increase its interest in the venture. One of the parties claimed that the holding company of the subsidiary breached the agreement. The court held that the holding company was not a party to this clause of the agreement. Rather, it was an undertaking given by its subsidiary, and the two were separate legal entities. It was impossible to infer an agency relationship between the holding and subsidiary companies in the circumstances.

Residency of holding company and subsidiary.

*Adams v Cape Industries plc* [1990] 1 Ch 433

**[2.103]** This case involved an attempt by Cape Industries plc (Cape), a UK company, to avoid liability to US-resident asbestos tort claimants who were awarded damages by a US court against Cape and its wholly owned US subsidiary NAAC. Proceedings



were commenced in the UK to enforce the US judgment. The main issue revolved around whether Cape was a US resident at the time of commencement of the action. To be a US resident, Cape was required to possess a place of business in the US or to carry on business through an agent who had power to conduct business on its behalf. Asbestos was marketed by NAAC until 1978 when it was put in liquidation. This raised the argument that Cape was a resident of the US through the activities of its subsidiary NAAC. Cape put NAAC in liquidation for the major reason that it wished to prevent US jurisdiction over it through its subsidiary's US business. Cape soon established another subsidiary in which it held no shares to conduct the marketing of its asbestos.

The Court of Appeal refused to consider the companies within the Cape group as a single economic unit or to lift the corporate veil despite the high degree of control exercised by the parent company over the US subsidiary. The court drew a distinction between situations where a parent company itself carried on business in a foreign country and the case where it traded in a foreign country through a subsidiary over which it exercised full control. In the latter case, the parent company was not a resident of the foreign country so as to be subject to the jurisdiction of the courts where the subsidiary carried on business. It was held that the economic inter-relationship of the companies did not justify piercing the corporate veil and departing from the *Salomon* principle. The corporate veil could be lifted where the subsidiary was a "façade", however, the Court of Appeal was not prepared to come to this conclusion in this case.

The *Cape* case involved the application of the principle in *Salomon's* case to corporate groups with the effect of defeating the claims of tort creditors. Such cases raise a number of economic, social and ethical issues which have led to the law in this area being questioned by judges and commentators. This is discussed further at [2.240]–[2.270].

**[2.104]** The courts may regard a company and its subsidiaries as separate legal entities in a wide range of other circumstances. For example, in *Australian Competition and Consumer Commission v Prysmian Cavi e Sistemi SRL (No 11)* [2015] FCA 876, the ACCC brought proceedings against a parent company to discover documents held by one of its subsidiaries. It was held that the companies were separate legal entities so the parent company did not necessarily have control over documents held by its subsidiaries even though they may have occupied the same premises and a senior officer of the parent company had access to inspect the documents of the subsidiary.

**[2.105]** The Understanding Company Law website at <http://www.uclaw.com.au/resources/> contains links to the CASAC's *Corporate Groups Final Report* (May 2000), an article by Phillip Lipton, "The Mythology of Salomon's Case and the Law Dealing with the Tort Liabilities of Corporate Groups: An Historical Perspective" (2014) 40 Mon ULR 452, and the Discussion Paper (Annexure T) appended to the *Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation* that discusses the application of the principle in *Salomon's* case to corporate groups.



## Piercing the veil of incorporation

**[2.110]** The principle that a company is a separate legal entity is often conceptualised as the drawing of a “veil of incorporation” or “corporate veil” between the company and its shareholders. This is because, once a company is formed, the courts usually do not look behind the “veil” to inquire into why the company was formed or who really controls it. Further, when the separate entity concept is coupled with limited liability, the corporate veil ensures that shareholders are not personally liable to the company’s creditors for their debts. In the case of a company limited by shares, their liability is limited to the amount, if any, unpaid on the nominal value of their shares: s 516.

The recognition that a company is a separate legal entity is often referred to as the “veil of incorporation” or “corporate veil”.

The decision in *Salomon v A Salomon & Co Ltd* [1897] AC 22 has enabled the application of the concepts of the company as a separate entity and limited liability to occasionally result in the misuse of companies as shams and façades for dishonest purposes. Piercing or lifting the corporate veil allows the separate legal personality of the company to be disregarded in narrowly defined circumstances. There are various statutory provisions that have the effect of piercing or looking behind the corporate veil. In addition, the courts have developed principles that sometimes enable the corporate veil to be pierced.

### *By statute*

#### **Directors’ liability for insolvent trading**

**[2.115]** In some circumstances, directors may become personally liable for debts incurred by their company. This liability arises where directors breach the duty contained in s 588G by failing to prevent the company incurring debts when there are reasonable grounds for suspecting that it is insolvent. This is known as “insolvent trading”.

Directors who breach this duty are liable to pay as compensation an amount equal to the loss or damage suffered by unsecured creditors in relation to the debts so incurred because of the company’s insolvency: ss 588J, 588K and 588M. Generally, the compensation is payable to the company’s liquidator who distributes it to the company’s unsecured creditors. As well as a liability to pay compensation, contravention of s 588G may also result in the imposition of a civil penalty order pursuant to Pt 9.4B. Directors may also commit a criminal offence under s 588G(3) if their failure to prevent the company incurring the debt was dishonest. The liability for failing to prevent insolvent trading is discussed at [18.100]–[18.245].

A director of a corporate trustee may be personally liable for the debts of the trustee where its right of indemnity as trustee was lost in specified circumstances: s 197(1). This is discussed at [3.200].

## Uncommercial transactions

[2.120] In some cases, the *Corporations Act* pierces the corporate veil for purposes of treating corporate insiders such as directors and other related entities of the company differently from others who have dealings with the company. The aim of these provisions is to ensure that such insiders do not obtain preferential treatment from the company at the expense of the company's external creditors.

For example, s 588FB is specifically aimed at preventing insolvent companies from disposing of assets prior to liquidation through uncommercial transactions that result in the recipient receiving a gift or obtaining a bargain of such magnitude that it could not be explained by normal commercial practice. The company's liquidator can set aside any uncommercial transaction entered into within two years of the commencement of winding up: s 588FE(3). If the recipient of an uncommercial transaction is a director or related entity of the company, the liquidator can avoid uncommercial transactions entered into within four years of the commencement of winding up. Uncommercial transactions are discussed at [32.520].

## Security interests granted to officers

[2.125] Section 588FP disregards the corporate veil in certain circumstances where officers lend money to their company secured by a security interest over its property. Under s 588FP(1) a security interest granted by a company is void if the secured party is an officer, a former officer or a person associated with an officer or former officer and the secured party purports to take a step to enforce the security interest within six months after it is made without the permission of the court. Under s 588FP(3) a secured party is regarded as taking a step to enforce a security interest if the secured party:

- appoints a receiver or receiver and manager;
- enters possession or assumes control of the company's property for the purposes of enforcing the security interest; or
- seizes the property for purposes of enforcing the security interest.

The court may permit the security interest to be enforced if it is satisfied that the company was solvent at the time the security interest was granted and it is just and equitable for the court to do so: s 588FP(4). Security interests granted by a company are discussed at [11.215]–[11.250].

## Financial assistance

[2.130] In some situations the veil is pierced to render officers liable for civil penalties if they were involved in their company's contraventions of the *Corporations Act*. Where a company provides financial assistance for the acquisition of its own shares in contravention of s 260A, any person involved in the contravention breaches the section and may be liable under the civil penalty provisions. The company is not guilty of an offence: s 260D. Financial assistance is discussed at [8.325]–[8.375].

## Taxation legislation

[2.135] There are also other statutes, particularly revenue legislation, which provide for lifting of the corporate veil. For example, the *Income Tax Assessment Act 1997* (Cth)

provides that directors may be liable to pay the company's unremitted PAYG tax instalments and other similar liabilities. They will be liable if, after receiving notice, they have not caused the company to pay the PAYG tax instalments owing or initiated an insolvency administration. This is discussed at [18.135].

### *At common law*

**[2.140]** In the absence of specific legislation, Australian courts, like their UK counterparts, have, generally, been reluctant to disregard the principle in *Salomon's* case and pierce the corporate veil. They have done so only in relatively rare situations to prevent the misuse of the corporate legal personality of a company where it is used as a façade or sham to evade the law or to frustrate its enforcement. Lord Sumption in the UK Supreme Court case *Prest v Petrodel Resources Ltd* [2013] UKSC 34 stated that a company could be used as a façade or sham in two types of situations:

... the court may disregard the corporate veil if there is a legal right against the person in control of it which exists independently of the company's involvement, and a company is interposed so that the separate legal personality of the company will defeat the right or frustrate its enforcement.

Lord Sumption described this as the “evasion principle” which involved piercing the corporate veil and which he distinguished from the “concealment principle” which arises where a company is interposed so as to conceal the identities of the persons behind the company. In these cases the court is not disregarding the façade, but only looking behind the company to discover the facts that the corporate structure is concealing.

### **Fraud**

The courts have lifted the corporate veil where a company is used as a vehicle for fraud.

#### *Re Darby* [1911] 1 KB 95

**[2.150]** Darby and Gyde formed a company of which they were sole directors and, together with five nominees, were the shareholders. The company purchased a licence to work a quarry and then floated another company, Welsh Slate Quarries Ltd, for the purpose of purchasing the licence at a substantial overvalue. The new company issued a prospectus and issued shares to the public. With the money thus obtained, Welsh Slate Quarries Ltd paid the company formed by Darby and Gyde for the licence. The profits were then divided between Darby and Gyde. Welsh Slate Quarries Ltd then failed and the liquidator claimed in the bankruptcy of Darby for the secret profit made by him. This claim was on the basis that Darby was in breach of his duty as a promoter of Welsh Slate Quarries Ltd. The duties of promoters are discussed in Chapter 6.

It was argued that the profit was made by the company formed by Darby and Gyde and not by Darby himself. This argument was rejected and Darby was ordered to disgorge his profit because the company he set up was a “dummy company”

formed for the purpose of enabling him to perpetrate a fraud. Thus the court looked behind the façade of the legal entity.

### Avoidance of legal obligations

[2.155] The courts will also pierce the corporate veil if a company has been used as a sham to avoid a legal obligation under contract or statute.

#### *Gilford Motor Co Ltd v Horne* [1933] Ch 935

[2.160] Horne was appointed managing director of Gilford Motor Co Ltd for a term of six years. The service agreement provided he was not to solicit or entice away from the company any of its customers during his appointment or after termination of his appointment. Some three years later, Horne resigned and started his own business in competition with the company. He then sent circulars to customers of the company seeking their business. Horne formed a company to conduct this business, the shareholders being his wife and an associate. Gilford Motor Co Ltd brought an action seeking to restrain Horne and the company he formed from soliciting their customers. The action was successful and an injunction was granted against both Horne and the company, even though the company was not a party to the contract with the plaintiff. Lord Hansworth MR considered that the company was a “mere cloak or sham” used as a device for enabling contractual obligations to be avoided.

#### *Jones v Lipman* [1962] 1 WLR 832

[2.165] Lipman was a vendor of land who entered into a contract for the sale of the land to Jones. Lipman then sought to avoid the contract by forming a company in which he and a nominee were the only directors and shareholders and selling the land to the company at undervalue in order to defeat Jones’ right to seek an order for specific performance of the contract. It was held that the company formed by Lipman was a façade and Jones succeeded in obtaining an order for specific performance against both Lipman and the company because Lipman had absolute ownership and control of the company which was “a device and a sham”.

[2.170] Directors owe a duty not to prejudice the interests of their company’s creditors where the company is insolvent or in financial difficulties. Where directors seek to avoid the company’s legal obligations to its creditors, they may breach their duties to the company: *Jeffree v NCSC* [1990] WAR 183. This is discussed at [18.10]–[18.95].

The High Court in *Ascot Investments Pty Ltd v Harper* (1981) 148 CLR 337 held that even if a company was not formed for the purpose of avoiding a legal obligation, it may lift the corporate veil if the company was used as a mere puppet of its controller.

## Involvement in directors' breach of duty

[2.175] The courts will also lift the corporate veil if a company knowingly participates in a director's breach of fiduciary duties.

*Green v Bestobell Industries Pty Ltd* [1982] WAR 1

[2.180] Green, the Victorian manager of Bestobell Industries, became aware that Bestobell was preparing a tender for certain construction works. Without Bestobell's knowledge or consent, Green incorporated his own company, Clara Pty Ltd, and caused it to submit its own tender for the work. Clara's tender was successful and it was awarded the contract. When Bestobell discovered this it brought proceedings against both Green and Clara.

It was held that Green, in tendering for the same project, had breached his fiduciary duty to Bestobell by placing himself in a position where his duty to it conflicted with his own interests. Further, because Clara knowingly and for its own benefit participated in Green's breach of duty, it was ordered to account to Bestobell Industries for the profit it derived. The distinction between a company and its director was disregarded and the corporate veil lifted.

## Attributing mind and will of company

[2.185] In some circumstances it is necessary to determine the mind and will or the purpose or intention of a company. Where this is the case, the courts will look behind the company itself and attribute the purpose or intention of individuals to the company itself. However, this attribution is only made in respect of the persons who are regarded as the "directing mind and will" of a company rather than as mere employees: *Tesco Supermarkets Ltd v Natrass* [1972] AC 153. This is discussed at [5.10]–[5.80].

## Lifting the corporate veil of group companies

[2.190] As discussed in [2.80]–[2.105], the principle in *Salomon's* case applies in respect of companies associated as a group where, to all outward appearances, they appear to operate as a single entity. The UK and Australian courts have been reluctant to depart from the separate entity principle where there is no legislation requiring them to do so. Slade LJ expressed this approach in the UK case *Adams v Cape Industries plc* [1990] 1 Ch 433:

... the court is not free to disregard the principle of *Salomon v A Salomon & Co Ltd* [1897] AC 22 merely because it considers that justice so requires. Our law, for better or worse, recognises the creation of subsidiary companies, which though in one sense the creatures of their parent companies, will nevertheless under the general law fall to be treated as separate legal entities with all the rights and liabilities that would normally attach to separate legal entities.

However, in several situations the *Corporations Act* or other legislation and the courts look behind the corporate veil and treat a group of companies as a single economic entity.

## *Holding company's liability for insolvent trading by subsidiary*

**[2.195]** Where companies operate as a group, the *Salomon* principle of separate personality prevents creditors of an insolvent company from gaining access to the funds of the other companies in the group for payment of their debts. The *Salomon* principle may be inappropriate where the business activity of a subsidiary has been directed or controlled by the holding company.

A holding company may be personally liable to the liquidator of its subsidiary if it fails to prevent the subsidiary incurring debts while insolvent.

Sections 588V–588X lift the corporate veil of subsidiary companies in certain circumstances by making holding companies liable for the debts incurred by their insolvent subsidiaries.

Under these provisions, if a holding company fails to prevent one of its subsidiaries from incurring a debt while there were reasonable grounds to suspect that the subsidiary was insolvent, the subsidiary's liquidator may recover from the holding company amounts equal to the amount of loss or damage suffered by the subsidiary's unsecured creditors. In order for the corporate veil to be lifted under these sections, the subsidiary must have incurred a debt prior to going into liquidation. A debt is incurred when a company "so acts to expose itself contractually to an obligation to make a future payment of a sum of money as a debt": *Hawkins v Bank of China* (1992) 26 NSWLR 562. A company also incurs a debt when a company exposes itself to an obligation to pay taxes: *Powell v Fryer* [2001] SASC 59. The term "incurs a debt" is discussed at [18.110] in the context of directors' personal liability for insolvent trading.

## *Consolidated financial statements*

**[2.200]** The financial statements, and in particular the entity-reporting requirements of the accounting standards, provide another instance where the *Corporations Act* disregards the corporate veil and treats all company members of a group as a single entity for the purpose of providing more meaningful information to investors and the market. As discussed at [22.95], s 296 requires a company's annual financial statement to comply with accounting standards. Under AASB 10 *Consolidated Financial Statements*, a company that is a parent and is a reporting entity must prepare consolidated financial statements in which it consolidates its investments in its subsidiaries in accordance with the standard. In this respect the *Corporations Act* and the accounting standards do not treat each entity in a group as separate but recognise the reality that the entities in a group function as one economic entity.

## *Taxation consolidation*

**[2.205]** Corporate groups headed or controlled by an Australian company may elect to lodge a single consolidated tax return for the entire group. This enables intra-group transactions to be ignored and permits pooling of losses and franking credits. In the same way as consolidated financial statements, this taxation regime allows a parent company to lift the corporate veil and treat the corporate group as a single taxpayer.

## *The benefit of the group as a whole*

**[2.210]** Because corporate groups are usually conducted as integrated enterprises with inter-company loans and cross-guarantees, the fortunes of individual companies will be closely tied to the other companies in the group. If one company becomes insolvent, this may lead to the insolvency of some or all other companies in the group. This commercial reality has implications for whether directors have breached their fiduciary duties where they act on the basis that the corporate group is a single entity.

*Equiticorp Finance Ltd (in liq) v Bank of New Zealand* (1993) 32 NSWLR 50

**[2.215]** The New South Wales Court of Appeal agreed with the *Walker v Wimborne* principle (see [2.85]) that directors of associated companies owe separate duties to act in the best interests of each company. However, it recognised that in some circumstances a transaction that is entered into for the benefit of one or more companies in the group can have derivative benefits for other companies in the group.

A bank loan to one company was repaid after funds were transferred from other companies in the group. Upon liquidation of the Equiticorp group, the liquidator of the transferring companies sought to recover the funds from the bank. It was claimed by the liquidator that the transfer of funds involved a breach of fiduciary duty by the directors to act in the best interests of the companies which transferred funds. The New South Wales Court of Appeal held that there was no breach of duty because, while the transaction benefited the group as a whole, it also indirectly benefited the transferring companies. Had the transactions not taken place, the companies would have lost the bank's support for their own funding arrangements.

This case took a different approach to that adopted in *Walker v Wimborne* (1976) 137 CLR 1, discussed at [2.85]. These cases show the difficulties in balancing the interrelated interests of a particular member of a corporate group and the group as a whole in an insolvency context.

## *Pooling in liquidation*

**[2.220]** The liquidation of an insolvent company that is part of a corporate group can raise complex issues where other companies in the group are also in liquidation and their financial affairs have been intermingled prior to their liquidations.

Sections 571–579Q provide for a statutory “pooling” mechanism to facilitate the external administration of corporate groups in liquidation. Initiating the pooling mechanism in a liquidation requires the consent of unsecured creditors, excluding creditors who are members of the group, or by order of the court.

Where companies in a corporate group go into liquidation, the pooling mechanism enables the group to be treated as a single entity so each company in the group is taken to be jointly and severally liable for the debts of other companies in the group. Debts between corporate group companies are extinguished.

Pooling is discussed at [32.620].



## *Subsidiaries as agents or partners*

**[2.225]** In some cases the courts have disregarded the corporate veil if a subsidiary has acted as an agent for its holding company. Such a finding enables a subsidiary's assets to be regarded as being owned by its parent company or for a parent company to be held liable for the acts of its subsidiary. The principle in *Salomon's* case held that a company is not an agent or trustee of its shareholders and the courts have rarely been prepared to imply an agency relationship, even though holding companies almost invariably control the actions of a subsidiary, appoint its directors and subsidiaries are generally established to carry out the holding company's purposes. It is unclear as to when the circumstances exist to warrant the implication of agency. The corporate veil between a parent company and its subsidiary may also be lifted if the circumstances of their relationship gives rise to a partnership, provided that they carry on business as tenants in common with a view to profit. Under partnership law one partner is jointly and severally liable for the debts and liabilities of co-partners.

The existence of agency or partnership are not true instances of piercing the corporate veil. Even though the existence of an agency or partnership relationship has a similar effect to piercing the corporate veil and regarding a parent company as the owner of a subsidiary's assets or liable for its acts, it does not involve an exception to the separate legal entity principle because the parent and subsidiary are still treated as separate legal entities. Rather, the subsidiary is regarded as acting as an agent for, or partner of, the parent company after the court has looked behind the corporate veil to ascertain the nature of the relationship between the parent company and its subsidiary.

The corporate veil may be lifted where a subsidiary is an agent for its holding company.

In the context of corporate groups, an agency relationship has arisen where a parent company has exercised such a degree of control over a subsidiary that the subsidiary was held to be an agent of the parent company and its acts deemed to be the acts of the parent company. The required degree of control that justifies a finding that a subsidiary was an agent for its parent company usually arises where the subsidiary lacks sufficient resources to act as an independent entity. The subsidiary in such cases has been described as the “alter ego” of the parent company.

*Smith, Stone & Knight Ltd v Birmingham Corporation* [1939] 4 All ER 116

**[2.230]** The Birmingham Corporation, a local government authority, sought to compulsorily acquire some land owned by Smith, Stone & Knight Ltd. To all outward appearances the land was occupied by, and the business conducted on it was operated by, Birmingham Waste Co Ltd, a wholly owned subsidiary of Smith, Stone & Knight. The Birmingham Corporation refused a compensation claim for disturbance of business because the subsidiary's tenancy of the land from its parent company was for less than a year and hence under the relevant legislation it was not entitled to compensation. Smith, Stone & Knight asserted that it in fact conducted the business on the land and was therefore entitled to compensation for



the disturbance caused by the compulsory acquisition. It argued that the subsidiary conducted the business as agent for the holding company. This agency argument was upheld by the court because of the special circumstances that existed.

Atkinson J was careful to point out that the existence of an agency relationship was not always present between holding and subsidiary companies. He held that the following six requirements must be established before the *Salomon* principle could be disregarded to support a finding that a subsidiary carried on a business as agent for its holding company:

- the profits of the subsidiary must be treated as the profits of the holding company;
- the persons conducting the business must be appointed by the holding company;
- the holding company must be the head and brain of the trading venture;
- the holding company must govern the venture and decide what should be done and what capital should be embarked on it;
- the profits of the business must be made by the holding company's skill and direction; and
- the holding company must be in effectual and constant control.

**[2.235]** The construction of an agency relationship was adopted by Lord Denning MR in *Wallersteiner v Moir (No 2)* [1975] QB 373. He described particular entities in that case as puppets of their controller.

He controlled their every movement. Each danced to his bidding. He pulled the strings. No one else got within reach of them. Transformed into legal language, they were his agents to do as he commanded. He was the principal behind them. I am of the opinion that the court should pull aside the corporate veil and treat these concerns as being his creatures – for whose doings he should be, and is, responsible.

*Smith, Stone & Knight Ltd v Birmingham Corporation* was followed in Australia in *Spreag v Paeson Pty Ltd* (1990) 94 ALR 679 to hold a parent company liable for the misleading and deceptive statements made by its subsidiary and for breaches of implied terms of a contract by the subsidiary. After considering the six propositions formulated by Atkinson J in *Smith, Stone & Knight*, Sheppard J held that a subsidiary was carrying on business for its parent company and stood in the position of an agent acting for an undisclosed principal. As a result, the parent company was liable for the statements and breaches of contract made by its subsidiary. A further consideration that led to these conclusions was that the subsidiary was under-capitalised and had no bank account or available funds. A creditor of the subsidiary therefore had no chance of successfully recovering money owed unless the parent company agreed to fund the liability.

In *Pioneer Concrete Services Ltd v Yelnah Pty Ltd* (1987) 5 ACLC 467, the court indicated that it would be prepared to disregard the corporate veil if there was evidence that companies in a group operated in partnership. Young J did not indicate what evidence would be

sufficient to indicate a partnership between a holding company and its subsidiary. It would seem from the conclusion in the case that more is required than the mere fact that the companies operated as a group under the control of the parent company.

## *Tort liability*

**[2.240]** As discussed in [2.80], the application of *Salomon's* principle to corporate groups has enabled holding companies in a number of cases, to avoid liability to tort creditors of subsidiary companies because the holding company was held to be a separate legal entity distinct from its subsidiaries and therefore not liable for the debts of its subsidiaries. Where the creditors of a subsidiary are tort creditors rather than contract creditors, this raises a number of complex economic, social and ethical questions, especially where the subsidiary is under-capitalised and cannot meet its future tort liabilities. A number of judges and commentators have expressed reservations as to whether *Salomon's* principle should be applied in such cases. There are indications that Australian courts may be increasingly prepared to look behind the veil of subsidiary companies to make a parent company liable for their subsidiaries' torts. This question has arisen in several asbestos injury cases.

### *Briggs v James Hardie & Co Pty Ltd* (1989) 7 ACLC 841

**[2.245]** Briggs suffered from asbestosis which he alleged he contracted while being employed by a subsidiary of James Hardie & Co Pty Ltd. In a negligence action against both his employer and the holding company, James Hardie & Co raised certain procedural matters including whether Briggs had a valid cause of action against it. In other words, Briggs argued that the corporate veil of the subsidiary could be lifted to make the holding company liable. The New South Wales Court of Appeal held that given the uncertainties of the law governing this point, lifting the corporate veil was a possibility and ordered that the issue should be determined at a trial of the negligence action.

Rogers AJA rejected as too simplistic the proposition that the corporate veil may be pierced where a holding company exercises complete dominion and control over a subsidiary. Nevertheless, he suggested that in deciding whether to lift the corporate veil in actions in tort, different considerations should apply from the criteria applied to actions in contract, taxation or compensation cases. He stated:

Generally speaking, a person suffering injury as a result of the tortious act of a corporation has no choice in the selection of the tortfeasor. The victim of the negligent act has no choice as to the corporation which will do him harm. In contrast, a contracting party may readily choose not to enter into a contract with a subsidiary of a wealthy parent. The contracting entity may inquire as to the amount of paid up capital and, generally speaking, as to the capacity of the other party to pay the proposed contract debt and may guard against the possibility that the subsidiary may be unable to pay ... However, whilst the employee may be able to choose whether or not to be employed by the particular employer, generally speaking, he has no real input in determining how the business will be conducted and whether reasonable care will be taken for his safety.

**[2.250]** A parent company may be held directly liable for its subsidiary's torts if the parent itself owes a duty of care to the subsidiary's employees who were injured because of the subsidiary's negligence.

This duty may arise in the absence of a direct employment relationship between the controlling company and the employee and is most likely to arise where the controlling company exercises a high degree of control over the day-to-day activities of its subsidiary out of which the tort claim arose. Under the law of negligence, this duty requires both foreseeability and a relationship of proximity between the parties with respect to both the relevant class of act or omission and the relevant kind of damage.

*CSR Ltd v Wren* (1997) 44 NSWLR 463

**[2.255]** The court held that where a parent company directed or controlled its subsidiary's operations and provided the subsidiary's management, the parent company owed a duty of care to the subsidiary's employees. CSR owed a duty directly to Wren because even though he was employed by AP, a subsidiary of CSR, all the management staff who had operational responsibility for AP's enterprise and therefore Wren's work conditions were CSR staff. CSR failed in its duty to provide a safe system and place of work.

*CSR Ltd v Young* (1998) 16 NSWCCR 56

**[2.260]** The plaintiff was born in Wittenoom and was exposed to asbestos from birth to the age of 27 months. Her father was employed by ABA, a subsidiary of CSR, as a draftsman and often returned home from work with asbestos fibres in his clothing. Tailings containing asbestos fibres were spread in areas in which children played. The plaintiff contracted malignant mesothelioma at 34 years of age and died soon after.

The court held that for the purposes of liability, CSR was in the same position as ABA, as CSR conducted the overall operations at Wittenoom. CSR owed a duty of care to the people living in the town which was co-extensive with that owed by ABA as an employer. The degree of control of the controlling company over the activities of the subsidiary was sufficiently strong so that the controlling company itself effectively conducted those activities and the subsidiary was merely a conduit or facade.

*James Hardie & Co Pty Ltd v Hall* (1998) 43 NSWLR 554

**[2.265]** The New South Wales Court of Appeal in this case was not inclined to find a holding company liable for the torts of a subsidiary. The plaintiff was a New Zealand resident who contracted mesothelioma as a result of exposure to asbestos dust at the premises of his employer, a New Zealand subsidiary of James Hardie. The action was brought in New South Wales against New South Wales-registered companies

which supplied and exported asbestos to the plaintiff's employer because common law actions seeking damages were barred in New Zealand. The New South Wales Court of Appeal had to determine whether the tort was committed in New South Wales or New Zealand and whether the holding company owed a duty of care to the plaintiff, who was employed by the New Zealand subsidiary.

The Court of Appeal held that the holding company was not responsible for workplace safety at the New Zealand plant. All that could be said was that the holding company was able to insist that proper workplace standards were maintained. This did not amount to a duty owed to the plaintiff when the holding company neither occupied the New Zealand premises nor employed those responsible for workplace safety.

**[2.270]** In Chapter 4 of its *Corporate Groups Final Report* (May 2000), CASAC rejected the idea of making a parent company automatically liable for the torts of the companies in its group. It was of the opinion that the imposition of additional tort liability on parent companies of corporate groups should be left to specific statutes and general common law principles. CASAC's *Corporate Groups Final Report* is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

The deep concerns raised by the events surrounding James Hardie's restructuring and the payment of compensation to asbestos victims led to the establishment by the New South Wales government in 2004 of a Special Commission of Inquiry. John Sheahan SC, Senior Counsel Assisting the Commission, recommended "reform of the *Corporations Act* so as to restrict the application of the limited liability principle as regards liability for damages for personal injury or death caused by a company that is part of a corporate group, confining the benefit of limited liability to members of the ultimate holding company". This submission is appended to the *Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation* (2004) in a Discussion Paper Annexure T *The Concept of Limited Liability – Existing Law and Rationale*. The full Report and Discussion Paper is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## A company compared with a partnership and a trust

### *Nature of the organisation*

**[2.285]** Upon registration of a company an artificial legal entity is created that is separate and distinct from its members (usually shareholders). Section 114 allows a company to be formed with one or more members. The *Corporations Act* does not require a company (other than a no liability company) to be formed for any specific purpose, including profit making. Its purpose or objects may be specified in its constitution if it chooses to have one.

A partnership, on the other hand, is defined as an association of two or more legal persons (they may be companies) carrying on business in common with a view of profit. This means that associations such as sports clubs and charitable organisations, for example, cannot be partnerships, as they generally do not carry on a business with

the purpose of profit for their members. The relationship among partners is governed by the various State Partnership Acts and any partnership agreement and is based on contractual and fiduciary principles.

A trust is the relationship between a trustee and beneficiaries in respect of trust property. It commonly involves three parties: the settlor, the trustee and the beneficiaries. A trust arises when the settlor, the creator of the trust, gives property to the trustee to hold or invest on behalf of the beneficiaries. The trustee is said to own the legal interest in the trust property and the beneficiaries own the equitable interest. The trustee's obligations are governed by rules of equity and are referred to as "fiduciary obligations". This means that a trustee is under a duty to act *bona fide* (that is, in good faith) when dealing with trust property and the beneficiaries. This is similar to the duties owed by directors to their companies, which is discussed in Chapters 13 and 15–18.

### *Separate legal identity*

**[2.290]** We have seen that, in the case of a company, registration creates a separate legal person distinct from its shareholders. The company's property is owned by it and not by its shareholders. Further, the company's shareholders are generally not responsible for the debts of the company. A shareholder of a company may also be a creditor of the company.

A partnership, on the other hand, is not a legal entity separate from its members, the partners. This is so, even though the State Partnership Acts refer to partners collectively as a "firm". Each partner has an interest in the assets of the partnership.

A trust, too, is not an entity recognised as separate and distinct from its constituents. It cannot sue or be sued in its own name. The trustee holds the legal title to trust property on behalf of beneficiaries who hold the equitable interest. For example, parents frequently open bank accounts for their infant children. The parents act as trustees and the account is in their names. The children, however, are the persons who are ultimately entitled to the money in the account.

### *Liability of members*

**[2.295]** The liability of members of a company depends on the type of company. Section 112 allows the formation of four different types of companies according to the liability of their members:

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

These are discussed at [3.10]–[3.35]. By far the most common type of company is a company limited by shares. The liability of shareholders in this type of company is limited to the amount, if any, unpaid on their shares.

In the case of a partnership, since it is not an entity separate from the partners, each of the partners is personally liable to outside creditors to the full extent of the partnership debt. Further, each partner is an agent of all the others and in most cases the act of a

partner binds the other partners, thereby making them all personally liable to the full extent of their assets. Partners cannot limit their liability to creditors of the partnership and are only entitled to a return from the partnership once all outside creditors are paid in full. In most Australian States partnership legislation permits the formation of limited partnerships where the liability of inactive partners is limited, with unlimited liability imposed only on the active partners.

In the case of a trust, two separate issues must be considered in determining liability to outside creditors; first, the trustee's liability and secondly, the liability of the beneficiaries. The trustee is personally liable in respect of all the costs and expenses involved in administering the trust. Trust creditors are entitled to look to the trustee for payment of their debts. The trustee has unlimited liability. Provided the trustee has not breached obligations towards the beneficiaries, the trustee is entitled to be reimbursed from trust assets in respect of any trust debts incurred. Indeed, the trustee is not required to pay trust creditors from personal assets and then seek reimbursement but can pay trust debts directly from trust assets. These rights are referred to as a "trustee's right of indemnity". If the trust assets are insufficient to satisfy the trustee's right of indemnity, the trustee can look to the beneficiaries to make up the shortfall. If they are of full age, the beneficiaries are personally liable to the trustee to the extent of their interest in the trust.

### *Enforcement of legal rights*

**[2.300]** As a general rule, the rights of a company belong to the company and so can only be enforced by the company itself. A shareholder of a company is generally not able to bring a legal action seeking to enforce rights accruing to the company. However, Pt 2F.1A (ss 236–242) permits a shareholder or an officer to bring legal proceedings on behalf of their company with prior court leave. This is discussed at [24.285]–[24.300].

A partner can bring an action enforcing rights of the partnership in the names of all the partners. This is because the relationship among partners is based on the law of agency. Difficulties that may be caused by requiring all partners to be parties to any legal action have been largely overcome by court rules which allow a partnership to sue and be sued in its firm name.

A trust, not being an entity recognised by the law as a legal person, is incapable of suing or being sued in its own name. Only the trustee on behalf of the trust has this power. Trustees who breach their fiduciary obligations can be sued by the beneficiaries. Subject to the trustee carrying out their duties in a proper way, beneficiaries cannot direct the trustee as to the way the trust should be administered.

### *Duration of existence*

**[2.305]** A company continues to exist even after the death of its shareholders. The shares of a deceased shareholder are transmitted to an incoming shareholder, but the existence of the company as a legal person is unaffected.

A partnership may exist for a fixed term or for as long as the partners wish it to continue. A partnership automatically dissolves on the retirement, death or bankruptcy of a partner. This is subject to an agreement to the contrary by the partners.

Under trust law, a trust cannot continue indefinitely. The “rule against perpetuities” limits the duration of a trust to the life of some nominated person – a life in being – plus 21 years. In some States an alternative period of 80 years can apply. Any trust that contravenes this rule is void. The only exception to the rule against perpetuities concerns trusts established for charitable purposes, which may continue forever. The death of a beneficiary does not affect the existence of the trust. The precise nature of a beneficiary’s interest in a trust determines whether that interest passes in the deceased beneficiary’s estate. Often, a trustee is given power to reallocate a deceased beneficiary’s interest in the capital of the trust to surviving beneficiaries. The death of the trustee, however, does affect the trust. A new trustee must be appointed. If the trustee does not appoint a successor, their executor or the beneficiaries or the courts can nominate a successor. Such difficulties are overcome in practice by the appointment of a company as trustee because, as noted above, a company does not end on the death of its members.

### *Transfer of interest*

**[2.310]** Registration of a company allows its shareholders to freely transfer their shares subject to the company’s constitution. When shares are transferred, the transferor is replaced by the incoming transferee in relation to the shares transferred. A company may impose restrictions on the transfer of its shares in its constitution and, in the case of a proprietary company, s 1072G provides for a replaceable rule that directors may refuse to register a transfer of shares in the company for any reason. In the absence of a restriction on the transfer of shares in its constitution, or applicable replaceable rules, there is a presumption that shares are transferable free from any restrictions.

In a partnership, a partner can assign their share in the partnership but generally the consent of all other partners is necessary. Retiring partners remain liable for debts of the partnership incurred while they were partners unless the creditors agree to release them.

Similarly, beneficiaries may assign their interest in a trust. The extent of their interest depends on what has been granted to them by the settlor – the person who created the trust.

### *Formalities and expense*

**[2.315]** Registration requires the lodgment of an application for registration, with attendant expense. During the life of a company there are certain formalities related to the keeping of financial records, financial statements, registers and minutes that must be complied with. In some cases, it may be necessary to appoint an auditor, which involves further expense. These expenses are greater for public companies than proprietary companies because they have more compliance requirements. Winding up is generally a costly procedure, especially if the company is insolvent.

A partnership does not require any formality in its formation. It can even be formed by verbal agreement, although a written partnership agreement is usually drawn up to clearly set out the relationship among the partners. The dissolution of a partnership is also an inexpensive and informal procedure in most cases.

Generally, a trust does not require any formality in formation. However, some types of trusts, such as trusts creating interests in land, do have to be evidenced in writing to



be enforceable. The procedure for winding up a trust is usually set out in the document creating the trust – the trust deed. If the trust is not wound up, it nevertheless comes to an end at the expiration of the perpetuity period. The legal interest in the capital of the trust is then allocated among the beneficiaries.

## *Disclosure of financial reports*

**[2.320]** The *Corporations Act* requires public companies and large proprietary companies to prepare and send their annual financial reports and other information to shareholders and lodge copies with ASIC. This information is then available for inspection by anyone paying the appropriate ASIC search fee. A small proprietary company does not have to comply with the financial disclosure requirements unless it:

- is directed to do so by ASIC or shareholders with at least five per cent of the votes; or
- has one or more crowd-sourced funding (CSF) shareholders (see [7.210]).

Neither a partnership nor a trust need publish or disclose any financial reports. If, however, the trustee is a company, then it must disclose the extent of its right of indemnity.

## *Audit*

**[2.325]** Companies are required to appoint an independent auditor. Small proprietary companies are generally exempt from this requirement and need only appoint an auditor in certain circumstances.

Neither a partnership nor a trust need appoint an auditor unless there is specific legislation to that effect. For example, a self-managed superannuation fund, or a partnership of solicitors who conduct a trust account for their clients, must have their accounts audited.

## *Management and ownership*

**[2.330]** The policy of the *Corporations Act* is to separate management and ownership. A company must appoint directors, whose task is to manage that company. The powers of directors are set out in the company's constitution or the replaceable rule in s 198A which provides that directors may exercise all the powers of the company subject to the *Corporations Act* or any constitutional requirements. Company constitutions generally confer wide powers of management on the board.

Ownership of the company vests in its shareholders. Generally, shareholders do not have the power to participate in management of the company, although in most small companies the directors and shareholders are the same persons. In such cases, those persons will sometimes act as directors and at other times as shareholders in accordance with the *Corporations Act* and the company's constitution. Directors are usually appointed and removed by the shareholders.

Partnership law presumes that all partners take part in management of the partnership business. This is subject to the partnership agreement providing otherwise. While this presumption is realistic in the case of partnerships with relatively few partners, it would be impractical in the case of a company with thousands of members.

The management of the affairs of a trust is vested in the trustee. The beneficiaries cannot interfere unless the trustee exercises those powers improperly.



## *Limits on size*

**[2.335]** While there are no limits on the maximum number of shareholders of a public company, s 113 requires a proprietary company to have no more than 50 non-employee shareholders. Crowd-sourced funding shareholders of a proprietary company are not counted for purposes of the 50-shareholder maximum.

Partnerships generally are limited to 20 partners. Partnerships of certain professions are allowed a greater number. For example, a partnership of accountants may consist of up to 1,000 partners and a partnership of solicitors may have up to 400 partners.

A trust can have an unlimited number of beneficiaries. Indeed, the beneficiaries need not even be individually named. They may be described as a class of persons. In such cases the courts require that the class of beneficiaries be able to be identified with certainty so that it is possible to decide whether any person is or is not within the class of beneficiaries. Family trusts, for example, often describe a class of beneficiaries as the children of a named person.

## *Raising capital*

**[2.340]** A company is generally able to raise funds in much the same way as an individual, a partnership or a trust. This includes the power to borrow money. A company is also able to raise funds by the issue of shares and debentures, which is regulated by the *Corporations Act*. Public companies seeking to raise funds are required to comply with the fundraising provisions in Ch 6D. These provisions require companies that seek to raise funds by the offer of their securities to provide investors with a prospectus or other disclosure document. The fundraising rules are discussed in Chapter 7. Proprietary companies are more restricted in their ability to issue shares and debentures. These restrictions are discussed in Chapter 3. A unique feature of companies is their ability to borrow funds by issuing debentures and granting security interests over their property: s 124(1). Debentures and security interests are discussed in Chapter 11.

A partnership commences with an initial capital contribution by partners. A partnership may raise further capital by the partners contributing further capital or by borrowing.

A trust initially gains its capital by means of a gift from the settlor. Trusts may raise funds from outsiders. A recent development is the operation of management trusts which are vehicles for pooled investment that bear some commercial similarities to public companies but are legally structured as trusts.

## *Income tax*

**[2.345]** The imputation system governs the taxation of dividends. Under this system a company pays tax on its taxable income. However, if it pays dividends from profits that have been taxed (“franked dividends”), Australian resident shareholders who receive them obtain a taxation credit (“imputation credit”) for the tax paid by the company. The imputation credit may then be offset against the tax liability on a shareholder’s other sources of income. The effect of this system is to impute the tax paid by a company on its profits to shareholders who receive dividends. It means that shareholders are, to the extent of the imputation credits, not liable to pay tax on dividend income and profits are taxed only once in the hands of the company.

Partnerships are not taxed separately from their partners. A partnership return is lodged but this is for the purpose of ascertaining the share of the partnership profit or loss attributed to each partner. This share is then taken into account in determining each partner's taxable income from all sources. Limited partnerships are treated as companies for tax purposes.

A trust is also not recognised as a separate entity for income tax purposes. If a trust derives income which the trustee distributes to beneficiaries, that income is included in their assessable income. If no distribution is made, the trustee is personally liable to pay tax at the highest marginal rate.

## Company registration

**[2.350]** In Chapter 1, we referred to the fact that a key feature of the *Corporations Act* is the provision for the registration (also referred to as incorporation) of companies. There are over 3 million companies registered in Australia. Here we outline the registration procedure for new companies. We deal first with the procedure for registration and then with the immediate post-registration requirements. Companies formed under the predecessors of the current *Corporations Act* are taken to be registered under it.

The *Corporations Act* does not directly specify who must incorporate. Rather, it prohibits the formation of certain partnerships or associations unless they are incorporated. Section 115 provides that a person must not participate in the formation of a partnership or association which has as an object gain for itself or any of its members and which has more than 20 members.

The *Corporations Regulations 2001* (Cth) (*Corporations Regulations*) may permit certain partnerships or associations to be formed with more than 20 members: *Corporations Act*, s 115(2). Regulation 2A.1.01 of the *Corporations Regulations* specifies the following professional partnerships and their respective maximum memberships:

|                               |                            |
|-------------------------------|----------------------------|
| • Accountants 1,000           | • Medical practitioners 50 |
| • Legal practitioners 400     | • Patent attorneys 50      |
| • Architects 100              | • Sharebrokers 50          |
| • Pharmaceutical chemists 100 | • Stockbrokers 50          |
| • Veterinary surgeons 100     | • Trade mark attorneys 50  |
| • Actuaries 50                |                            |

## Company name

### Requirements

**[2.355]** The persons forming the company may choose the company name. A company name may be its ACN, which is a nine-digit number allocated by ASIC upon the company's registration: s 148(1).

There are certain requirements and restrictions regarding company names. A limited company must have the word "Limited" or the abbreviation "Ltd" as part of and at the

end of its name and a limited proprietary company must have the words “Proprietary Limited” or its abbreviation “Pty Ltd” at the end of its name: s 148(2). A no liability company must have the words “No Liability” or the abbreviation “NL” as part of and at the end of its name: s 148(4).

The purpose of these requirements is to act as a notice to those dealing with the company that its members have limited liability. This is especially important in the case of companies limited by shares because shareholders of such companies have liability limited to the amount, if any, unpaid on their shares. Creditors and prospective creditors are warned of this every time they see the company name. Unlimited companies have no such requirements because members of such companies have unlimited liability.

## *Availability of name*

**[2.360]** Persons wishing to form a company with a name other than its ACN should ensure that the proposed name is available. Under s 147(1) a name is available to a company unless it is identical to a name that has already been reserved or registered or it is unacceptable.

Schedule 6 of the *Corporations Regulations* sets out rules for determining whether a name is identical and provides a number of instances where a name is unacceptable or restricted for the purposes of s 147(1). These include names that in the opinion of ASIC are undesirable or likely to be offensive or the name contains specified words or phrases which imply a connection with a government or certain other organisations. A name is also unacceptable if it misleadingly implies an untrue association or status.

Other sections of the *Corporations Act* also restrict the use of particular names. For example, s 923B restricts the use of the names “stock broker” or “share broker” to persons authorised to do so by a financial services licence held by them.

ASIC provides a Check Name Availability facility to enable searches of whether a proposed company name is identical to one already registered on the ASIC database. ASIC’s Organisations and Business Names search facility permits the making of electronic searches of all currently registered names recorded on ASIC’s registers. The Understanding Company Law website at <http://www.uclaw.com.au/resources/> provides a link to ASIC’s Check Name Availability search facility and the Business Name Availability search facility.

## *Reserving a name*

**[2.370]** Reservation of a proposed name is optional. A person may lodge an application to reserve a specified name of an intended company: s 152(1). If the name is available, it must be reserved by ASIC for two months: s 152(2). The period of reservation may be extended.

## *Change of name*

**[2.375]** A company may, by special resolution, change its name: s 157(1). The proposed new name must be available: s 157(3). An application and a copy of the special resolution approving the change of name must be lodged with ASIC: s 157(1) and (2).

A company cannot change its name or reserve a name after the commencement of winding up as the members lose their powers to pass a special resolution and directors can no longer act.

## *Omission of “Limited” from name*

**[2.380]** Although limited companies are generally required to include the word “Limited” as part of their name, s 150(1) allows a company limited by guarantee to dispense with this requirement if it is a registered charity as defined in s 25-5(5) of the *Australian Charities and Not-for-profits Commission Act 2012* (Cth) and the constitution of the company:

- prohibits the payment of fees to its directors; and
- requires the directors to approve all other payments made to directors.

The purpose of this section is to enable organisations of a charitable or socially beneficial nature, which do not seek to operate for the financial benefit of their members, to dispense with the appearance of being a commercial enterprise while still gaining the advantages of registration as a company.

## *Publication and display of company name*

**[2.385]** A company is required to set out its name followed by its ACN on its common seal and on all its public documents and negotiable instruments: ss 123(1) and 153(1). “Public document” is defined in s 88A as including “a business letter, statement of account, invoice, receipt, order for goods, order for services or official notice” of the company. It does not include documents of a non-contractual nature: *National Education Advancement Programs Pty Ltd v Ashton* (1996) 14 ACLC 30.

In Regulatory Guide RG13 *ACN, ARBN and Company Names*, ASIC sets out guidelines for compliance with the law governing the use and display of company names and numbers. For example, a company’s name and ACN do not have to appear on advertisements as these are not generally “public documents”.

The company name must also be prominently displayed at every place at which the company carries on business and that is open to the public: s 144(1). A public company must also display its name at its registered office: s 144(2).

## *Misuse of identical or similar name*

### **Passing off**

**[2.390]** The common law provides some protection to owners of a business name from others using a similar name. It does so in circumstances where the purpose of using the similar name is to create the impression that the business is that of another and is thereby unfairly taking advantage of the reputation of that business. The existing business may bring an action in the tort of passing off and seek damages for loss of profits and loss of goodwill. The party passing off may be ordered to pay over profits made as a result of the passing off. An injunction may also be obtained restraining the defendant from continuing with its business or company name.

It is not necessary in establishing passing off to prove that the defendant intended to deceive. However, the defendant must carry on the same kind of business as the plaintiff. A person may, however, use a similar or identical name to someone else if the person is using their own name and does so honestly.

*Cameron Real Estate Pty Ltd v Cameron* (1985) 3 ACLC 83

[2.395] The Supreme Court of the Australian Capital Territory granted an injunction to prevent the promoters of a company from proceeding with the registration of “Don and Mary Cameron Realty Pty Ltd”. There was a real likelihood that the name could be confused with “Cameron Real Estate Pty Ltd”, a registered company carrying on a business in the same industry and in the same locality.

### Misleading and deceptive conduct under the Australian Consumer Law

[2.400] Another remedy available in similar circumstances to passing off is under s 18 of the *Australian Consumer Law* which prohibits a person (including a company), in trade or commerce, from engaging in misleading or deceptive conduct. This includes the misleading use of another’s name.

A problem that arises occasionally is when a foreign company with an internationally known name wishes to set up operations in Australia, only to find that its name is unavailable because a company with a similar name is already incorporated. Sometimes the only reason the local company has been formed is to enable its promoters to “sell” the name back to the foreign company. However, if the foreign company’s name has become associated with it in Australia, the use of the name by the local company may amount to misleading or deceptive conduct for the purposes of s 18 of the *Australian Consumer Law*.

## Registration procedure

### *Application for registration*

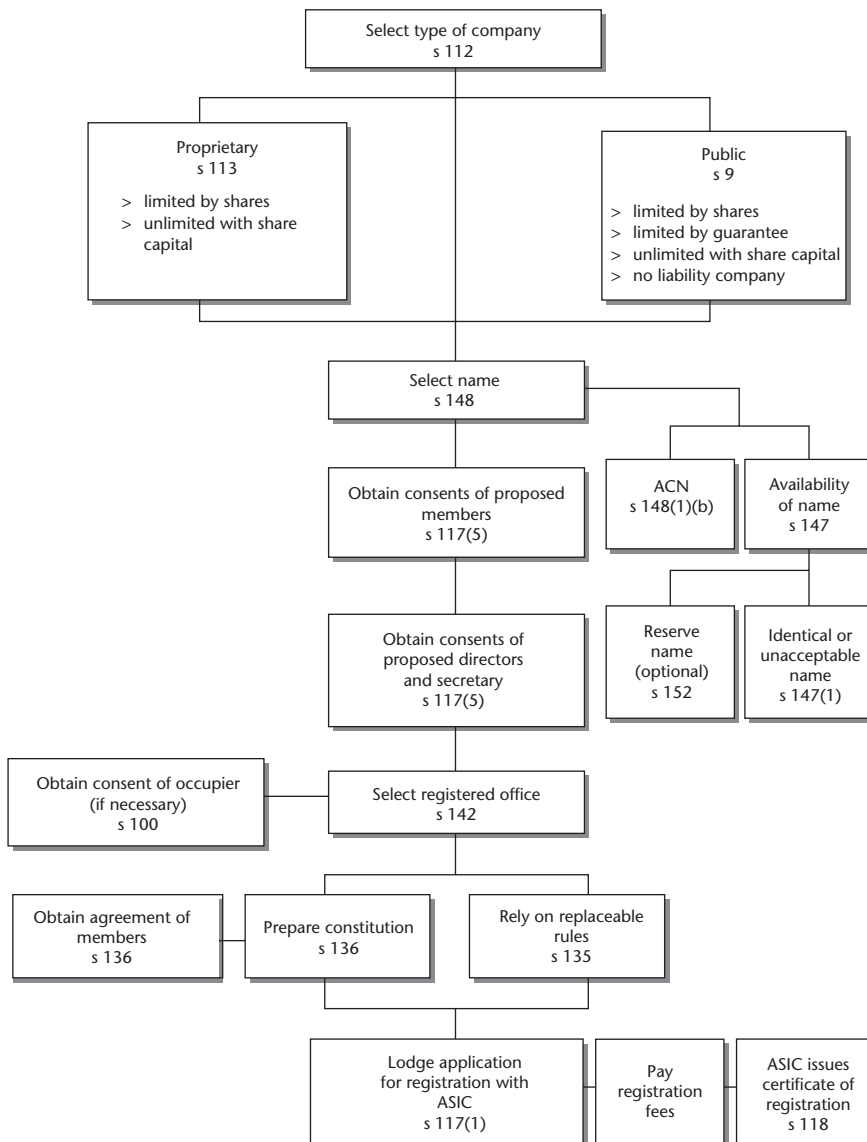
[2.410] Figure 2.1 illustrates the registration procedure. To register a company, a person must lodge an application with ASIC using the prescribed form (Form 201): s 117(1). The Understanding Company Law website at <http://www.uclaw.com.au/resources/> has a link to a blank application form.

The application must state specified information: s 117(2). This includes:

- the type of company;
- the company’s proposed name;
- names and addresses of persons consenting to be members;
- names, addresses and date and place of birth of persons consenting in writing to be directors and company secretary;
- address of registered office and hours of opening;
- address of principal place of business;
- details of issued shares including whether fully paid and beneficially owned by the member on registration;
- whether the company will have an ultimate holding company and if so, details of that ultimate holding company; and
- prescribed information regarding issues of shares for non-cash consideration by public companies.

An applicant must have the consents and agreements in respect of persons becoming directors, secretary or members when the application is lodged: s 117(5). After registration, these consents and agreements must be retained by the company. A proposed public company which is to have a constitution must lodge it together with the application for registration.

**Figure 2.1: Registration procedure**



## *Registered office*

**[2.415]** A company must have a registered office in Australia to which communications and notices to the company may be addressed: s 142(1). A document is validly served on a company by posting it to, or leaving it at, the registered office: s 109X(1).

If the registered office is at premises not occupied by the company, the company must show ASIC the occupier's written consent to the address being used as the company's registered office: s 143(1). This commonly occurs where the registered office is the place of business of the company's accountant.

A company must lodge a notice of change of address of its registered office no later than 28 days after the date of the change: s 142(2). The company's name must be prominently displayed at its registered office together with the words "registered office": s 144(2).

Under s 145(1) the registered office of a public company must be open to the public:

- each business day from at least 10 am to 12 noon and from at least 2 pm to 4 pm; or
- at least three hours chosen by the company between 9 am and 5 pm each business day.

If a company chooses its own opening hours, the hours must be specified in either its application for registration or in a notice lodged with ASIC: s 145(2) and (3).

The address of the company's principal place of business (if it is not the registered office) must also be notified to ASIC: s 146.

## *Replaceable rules and constitution*

**[2.420]** The *Corporations Act* contains a set of basic rules that regulate the internal management of companies. They are called replaceable rules. New companies may choose to be governed by the replaceable rules, their constitution or by a combination of both: s 134. The company constitution and replaceable rules are discussed in Chapter 4.

## *Shareholders and officers*

**[2.425]** The persons named with their consent in the application for registration become the members, directors and company secretary from the time of registration of the company: s 120(1). The shares stated in the application to be taken up by the members are taken to be issued on registration of the company: s 120(2). A share certificate must be issued within two months of the shares being issued: s 1071H(1).

## *Fees*

**[2.430]** Together with lodgment of the application for registration, prescribed fees are payable for registration and reservation of name where this is sought.

## *Certificate of registration*

[2.435] If an application for registration is lodged, ASIC may:

- allot the company an ACN;
- register the company; and
- issue a certificate stating the company's name, ACN and type of company. The certificate states the date of registration and that the company is registered under s 118(1) of the *Corporations Act*.

While ASIC has a discretion whether to register a company, it will only refuse to register a company in unusual cases where registration would involve a breach of the *Corporations Act*. This could arise, for example, where a disqualified director is named in the application as a director of the company.

A certificate of registration is conclusive evidence that all requirements for registration have been complied with and the company was duly registered on the specified date: s 1274(7A).

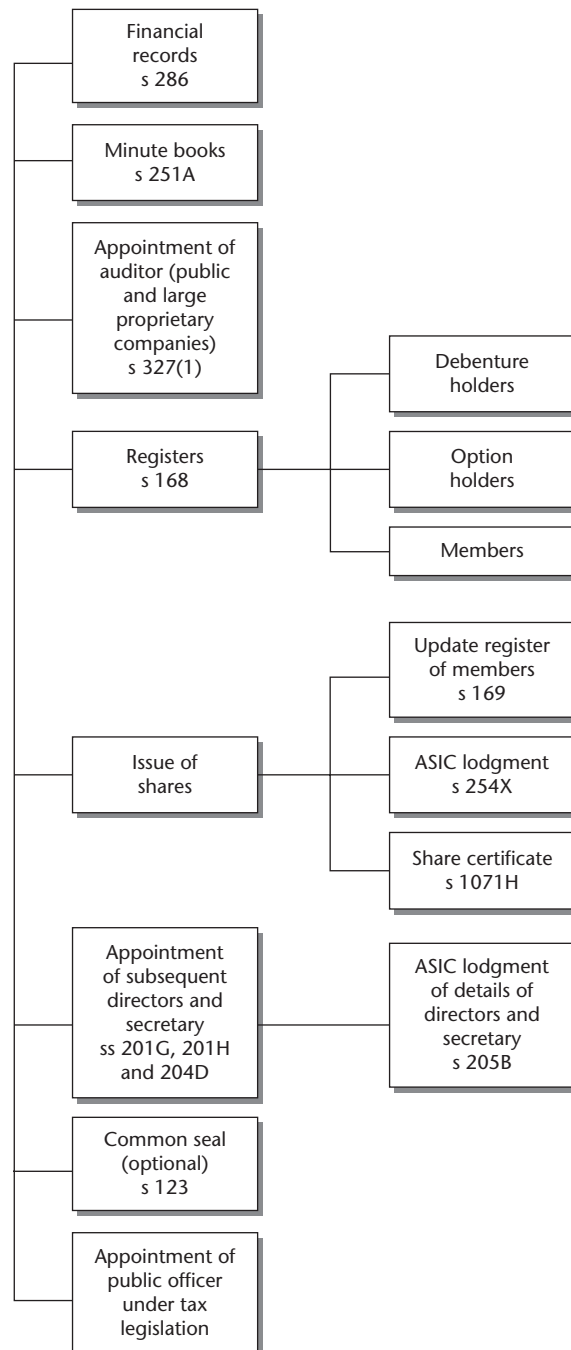
## *Corporate key*

[2.440] Shortly after a new company is registered, ASIC issues an eight-digit “corporate key” to the company. A company (or its registered agent) must quote its corporate key when lodging forms with ASIC. Similar to a PIN for a bank account, a corporate key is a mechanism to ensure the company's information on the national database is kept secure and not hacked by unauthorised people.

## **Post-registration requirements**

[2.445] Figure 2.2 illustrates the post-registration requirements. ASIC's *Checklist For Registered Companies and Their Officers*, summarises the document lodgment requirements of the *Corporations Act*. ASIC's information sheet INFO 76 *What Books and Records Should My Company Keep?* provides further post-registration requirements. Both ASIC documents are linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.



**Figure 2.2: Post-registration requirements**

## *Appointment of directors and secretary*

**[2.450]** The initial directors and secretary are those persons named with their consent in the application for registration. Subsequent appointments of directors may be made in accordance with the replaceable rules contained in ss 201G and 201H or the company's constitution. Under the replaceable rules, a company may appoint a director by resolution passed at a general meeting or the other directors may appoint a person as a director. Where the other directors appoint a director, the appointment must be confirmed by the general meeting: s 201H(2) and (3). A public company must have at least one secretary: s 204A(2). A proprietary company need not have a secretary: s 204A(1). The directors appoint the company secretary: s 204D.

## *Common seal*

**[2.455]** As discussed at [5.120], it is no longer mandatory for a company to have a common seal. If a company chooses to have a common seal, its name and ACN or ABN must be set out on the seal: s 123(1).

The common seal is often affixed to certain formal documents, for example, share certificates and finance documentation.

## *Registers*

**[2.460]** Section 168 requires a company to set up and maintain the following registers:

- a register of members (this is discussed at [9.20]);
- a register of option holders and copies of option documents if the company grants options over unissued shares (this is discussed at [8.15]); and
- a register of debentures if the company issues debentures (this is discussed at [11.60]).

Under s 172 these registers must be kept in Australia at the company's registered office, principal place of business or another office approved by ASIC. Companies with large numbers of shareholders often employ independent contractors to keep and maintain their share registers. Section 172(1)(c) permits the registers to be kept at the offices of such contractors.

A company must allow anyone to inspect its registers: s 173. Shareholders, registered option holders or registered debenture holders may inspect the registers without charge: s 173(2). Other people may inspect the registers on payment of a fee (up to the prescribed amount) required by the company. If requested, a company must provide copies of registers or parts of them within seven days. People asking for copies must first pay any fee (up to the prescribed amount) required by the company. Section 177 ensures that people will not be able to inspect a company's registers for a commercial purpose, such as junk mail advertising, that is unrelated to their holding unless inspection is approved by the company.

## *Minute books*

**[2.475]** All companies must keep minute books in which are recorded within one month of the proceedings or resolutions of meetings of the company's members and

directors: s 251A. Section 1306 deals with the way minute books are to be kept or prepared. Entries may be made in a bound or looseleaf book or may be stored by computer or on microfilm as long as it may be reproduced in written form at any time. Minutes are further discussed at [21.195].

## *Issue of shares*

**[2.480]** After registration, a company has the power to issue shares. This power will generally be exercised by the directors: s 198A. A share certificate must be issued within two months of allotment: s 1071H. The company must lodge a notice with ASIC setting out details of the share issue: s 254X.

## *Notice of details of directors and secretary*

**[2.485]** Where a director or secretary is appointed after registration, the company must lodge with ASIC a notice of the personal details of the director or secretary within 28 days of their appointment: s 205B(1). The personal details required on the prescribed form include:

- name;
- date and place of birth; and
- address.

Similarly, a notice must also be lodged within 28 days where a person ceases to be a director or secretary.

Under s 205A(1), a director or secretary who resigns or retires may also give notice of the resignation or retirement to ASIC. Companies are relieved of the obligation to lodge notice of cessation of directors and secretaries with ASIC where the office holders themselves lodged such notices.

## *Financial records and auditor*

**[2.490]** A company must keep written financial records that properly record and explain its financial position and performance. The financial records must enable true and fair financial statements to be prepared and audited: s 286(1).

A company that merely keeps a collection of receipts, invoices and bank statements does not satisfy its obligations under s 286. A systematic record of its financial transactions is required. Financial records are discussed at [22.20]–[22.30]. Section 327(1) requires a company's directors to appoint an auditor within one month after its registration. The directors of a proprietary company may appoint an auditor where the general meeting has not done so: s 325. Auditors are discussed in Chapter 23.

## *Use of name*

**[2.495]** Section 144 obliges a company to display its name in a prominent position outside its registered office as well as outside premises where its business is being carried on and that is open to the public. The registered office of a public company must prominently bear the words “registered office” associated with the company name. Further, a company must ensure that its name and either its ACN or ABN appear on every public document

and negotiable instrument: s 153(1). This includes letterheads, invoices, cheques and receipts.

### *Public officer*

**[2.500]** Every company is required to appoint a “public officer” within three months of commencing to carry on business. This requirement is imposed by s 252 of the *Income Tax Assessment Act 1997* (Cth). The company’s public officer is responsible for doing all things required to be done by the company under that Act.

### *Bank account*

**[2.505]** It is prudent for companies to open a bank account. Such an account is used for the company’s daily transactions as well as initially holding the paid up capital.

### *ASIC notifications*

**[2.510]** A company must notify ASIC of changes that affect the company. These include issues of shares, change of company name, changes to the address of the registered office, change of directors or their details, and changes to the register of members.

## **Shelf companies**

**[2.515]** A common way to form a company is by the acquisition of an existing “shelf company” rather than by completion of the company registration procedure described at [2.410]–[2.435]. “Shelf company” is not a legal term. It describes a company that has not previously operated a business and has been formed specifically for the purpose of being sold to a purchaser of the company. Lawyers and accountants often register shelf companies for sale to their clients when they need a registered company.

The acquirer of a shelf company must go through certain steps to transfer ownership and control to themselves. These steps include transfers of shares, changes of directors and registered office, and inclusion of constitutional provisions. The purchasers of a shelf company must also notify ASIC of the changes so that the ASIC database can be updated.

## **Tutorial questions**

The following questions dealing with the effect of registration may best be answered by reading this chapter and considering the internet resources on the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

1. Welsh Enterprises Pty Ltd was registered with Michelle and Derek as its directors. Michelle, Derek and their two daughters, Ellen and Molly, each own one share in the company. After the company’s formation the following occurred:
  - Welsh Enterprises Pty Ltd entered into a lease for new premises for the business;
  - Welsh Enterprises Pty Ltd borrowed \$30,000 from ANZ Bank to fund expansion of the business. Michelle and Derek personally guaranteed repayment of the loan;

- Welsh Enterprises Pty Ltd purchased several computers from Acme Computers Pty Ltd. One third of the purchase price was paid on delivery and the balance payable in equal monthly instalments.

Assume that six months after these transactions were entered into, Welsh Enterprises Pty Ltd was unable to make the various required payments.

Would the shareholders of Welsh Enterprises Pty Ltd be personally liable to the landlord, the ANZ Bank or Acme Computers Pty Ltd? Explain.

2. Plasto Pty Ltd was a small manufacturer of plasterboard. Its shareholders and directors were John and Peter. Many of Plasto Pty Ltd's customers complained about the quality of the plasterboard that Plasto manufactured. The plaster had been falling off the walls and in many cases had to be replaced. Some of Plasto's customers threatened to take legal action against Plasto Pty Ltd, alleging their plasterboard breached the guarantee of acceptable quality.

John and Peter were fearful that Plasto Pty Ltd would lose the threatened legal actions and that it did not have enough money to pay the damages claims. They therefore decided to form a new company, Plasto Australia Pty Ltd, transfer all of the assets of Plasto Pty Ltd to the new company and continue to trade under the new company. Plasto Pty Ltd was not in liquidation but was left an empty shell with no money, business or other assets.

Advise the customers whether they can make John, Peter and Plasto Australia Pty Ltd liable for the damages caused by Plasto Pty Ltd.

3. Wacca Dacca Ltd is a company controlled by the members of the hard rock band, WC/DC. A number of wholly owned subsidiaries of Wacca Dacca Ltd are involved in setting up and running the band's concerts. One of the subsidiary companies, Heavy Metal Sounds Pty Ltd, is responsible for setting up the sound equipment at WC/DC concerts in Australia. At a recent WC/DC concert in Melbourne, Heavy Metal Sounds Pty Ltd negligently set the sound levels too high with the result that five audience members suffered permanent hearing loss. Unfortunately for those audience members, Heavy Metal Sounds Pty Ltd had no negligence insurance and cannot pay the likely damages claims.

Advise the injured audience members whether they can make Wacca Dacca Ltd liable for Heavy Metal Sounds Pty Ltd's negligence.

4. In light of the circumstances surrounding the James Hardie restructure, should parent companies be liable for tort claims against their subsidiaries? Read H Hansmann and R Kraakman "Towards Unlimited Shareholder Liability for Corporate Torts" (1991) 100 Yale LJ 1879 and Discussion Paper Annexure T "The Concept of Limited Liability – Existing Law and Rationale" in the *Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation* (2004). Both papers are linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.
5. David and his sister Stephanie were actively involved in running a profitable partnership business that had an annual turnover of \$50 million. They inherited the business from their parents. David and Stephanie were both married with young children. While

they eventually would like their respective spouses and children to have a share in the business, David and Stephanie want to maintain managerial control. They appreciate that their business needs additional money to grow and would be happy to sell 20 per cent of their business for a significant cash injection from one or more investors. They confidently expect that with additional funding their business would quickly achieve a \$100 million turnover and control 30 per cent of the market.

Advise David and Stephanie whether or not they should continue to operate their business as a partnership. Would another type of structure be more appropriate for them in the future? Explain your reasons fully.

6. Abe and Phillip would like to form a company to be called Vandalay Industries Pty Ltd. Is the name available?
7. Assume you wish to form a company.
  - (a) Select an available name for your proposed company.
  - (b) Fill in an application for registration form.
  - (c) What is the fee for lodging an application for registration with ASIC?
  - (d) What consents must be obtained before the application for registration can be lodged with ASIC?
  - (e) Do you need to prepare a constitution for your proposed company?
  - (f) Outline the books, records and registers that your company must establish after it is formed.
  - (g) Can your company's invoices set out its ABN instead of its ACN?

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.
- For further corporations law links and material please refer to the Understanding Company Law website at <http://www.uclaw.com.au>.



## Chapter 3

# Types of companies

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## Key points

- The *Corporations Act* classifies companies in several ways. Companies are classified according to the liability of members. A company limited by shares is the most common type of company. The liability of shareholders of such companies is limited to the amount, if any, unpaid on the issue price of their shares. Therefore, shareholders who own fully paid shares have no further liability.
- Companies are also classified according to whether they are public or proprietary companies. Proprietary companies are generally subject to fewer obligations than public companies, particularly in relation to disclosure requirements.
- As a general rule, a proprietary company must have no more than 50 shareholders and cannot issue shares or debentures in circumstances that would require disclosure to investors under the fundraising provisions of the *Corporations Act*. The 50-shareholder maximum can be exceeded where a proprietary company has issued shares under a crowd-sourced equity funding scheme. A company that does not comply with these prohibitions is classified as a public company.
- Proprietary companies are divided into two sub-classifications: large proprietary companies and small proprietary companies. Whether a proprietary company is large or small depends on specified criteria such as its consolidated operating revenue, value of its consolidated gross assets and number of employees.
- The *Corporations Act* imposes further disclosure requirements on listed companies and other disclosing entities. A disclosing entity must prepare and lodge half-yearly financial reports as well as end-of-year financial reports. They are also subject to the continuous disclosure requirements.
- A holding company–subsidiary relationship arises where the holding company controls over half the issued capital of the subsidiary or controls the composition of its board of directors. A holding company, its subsidiaries and subsidiaries of subsidiaries are all referred to as “related” companies.

## Corporations and companies

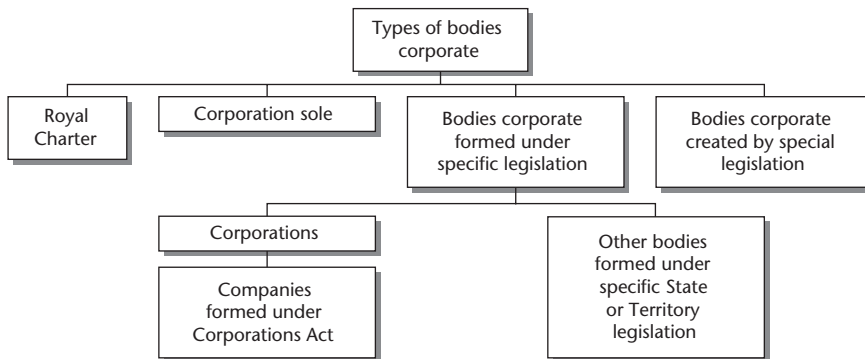
[3.05] In their general meanings the terms “body corporate” and “corporation” refer to entities recognised by the law as separate from their members and capable of acting in their own rights. The *Corporations Act*, however, defines these terms differently. A corporation is defined in s 57A to include:

- a company; and
- any body corporate (whether incorporated in this jurisdiction or elsewhere); and
- an unincorporated body that under the law of its place of formation, may sue or be sued, or may hold property in the name of its secretary or of an officer of the body duly appointed for that purpose.

Excluded from the definition are:

- an exempt public authority. These are public authorities, instrumentalities or agencies of the Crown; and
- a corporation sole, for example the Public Trustee.

**Figure 3.1: Types of bodies corporate**



The oldest form of incorporated entity is a body corporate established by Royal Charter. The University of Sydney is an example of such a body. There are also numerous instances where corporations have been formed by special legislation. Monash University is one example of such an entity. There are also some types of legal entities that come into existence under specific legislation. Trade unions are legal entities recognised under industrial legislation. Bodies corporate or owners’ corporations established under strata titles or owners’ corporation legislation to manage common property are another instance of where a corporation is formed by special legislation.

In this book we are concerned mainly with companies registered under the *Corporations Act* and its predecessors. According to ASIC registration statistics, there were more than three million companies registered in Australia as at the end of June 2023. The *Corporations Act* also recognises certain bodies, such as building societies, credit unions and incorporated associations, formed under specific State or Territory legislation. These are referred to as “registrable Australian bodies” and must be registered under the *Corporations Act* if they do business outside their State or Territory of formation.

The *Corporations Act* classifies companies in a variety of ways. The more significant classifications are according to:

- the liability of members (see [3.10]–[3.35]);
- their public status, that is, whether they are public or proprietary companies (see [3.30]–[3.95]);
- the size of proprietary companies (see [3.100]–[3.105]);
- their relationship with other companies, that is, holding companies, subsidiary companies, related bodies corporate and members of economic entities (see [3.130]–[3.170]);
- whether or not they are disclosing entities (see [22.125]);
- the place of formation, that is, whether they are registered in Australia or are foreign companies (see [3.175]–[3.185]); and
- the type of business they conduct, such as mining companies (see [3.30]), managed investment schemes and corporate collective investment vehicles (see Chapter 27) and trustee companies: see [3.190]–[3.200].

## Classification according to liability of members

**[3.10]** Selection of the type of company is made at the time of its formation. Among other matters, the application for registration of a new company must state the type of company that is proposed to be registered: s 117(2)(a).

There are four types of companies that are classified according to the liability of members in s 112(1).

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

**Table 3.1: Types of company – s 112(1)**

|                       |                              |
|-----------------------|------------------------------|
| Proprietary companies | Limited by shares            |
|                       | Unlimited with share capital |
| Public companies      | Limited by shares            |
|                       | Limited by guarantee         |
|                       | Unlimited with share capital |
|                       | No liability company         |

## Company limited by shares

**[3.15]** This is by far the most common type of company. Companies limited by shares comprise approximately 99 per cent of all companies registered in Australia. Such companies can raise funds (referred to as equity or share capital) by issuing shares to investors.

The liability of members of a company limited by shares is limited to the amount, if any, unpaid on the shares respectively held by them.

A company limited by shares is defined in s 9 as a company formed on the principle of having the liability of its members limited to the amount, if any, unpaid on the shares respectively held by them. Once shareholders' details are entered on a company's register of members they are regarded as members: s 231.

The issue price for a share is determined by agreement between the company and the investor. Shares may be issued on the basis that the investor pays the entire issue price in one instalment. Such shares are referred to as "fully paid shares". A shareholder who owns fully paid shares has no liability to contribute any further amounts to the company.

Shares may also be issued on the basis that the shareholder pays only part of the issue price immediately. Such shares are referred to as "partly paid shares". A shareholder who owns partly paid shares is liable to pay the balance of the issue price of their partly paid shares if the company, through its directors, makes a call.

In the event of a liquidation, s 515 requires members (referred to as "contributories") 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 the winding up. However, a member need not contribute more than the amount, if any, unpaid on the shares in respect of which the member is liable as a member: s 516.

In some situations, a past member may also be liable to contribute to the company's property on a winding up. They need not contribute if they ceased being members more than one year before the commencement of winding up: s 521. Further, past members are only liable if the court is satisfied that the existing shareholders are unable to satisfy the contributions they are liable to make: s 522. In any event, past members will not be liable for any debt or liability of the company contracted after the past member ceased to be a member: s 520.

Because the shareholders of a company limited by shares have limited liability, creditors of such a company do not have access to the personal property of the shareholders to satisfy their debts. Therefore, s 148(2) requires a limited company to have the word "limited" or its abbreviation "Ltd" as part of and at the end of its name. This is a notice to potential creditors that the liability of the shareholders is limited and debts of the company can only be satisfied from the assets of the company. The prudent creditor should ascertain whether the issued capital of the company is sufficiently large and the company holds sufficient assets to cover the debt. Some creditors may also seek personal guarantees from the directors. Limited liability is discussed at [2.20]–[2.35].

The *Corporate Collective Investment Vehicle Framework and Other Measures Act 2022* (Cth) inserted Ch 8B into the *Corporations Act*, which recognised a corporate collective investment vehicle (CCIV) as a new type of company limited by shares used for fund management. The key policy objective of the amending legislation is to increase the competitiveness of Australia's managed funds industry internationally to attract offshore investment. CCIVs are discussed at Chapter 27.

## Company limited by guarantee

**[3.20]** A company limited by guarantee is a company whose members have their liability limited to the amounts that they have undertaken to contribute to the property of the company in the event of it being wound up: s 9.

Such a company does not have a share capital as members do not contribute capital while the company is operating. Companies limited by guarantee still retain the advantages of being legal entities with the liability of their members limited to the amount of the guarantee. However, in the event of the company being wound up and its assets being insufficient to meet its liabilities, its members are liable to pay up to the amount specified as the members' guarantees: s 517. The guaranteed amounts must be set out in the company's application for registration: s 117(2)(m).

The obvious limitation with this type of company is that it does not raise initial or working capital from its members. Accordingly, such companies are very rarely used for conducting businesses and are predominantly used as not-for-profit entities such as sports and recreation-related organisations, charities and community service organisations, education-related institutions and religious organisations. An incorporated association formed under specific State legislation, such as the *Associations Incorporation Reform Act 2012* (Vic) or the *Associations Incorporation Act 2009* (NSW), is an alternative to a company limited by guarantee for not-for-profit associations.

As in the case of a company limited by shares, the past members of a company limited by guarantee may also be liable in a winding up of the company, if its assets are insufficient to meet its debts and the present members are unable to meet the company's liabilities. Past members' liability to contribute arises only in respect of those persons who were members within a year prior to the commencement of winding up. They are not liable to contribute towards those company debts incurred after they ceased to be members.

Because members of a company limited by guarantee have limited liability, the company name must generally include the word "limited" at the end of its name. A company is not required to have the word "Limited" at the end of its name if it is a registered charity as defined in s 25-5(5) of the *Australian Charities and Not-for-profits Commission Act 2012* (Cth) and the company's constitution (i) prohibits the company paying fees to its directors; and (ii) requires the directors to approve all other payments the company makes to directors: s 150(1). The s 150 requirements and prohibitions are discussed at [2.380].

As companies limited by guarantee do not have a share capital they cannot be proprietary companies and so must be public companies. Companies limited by guarantee are subdivided into three categories according to the size of their annual revenue for purposes of their annual financial reporting obligations.

Three categories of companies limited by guarantee.

Section 285A sets out in tabular form the annual financial reporting obligations of the three categories of companies limited by guarantee.

### Small company limited by guarantee.

According to s 45B, a small company limited by guarantee has annual revenue of less than \$250,000 and is not a deductible gift recipient for income tax purposes. Such companies are not required to prepare a financial report or directors' report.

Where a company limited by guarantee is required to prepare a directors' report, there are more simplified contents requirements than that required of other companies.

Section 254SA prohibits companies limited by guarantee from paying dividends to members.

## Unlimited company

**[3.25]** An unlimited company is defined in s 9 as a company whose members have no limit placed on their liability to the company. This is the oldest type of company. Once unlimited companies were able to register either with or without a share capital. However, unlimited companies formed after July 1998 must now have a share capital.

Members of unlimited companies are liable in a winding up for the debts of the company without limit if the company has insufficient assets to meet its debts. In this respect, an unlimited company is similar to a partnership. However, it has all the other characteristics of incorporation including recognition as a separate legal entity.

Because limited liability is one of the most important reasons for forming a company, unlimited companies are rare in the case of trading companies. In the past, some accountancy and solicitors' practices were conducted as unlimited companies because until recently, professional rules prohibited their practices being conducted with limited liability, yet they still desired obtaining the other advantages of incorporation.

## No liability company

**[3.30]** Mining has played an important role in the economic development of most Australian states. Victoria introduced the no liability company in 1871 to encourage investment in the mining industry.

A public company may be registered as a no liability company or convert into one under s 162. A no liability company must:

- have a share capital;
- state in its constitution that its sole objects are mining purposes; and
- have no contractual right under its constitution to recover calls made on its shares from a member who fails to pay a call: s 112(2).

A no liability company is prohibited from engaging in activities that are outside its mining purposes objects.

A no liability company is prohibited from engaging in activities that are outside its mining purposes objects: s 112(3). Directors of a no liability company must not let a

mine or claim or enter into a contract for working any land over which it has a claim unless this is approved by a special resolution of the company's shareholders: s 112(4).

A no liability company must have the words "No Liability" or the abbreviation "NL" at the end of its name: s 148(4). Only no liability companies are able to use these words in their name: s 156.

The acceptance of shares in a no liability company does not constitute a contract by the shareholder to pay calls or contribute to the debts and liabilities of the company: s 254M(2).

A share in a no liability company is forfeited if a call is unpaid 14 days after it became payable: s 254Q(1). Forfeited shares must be offered for sale by advertised public auction within six weeks after the call becomes payable: s 254Q(2) and (3).

A shareholder whose shares have been forfeited may, at any time before the sale, redeem the shares by paying the calls due on the shares and if the company requires, a proportion of expenses incurred in the forfeiture on a pro rata basis: s 254R.

Shares in a no liability company are issued on the basis that if the company is wound up, any surplus must be distributed among the shareholders in proportion to the number of shares held by them irrespective of the amounts paid up. Where a shareholder is in arrears in payment of a call, the right to participate in the distribution in respect of those shares is lost until the amount owing is paid: s 254B(2).

## Company limited both by shares and guarantee

**[3.35]** Since 1998 this type of company may no longer be registered. Very few companies of this type were previously formed but a small number of those registered before 1998 still remain. Their essential feature is that a member of such a company need not contribute more than the aggregate of the following:

- any sums unpaid on any shares held by the member; and
- the amount the member has undertaken to contribute to the company's property if the company is wound up.

## Proprietary and public companies

**[3.40]** Companies vary greatly in size and objectives, from large companies listed on the Australian Securities Exchange Ltd (ASX) with many thousands of shareholders to small family companies carrying on a relatively small scale business.

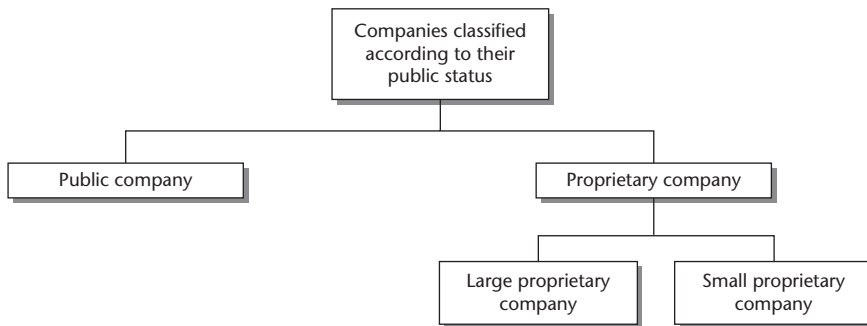
Public companies generally have more detailed disclosure and investor protection obligations than proprietary companies.

The *Corporations Act* recognises that there are different regulatory needs depending on the size and nature of a company. For this reason a distinction is drawn between public and proprietary companies.



More detailed obligations are imposed on public companies because disclosure and investor protection are important concerns of the legislation where a company is listed or is able to seek capital from investors. Proprietary companies must have restrictions on who may become a shareholder and have a relatively small number of shareholders and so there is less need for them to be heavily regulated by the *Corporations Act*.

**Figure 3.2: Public and proprietary companies**



Proprietary companies encompass a wide range of business organisations. Subsidiaries of public companies are often proprietary companies even though they may own very substantial assets. Some proprietary companies evolved from small family businesses to become operators of very large-scale enterprises but still wish to restrict share ownership to a relatively small number of shareholders. Other proprietary companies evolved from sole traders or partnerships, perhaps for income tax reasons, and have remained relatively small enterprises. The managerial and ownership functions continue very much as they did prior to the formation of the company.

A distinction is made between large and small proprietary companies in recognition of the fact that many large proprietary companies are either subsidiaries of public companies or operate large businesses with substantial numbers of employees. It is in the public interest to ensure that such businesses have greater public transparency of their financial operations than small businesses. As a result, the disclosure obligations applicable to large proprietary companies are more detailed than in the case of small proprietary companies.

The Small Business Guide contained in Pt 1.5 of the *Corporations Act* is written in plain English and summarises the main provisions of the legislation that are likely to be relevant to small companies. It is designed to help people who operate such companies understand their legislative rights and responsibilities.

## Definitions

**[3.45]** The definitions of public and proprietary companies are mutually exclusive. All companies must be one or the other. A “public company” means a company other than a proprietary company: s 9.

A proprietary company must have a share capital and must have no more than 50 non-employee shareholders.

Under s 112(1) a proprietary company must be either a company limited by shares or an unlimited company with a share capital. Further, it must have no more than 50 non-employee shareholders: s 113(1). Joint holders of shares are counted as one person: s 113(2). Shareholders who acquired their shares under a crowd-sourced funding (CSF) scheme are not counted for purposes of the 50-shareholders maximum: s 113(2) (c). The CSF scheme is discussed in Chapter 7 at [7.210]. This means that the maximum number of proprietary company shareholders is 50 *plus* employee shareholders *plus* any CSF shareholders.

Subject to certain exceptions, proprietary companies must not engage in any activity that would require disclosure to investors under Ch 6D.

Under s 113(3) proprietary companies must not engage in any activity, such as issuing shares or debentures, that would require disclosure to investors under Ch 6D of the *Corporations Act*, except:

- for an offer of its shares to existing shareholders or to employees of the company or of its subsidiary; or
- a CSF offer. CSF offers are discussed at [7.210]. The Chapter 6D disclosure requirements are discussed in Chapter 7.

An act or transaction is not invalid merely because of a contravention of s 113(3): s 113(4). Contravention is an offence of strict liability with a maximum five-penalty unit fine: s 113(3A). In addition, ASIC may require a company that contravenes s 113 to convert to a public company: s 165.

It is not size that is the key characteristic of proprietary companies, but the fact that they adhere to the restrictions and prohibitions of s 113. These ensure that members of the investing public who have no connection to other shareholders are unlikely to be shareholders of proprietary companies.

## Public and proprietary companies compared

### *Function*

**[3.50]** Proprietary companies vastly outnumber public companies and make up 99 per cent of all registered Australian companies.

There are various reasons for the popularity of proprietary companies. They are particularly suited as the vehicle for carrying on a small to medium size business. Such businesses are usually family-run or tightly held and consequently there is no intention to have large numbers of members or to raise capital from outside investors.

Public companies are more suited to large businesses that require many investors to participate in fundraising.

The *Corporations Act* imposes greater disclosure obligations on public companies because they can raise money from large numbers of people. Family-run businesses usually raise funds from their own internal sources or from lenders in much the same way as individuals and partnerships. The regulatory advantage of proprietary companies is that they have fewer disclosure requirements and so are cheaper to maintain than public companies.

## Membership

**[3.55]** Both public and proprietary companies must have at least one member: s 114. Section 113 specifies 50 as the maximum number of non-employee shareholders of a proprietary company. Persons who become shareholders pursuant to a CSF offer are not counted for purposes of the 50-shareholder maximum requirement: s 113(2)(c). There is no such maximum in the case of public companies.

Proprietary companies usually choose to have restrictions on the right to transfer shares. The proprietary company replaceable rule in s 1072G is an example of such a restriction. It gives directors the power to refuse to register a transfer of shares for any reason.

## Name

**[3.60]** All companies whose members have limited liability, except no liability companies, must have the word “Limited” or the abbreviation “Ltd” as part of and at the end of their name. Proprietary companies must in addition have the word “proprietary” or the abbreviation “Pty” as part of their name inserted immediately before the word “limited”: s 148(2).

An unlimited proprietary company need only have the word “proprietary” at the end of its name: s 148(3).

## Replaceable rules and company constitution

**[3.65]** A company’s internal management may be governed by provisions of the *Corporations Act* that apply to the company as replaceable rules, by a constitution, or by a combination of both: s 134. Some of the provisions are replaceable rules for proprietary companies and mandatory rules for public companies. For example, s 249X gives a member the right to appoint a proxy. This is a replaceable rule for proprietary companies but a mandatory rule for public companies.

Single director/shareholder proprietary companies do not require comprehensive, formal rules, so such companies are not governed by the replaceable rules: s 135(1). The *Corporations Act* has several basic rules appropriate for single director/shareholder proprietary companies. These provide that a director may appoint another director by recording the decision and signing the record and may exercise all the company’s powers and is responsible for the management of the company’s business: ss 198E and 201F.

The replaceable rules and constitution are discussed in Chapter 4.

## Directors

**[3.70]** Proprietary companies must generally have at least one director. However, a proprietary company with one or more CSF shareholders must have at least two

directors: s 201A(1A). A public company must have at least three directors: s 201A. At least two of the directors of a public company and one director of a proprietary company must ordinarily reside in Australia.

Directors of public companies must be individually appointed unless a general meeting of members unanimously agrees to appoint two or more directors by a single resolution: s 201E(1).

Directors of a public company can only be removed by resolution of its members: ss 203D and 203E. The question of who can remove directors of a proprietary company is left to the company's constitution (if any). The proprietary company replaceable rule in s 203C gives this power to the general meeting of shareholders.

Chapter 2E of the *Corporations Act* prohibits public companies from giving financial benefits to directors or other related parties without prior member approval: s 208. Member approval is not required if the financial benefit falls within certain exceptions. Chapter 2E applies to proprietary companies that have one or more CSF shareholders as if they were public companies: s 738ZK. Chapter 2E is discussed at [16.40]–[16.80]. Public company directors who have a material personal interest in a matter that is being considered at board meetings are not permitted to attend or to vote: s 195.

## Secretary

**[3.75]** The *Corporations Act* does not require a proprietary company to have a secretary. If it chooses to appoint one or more secretaries, at least one must ordinarily reside in Australia: s 204A(1). A public company must have at least one secretary and at least one must ordinarily reside in Australia: s 204A(2). According to the August 2015 Consultation Paper, *Facilitating Crowd-Sourced Equity Funding and Reducing Compliance Costs for Small Business*, as at January 2015, there were almost 168,000 companies with a sole director and no company secretary.

## Raising funds

**[3.80]** Proprietary companies are prohibited by s 113(3) from engaging in any activity that would require disclosure to investors under Ch 6D. There are exceptions where there is an offer of shares to:

- existing shareholders;
- employees of the company or of a subsidiary; or
- a CSF offer.

This means that unless a proprietary company complies with the requirements of the CSF legislation contained in Pt 6D.3A, it cannot raise funds by offering its shares or debentures to a large number of people. Public companies are not so prohibited. However, public companies that wish to issue shares, debentures or other securities must comply with the fundraising provisions in Ch 6D. Unless one of the specific exceptions applies, a disclosure document must be prepared and lodged with ASIC. The fundraising provisions are discussed in Chapter 7. The CSF provisions enable public and proprietary companies with less than \$25 million in assets and annual turnover to raise up to \$5 million in any

12-month period where they comply with the CSF scheme. The CSF scheme is discussed at [7.210]–[7.215].

### *Annual general meeting*

**[3.85]** A public company is required to hold an annual general meeting (AGM) at least once a year unless it has only one member: s 250N. The first AGM must be held within 18 months of incorporation: s 250N(1). An AGM gives shareholders an opportunity to consider the company's audited financial report. Proprietary companies do not have to hold an AGM unless this is required by their constitution.

A proprietary company with more than one shareholder may pass a resolution without a general meeting being held if all the shareholders sign a document stating that they approve of the resolution set out in the document: s 249A. This is known as a “circulating resolution”. This procedure cannot be used to pass a resolution to remove an auditor. Shareholders' meetings are discussed in Chapter 21.

### *Annual financial reports and auditors*

**[3.90]** Public companies and large proprietary companies must prepare annual financial reports: s 295; and have them audited: s 301. They must also prepare directors' reports: s 298. The financial report, directors' report and auditor's report must be provided to members and copies lodged with ASIC: ss 314 and 319. The financial reporting requirements and auditors' reports are discussed in Chapters 22 and 23 respectively.

Small proprietary companies that have no CSF shareholders can keep their financial affairs confidential. They do not have to prepare annual financial reports, directors' reports and do not have to appoint an auditor unless required to do so by either shareholders holding at least 5 per cent of the voting shares or by ASIC: see ss 293(3)(c) and 294. Small proprietary companies that have one or more CSF shareholders must prepare annual financial reports *and* if they raised more than the CSF audit threshold (more than \$3 million from all CSF offers made), appoint an auditor and have their annual financial reports audited: ss 292(2)(c) and 325(2). CSF is discussed at [7.210]–[7.215].

Auditors of public companies and large proprietary companies must satisfy the general requirement for auditor independence in ss 324CA–324CD as well as the specific independence requirements in ss 324CE–324CG. These requirements are discussed at [23.45]–[23.80]. As a general rule, small proprietary companies may appoint officers as their auditor provided that the small proprietary company does not have any CSF shareholders or has raised a total of less than the CSF audit threshold (\$3 million) from all the CSF offers it has ever made: s 324CH(3A).

### *Registered office*

**[3.95]** While all companies must have a registered office, proprietary companies do not have to keep it open to the public. Public companies must keep their registered office open to the public during the opening hours specified in s 145. Public companies must also display their name and the words “registered office” prominently at their registered office: s 144.

## Large and small proprietary companies

[3.100] When the distinction between public and proprietary companies was originally introduced in Victoria in 1896, proprietary companies were seen as entities suitable for closely held small business enterprises and so were exempted from the disclosure requirements that applied to public companies.

It became apparent that many public companies misused the legislation to avoid making detailed disclosure of their financial positions by conducting their businesses through proprietary company subsidiaries. The only disclosure then required of the public company was an accounting entry showing dividends received from the subsidiary.

To overcome such avoidance practices the legislation was altered in two ways. First, as discussed at [22.55], accounting standard AASB 10 *Consolidated Financial Statements* requires an entity that is a parent entity of a group that is a reporting entity to prepare consolidated financial statements in which it consolidates its investments in its subsidiaries.

Secondly, the *Corporations Act* classifies proprietary companies as either large or small proprietary companies. This distinction seeks to distinguish small, closely held proprietary companies conducting small scale business enterprises, from large proprietary companies which are often subsidiaries of public companies. As discussed at [3.105], small proprietary companies have less detailed disclosure requirements and lower compliance costs. The overwhelming majority of proprietary companies are small proprietary companies.

The classification of proprietary companies into small or large proprietary companies is based on the size of the company's business.

Section 45A defines the terms “small proprietary company” and “large proprietary company”. A proprietary company that does not come within the definition of a small proprietary company is regarded as a large proprietary company.

Section 45A(2) explains when a proprietary company is regarded as a “small proprietary company” for a financial year in terms of whether it satisfies at least two of three criteria that deal with the scale of the company's business and the number of its employees. Each of the criteria are subject to other amounts prescribed by the regulations. To ensure that the burden of complying with financial reporting obligations was restricted to economically significant companies reg 1.0.02B was inserted and doubled the amounts previously specified in the three criteria. The effect of reg 1.0.02B is that currently, a proprietary company is regarded as small if it satisfies at least two of the following criteria:

- the consolidated operating revenue for the financial year of the company and the entities it controls is less than \$50 million, or any other amount prescribed by the regulations;
- the value of the consolidated gross assets at the end of the financial year of the company and the entities it controls is less than \$25 million, or any other amount prescribed by the regulations; and
- the company and the entities it controls have fewer than 100 employees, or any other amount prescribed by the regulations, at the end of the financial year.

“Consolidated operating revenue” and the value of “consolidated gross assets” are calculated in accordance with applicable accounting standards: s 45A(6). In counting employees for purposes of the s 45A definition, part-time employees are taken into account as an appropriate fraction of a full-time equivalent: s 45A(5). The question whether a proprietary company “controls” an entity is decided in accordance with accounting standards such as AASB 10 *Consolidated Financial Statements*: s 45A(4).

## Advantages of small proprietary companies

**[3.105]** The main advantages of small proprietary companies are that they are subject to fewer requirements in relation to preparation, lodgment and audit of financial reports. These advantages do not apply if the small proprietary company has one or more CSF shareholders.

Public companies and large proprietary companies are required to prepare annual financial reports and directors’ reports: s 292. They are also required to have their financial reports audited: s 301. Copies of the financial report, directors’ report and auditor’s report must be sent to members: s 314. In addition, the financial reports and directors’ reports must be lodged with ASIC: s 319.

Small proprietary companies do not have to prepare audited financial reports unless directed to do so.

Every company must keep and maintain sufficient financial records to allow true and fair financial statements to be prepared: s 286.

With some exceptions, a small proprietary company is not required to prepare annual financial reports, directors’ reports or appoint an auditor. This is a significant cost saving for small proprietary companies.

Small proprietary companies need to prepare financial reports only if directed to do so by shareholders holding 5 per cent or more of the voting shares (s 293) or ASIC (s 294) or if they have one or more CSF shareholders.

Written requests for financial reports by small proprietary company shareholders may be made at any time within 12 months after the end of the financial year concerned: s 293(2). Unless shareholders specify otherwise, the financial reports must be prepared in accordance with applicable accounting standards: s 293(3)(a). Shareholders of a small proprietary company may also request that the financial reports be audited: s 293(3)(c). Small proprietary companies that have one or more CSF shareholders *and* raised more than the CSF audit threshold (more than \$3 million from all CSF offers made), must appoint an auditor and have their annual financial reports audited: ss 292(2)(c) and 325(2).

The auditor of a small proprietary company is permitted to be employed as an officer of the company. This is not the case for auditors of public and large proprietary companies. Their auditors must satisfy the general requirement for auditor independence in ss 324CA–324CD as well as the specific independence requirements in ss 324CE–324CG.



Even though the *Corporations Act* does not require small proprietary companies to prepare annual financial reports, they must still prepare profit and loss statements for taxation purposes. In addition, banks and other financial institutions may insist on receiving financial reports before lending money to small proprietary companies.

## Conversion from proprietary to public company

**[3.115]** A proprietary company may wish to convert to a public company as a preliminary step in either an application for listing on the stock exchange or to raise capital from the public. The *Corporations Act* permits a proprietary company limited by shares to convert to a public company limited by shares by passing a special resolution to this effect and lodging an application with ASIC: ss 162 and 163. The company name must also be changed by omitting the word “Proprietary” from the company name. The company is then issued with an amended certificate of registration and becomes a public company. This does not create a new legal entity and does not affect any rights and liabilities of the company.

Under s 165, ASIC may direct a proprietary company to change to a public company if it is satisfied that the company has contravened s 113. This provision specifies the maximum membership of proprietary companies and prevents them from engaging in an activity that would require disclosure to investors under Ch 6D.

## Conversion from public to proprietary company

**[3.120]** A public company limited by shares may wish to convert to a proprietary company to reduce its financial disclosure obligations. The *Corporations Act* permits a public company to convert to a proprietary company by passing a special resolution and lodging an application to this effect with ASIC: ss 162 and 163. The special resolution must alter the company name to include “Proprietary” or the abbreviation “Pty”.

The company must also comply with s 113. That section requires proprietary companies to have a share capital and a maximum of 50 shareholders. As in the case of conversion from a proprietary to a public company, an amended certificate of registration is issued. A change of type of company does not create a new legal entity, affect the company's rights or obligations or any legal proceedings involving the company: s 166(1).

## Listed companies

**[3.125]** Most of the largest businesses in Australia are public companies that have chosen to have their shares and other securities listed on the ASX which operates several financial markets including Australia's main share market where the buying and selling of shares of listed companies takes place.

The ASX website (<http://www.asx.com.au>) contains valuable information about the ASX and the ASX listed companies. This website is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

There are also a number of other licensed market operators which mostly cater for smaller or specialised listings. These include the National Stock Exchange of Australia (NSX) and Cboe Australia (CXA).



Listed companies are regulated by both the *Corporations Act* as well as the ASX Listing Rules.

ASX listed companies are regulated by the *Corporations Act* and are also required to comply with the even more detailed disclosure and other obligations imposed by the ASX Listing Rules. The ASX Listing Rules deal with such matters as admission to the list and disclosure of information. The Listing Rules are set out on the ASX website which is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

Other licensed market operators also have Listing Rules and are regulated in the same way as the ASX.

The main reason public companies choose to be listed and become more heavily regulated is that they have a greater ability to raise capital. Listing gives shareholders a better opportunity to sell their shares and enhances the ability of potential investors to acquire shares and thus broaden the company's shareholder base. Listed companies have a higher public profile with their customers and suppliers who often perceive listed companies as having greater financial strength.

To gain ASX listing, a public company must satisfy the various requirements in *ASX Listing Rule 1*. These detailed requirements include a minimum shareholder requirement and a company size requirement. The minimum shareholder requirement seeks to make sure that there are enough shareholders to make a market for share trading and the company size requirement ensures that listed companies have a history of profits or have significant assets apart from cash.

There are two alternative minimum shareholder requirements that a company must meet. These are that the company has:

- a minimum of 300 non-affiliated shareholders, each holding a parcel of shares with a value of at least \$2,000; and
- a free float of at least 20 per cent of shares held by non-affiliated shareholders.

The company size requirement may be satisfied by either a profits test (aggregated profit of at least \$1 million from continuing operations for the last three financial years and \$500,000 from continuing operations over the last 12 months) or an assets test (net tangible assets of at least \$4 million or \$15 million market capitalisation).

The *Corporations Act* imposes additional disclosure requirements on listed companies. For example, under s 300A, the directors' report of listed companies must include specified information about remuneration of directors and other key management personnel: see [12.305]–[12.310].

Listed companies are disclosing entities and must comply with both periodic reporting and continuous disclosure obligations.

Listed companies are “disclosing entities” as defined in Pt 1.2A. The definition of “disclosing entity” is complex but corresponds in most cases to listed entities. Under s 111AC, a body is regarded as a disclosing entity if any of its securities (for example,

shares) are enhanced disclosure securities (ED securities). Securities are ED securities if they are securities of a body that is included in a licensed market's official list: s 111AE. The definition of disclosing entity is further discussed at [22.125].

Disclosing entities are subject to an enhanced disclosure scheme. The enhanced disclosure scheme has two main features:

- periodic reporting; and
- continuous disclosure.

The *Corporations Act* requires disclosing entities to prepare and lodge half-year financial reports as well as annual financial reports. In addition, ASX listed companies must comply with the periodic disclosure requirements in *ASX Listing Rule 4*. The periodic reporting requirements in the *Corporations Act* and *ASX Listing Rule 4* are discussed at [22.130].

In addition, disclosing entities are subject to the continuous disclosure requirements of Ch 6CA which requires a disclosing entity to disclose information that a reasonable person could be taken to expect would have a material effect on the price or value of its securities. For example, ASX listed disclosing entities must comply with the continuous disclosure requirements in *ASX Listing Rule 3.1*: s 674. Under that listing rule, the continuous disclosure information must be provided to the ASX, which makes it available to the public. The continuous disclosure requirements are further discussed at [22.135]–[22.145].

Prospectuses issued by listed disclosing entities do not have to be as detailed as prospectuses of other corporations: s 713. This is because the enhanced disclosure scheme requires ASX listed disclosing entities to disclose information to the ASX which would be likely to have a material effect on the price of their securities. Consequently, much of the information that would normally be required to be contained in prospectuses issued by listed disclosing entities is already known to potential investors. Prospectuses are discussed at [7.100]–[7.120].

Disclosure of governance practices of ASX listed companies.

The ASX Listing Rules also regulate the governance practices of ASX listed companies. For example, under *Listing Rule 4.10.3* the annual reports of listed companies must disclose the extent to which the company has followed the *ASX Corporate Governance Principles and Recommendations* (4th ed). These are discussed at [14.30] onwards.

The ASX Listing Rules contain various enhanced shareholder protection mechanisms. For example, under *ASX Listing Rule 7*, significant changes in share capital and new issues require shareholder approval. Under *ASX Listing Rule 10*, shareholder approval is also required for significant company transactions with persons in a position of influence such as directors or major shareholders.

## **Holding and subsidiary companies – related bodies corporate**

[3.130] The *Corporations Act* classifies companies as holding and subsidiary companies. AASB 10 *Consolidated Financial Statements* requires a parent entity that controls one or

more subsidiaries to present consolidated financial statements. The AASB 10 definitions of the terms “parent” and “subsidiary” for purposes of that accounting standard are based upon the concept of control and are different from the *Corporations Act* definitions: see [3.135].

Despite not being relevant for the purposes of the accounting standards, the holding and subsidiary company classification as defined in the *Corporations Act* still has application in certain contexts.

Significance of holding company and subsidiary classification.

The *Corporations Act* definitions apply:

- under s 260A(1), a company may financially assist a person to acquire shares in itself or its holding company only if certain requirements are met (see [8.325]–[8.375]);
- under ss 588V–588X, a holding company may be personally liable for debts incurred by its insolvent subsidiary if at the time the debts were incurred there were reasonable grounds for suspecting that the subsidiary was insolvent (this is discussed at [2.195]); and
- under s 202B, a company must disclose the remuneration paid to each director of the company or a subsidiary by the company or by a controlled entity if directed to do so by members holding at least 5 per cent of voting shares or at least 100 members.

## Definition of subsidiary

**[3.135]** The term “holding company” is not defined directly in the *Corporations Act*. Instead, ss 9 and 46 define whether a body corporate is a subsidiary of another body corporate (the holding company).

Under s 46(a), a body corporate is regarded as a subsidiary of another body corporate if, and only if, the other body:

- controls the composition of the board of directors of the subsidiary (s 46(a)(i));
- 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 subsidiary (s 46(a)(ii)); or
- holds more than one-half of the issued share capital of the subsidiary: s 46(a)(iii).

Shares that carry no right to participate beyond a specified amount in a distribution of either profits or capital are not counted. Preference shares usually fall within this excluded category.

The subsidiary of a holding company that is itself a subsidiary of another body corporate, is regarded as a subsidiary of that other body corporate: s 46(b).

## Control of composition of board

**[3.140]** For the purposes of s 46(a)(i), the composition of the board of directors is taken to be controlled by another body corporate if the other body can exercise a power to

appoint or remove all or a majority of the directors: s 47. This power must be a legally enforceable power to control the composition of the board of directors and not practical or de facto control that arises because of a significant shareholding in a company: *Mount Edon Gold Mines (Aust) Ltd v Burmine Ltd* (1994) 12 ACLC 185.

### *Position to cast or control the casting of the majority of votes*

**[3.145]** Section 46(a)(ii) has two alternative tests for determining whether a company is a subsidiary of another. A company is a subsidiary if another company:

- is in the position to cast more than half the maximum number of votes that might be cast at a general meeting of the company; or
- controls the casting of more than half the maximum number of votes that might be cast at a general meeting of the company.

The second test in s 46(a)(ii) – the “control” test – is satisfied if a company has a legally enforceable power to control the casting of the necessary number of votes required. However, according to *Bluebird Investments Pty Ltd v Graf Holdings Pty Ltd* (1994) 12 ACLC 724, certain arrangements falling short of control will satisfy the first test in s 46(a)(ii) – the “position to cast” test. For example, a company is in a position to cast the required percentage of votes if it has a present ability to cast the votes. This would be the case if the company held open proxies enabling it to cast more than 50 per cent of the votes at a general meeting of another company.

### *Holding more than half issued capital*

**[3.150]** Under s 46(a)(iii), a company is regarded as a subsidiary if another company holds more than half its issued capital. A company “holds” shares if it is a registered member. Shares in a subsidiary held by a nominee on trust for the holding company are treated as being held by the holding company: s 48(3). On the other hand, where a company is merely holding the shares in a fiduciary capacity, such as a trustee, the shares are not treated as being held by a holding company: s 48(2).

## **Deficiencies of definition**

**[3.155]** The s 46 definition of subsidiary company contains significant loopholes. For example, a company may have de facto control over another without that other company falling within the s 46 definition of subsidiary company. Further, under s 46, only bodies corporate are capable of being classified as subsidiaries. Under previous group accounting provisions, an unincorporated entity, such as a trust, could not be considered as a subsidiary even though it was controlled by the holding company. As a result, the trust’s assets and liabilities did not have to be consolidated in the group’s balance sheet. These “off-balance sheet” devices were sometimes used so that members and other users of accounts did not receive meaningful information of the “group’s” overall financial position. This led to the introduction of entity-based reporting in the accounting standards which adopts the broader concept of control.

## Ultimate holding company

**[3.160]** A body corporate is defined in s 9 as an ultimate holding company of another if:

- that other body corporate is a subsidiary of that holding company; and
- the holding company is not itself a subsidiary of another.

Where applicable, the annual return must give particulars of the company's ultimate holding company.

## Wholly owned subsidiary

**[3.165]** A body corporate is a wholly owned subsidiary if none of its members is a person other than:

- its holding company;
- a nominee of its holding company;
- another wholly owned subsidiary of the holding company; or
- a nominee of such a wholly owned subsidiary.

Under s 187, discussed at [15.100], a director of a wholly owned subsidiary is taken to act in good faith in the best interests of the subsidiary if:

- the constitution authorises the director to act in the interests of the holding company;
- the director acts in good faith in the best interests of the holding company; and
- the subsidiary remains solvent.

An issue or transfer of shares of a company to an entity it controls is void unless the transfer is by a wholly owned subsidiary and the entity is also a wholly owned subsidiary of the same body corporate: s 259C(1)(d).

## Related bodies corporate

**[3.170]** Under s 50 where a body corporate is:

- a holding company of another body corporate;
- a subsidiary of another body corporate; or
- a subsidiary of a holding company of another body corporate

all the companies are related to each other.

## Foreign companies

**[3.175]** A body corporate incorporated outside Australia is referred to as a “foreign company” and is not permitted to carry on business in Australia unless it is registered with ASIC: s 601CD. Once a foreign company is registered with ASIC it may carry on business in Australia without any additional requirements.

## Registrable Australian bodies

**[3.185]** Under s 57A, the term “corporation” includes bodies incorporated or formed under specific State or Territory legislation. These include incorporated associations, co-operatives, building societies and credit unions. Such bodies are referred to in s 9 as “registrable Australian bodies”.

As long as a registrable Australian body carries on business exclusively in the State or Territory of its formation it need not become registered under the *Corporations Act*.

A registrable Australian body must not carry on business outside the State or Territory of its origin unless it is registered under Pt 5B.1.

To be registered, a registrable Australian body must lodge an application for registration with ASIC using the prescribed form. The application must be accompanied by the documents referred to in s 601CB.

## Trustee companies

### Types of trustee companies

**[3.190]** Trustee companies serve a variety of commercial purposes. For example, the States and Territories have legislation that empowers a small number of companies to act as executors and personal representatives of deceased estates. These statutory trustee companies have a high degree of skill and experience in administering trusts. They are required by legislation to have substantial asset backing and in some States the liability of their members is greater than in the case of ordinary companies limited by shares. Because of the nature of their activities, they are entitled to charge fees for their services. Apart from acting as executors, statutory trustee companies often administer other types of trusts. For example, they are eligible for appointment as trustees for debenture-holders: s 283AA(1). This is discussed at [11.40]. In addition, because of their recognised integrity and skill, they are often appointed to act as trustees of public unit trusts and as responsible entities of managed investment schemes, discussed in Chapter 20.

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| Regulation of trustee companies. |
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Since 2009, these types of trustee companies have been regulated under the *Corporations Act*. Among other things, authorised trustee companies are required to hold an Australian financial services licence, and “traditional trustee company services” are included within “financial services”. As a result, the activities of authorised trustee companies are regulated in the same way as those of other providers of financial services. This is discussed at [26.75]–[26.110].

Most banks and other financial service providers operate associated trustee companies. These are not statutory trustee companies as described above. For a fee, they hold investments, usually shares, as nominees for clients who for various reasons wish to remain anonymous.

## Discretionary trusts.

There are many proprietary companies formed with minimal issued capital, commonly referred to as “\$2 companies”. Typically, such companies are formed to act as trustees of trusts that own family investments or operate family businesses. The most popular type of family trust is the discretionary trust in which the trustee is given a discretion to distribute trust income and capital among a nominated class of beneficiaries. The trustee company’s directors can control the trust through the exercise of the trustee’s discretionary powers.

Discretionary trusts allow for greater flexibility for income-splitting than companies. Trustees of discretionary trusts are usually able to vary the amounts of trust income to be distributed to particular beneficiaries from year to year. While variable distributions of dividends to members holding different classes of shares are possible, the tax legislation discourages the practice.

Companies are usually appointed to act as trustees of family discretionary trusts for several reasons. As explained at [2.15], companies continue to exist until deregistered by ASIC. This avoids the need to replace human trustees when they die. Another reason companies are selected is to ensure limited liability for trust debts.

## Trustees’ right of indemnity

**[3.195]** According to trust law, trustees are personally liable to trust creditors for the debts and liabilities properly incurred in administering the trust investments or carrying on its business. If trustees pay trust debts or liabilities from their own personal resources, they are entitled to be reimbursed from the assets of the trust. In some situations trustees have the right to be reimbursed by the beneficiaries themselves: *JW Broomhead (Vic) Pty Ltd v JW Broomhead Pty Ltd* (1985) 3 ACLC 355. This right is referred to as a “right of reimbursement”.

Trustees, however, are not required to pay trust creditors from their own resources and then reimburse themselves. They are permitted to pay trust debts and liabilities directly from trust assets. This right is referred to as a “right of exoneration”.

A trustee’s rights of reimbursement and exoneration are collectively known as a “trustee’s right of indemnity”. The right of indemnity is regarded as an asset of a trustee. Accordingly, if a trustee is a “\$2 company”, its right of indemnity will be the only meaningful asset it has to meet the claims of trust creditors.

## Liability of directors of trustee companies

**[3.200]** A trustee’s right of indemnity is not always available. It is lost if the trustee breaches the trust while incurring debts or liabilities. For example, there will be a breach of trust if the trustee invests trust assets in unauthorised investments or if the trustee acts carelessly.

The loss of the right of indemnity due to a breach of trust can cause considerable hardship to trust creditors, particularly if the trustee has no other assets to meet the

creditors' claims. This is usually the case with \$2 companies. Trust creditors bear the loss despite the fact that they have no way of knowing that the trustee has breached the trust.

The hardship to trust creditors has to some extent been alleviated by s 197. In the following limited circumstances, s 197 makes directors of trustee companies individually and jointly liable with the company for a liability incurred by their company while it acts as a trustee:

- the trustee company has not and cannot discharge the liability; and
- the trustee company is not entitled to be fully indemnified against the liability out of the trust assets solely because of any one or more of the following:
  - a breach of trust by the company;
  - the company's acting outside the scope of its powers as trustee; or
  - a term of the trust denying or limiting the company's right to be indemnified against the liability.

Section 197 makes it clear that trustee company directors may be personally liable under that section only if their company cannot pay trust debts *and* the company is not entitled to pay those liabilities from trust assets because its right of indemnity is lost for the reasons specified in s 197(1)(b)(i)–(iii). Consequently, a trustee company director is not personally liable for the trustee company's liabilities merely because the trust is insolvent. Trustee company directors may, however, become personally liable if they breach s 588G by failing to prevent the company incurring debts when there are reasonable grounds for suspecting it is insolvent. This is discussed at [18.100]–[18.245].

Section 197 applies only to the recovery of debts incurred by the corporate trustee in performance of the trust and not to any claim by beneficiaries for breach of trust: *Cole v Tillman* [2015] FCA 1512.

The liquidation of trustee companies raises some particular issues and these are discussed at [32.715]–[32.760].

## Tutorial questions

1. Abe was recently appointed company secretary of Mich-Phil Autos Pty Ltd, the operator of a successful used car dealership. Abe noticed that Mich-Phil Autos Pty Ltd did not prepare annual financial statements for the previous financial year.
  - (a) Explain whether or not Mich-Phil Autos Pty Ltd needs to prepare annual financial statements for the current financial year.
  - (b) To what extent, if at all, would your answer be different if Mich-Phil Autos was a public company?
2. For the past year Dr Nick Riviera, a bio-geneticist, and 25 of his colleagues at the Hollywood Upstairs Medical College have been working on a research project in their spare time to develop genetically modified brussels sprouts that taste like chocolate. While they believe that their project has the potential to earn significant amounts of money, considerable additional research and development is still required. Indeed, early testing of the genetically modified brussels sprouts caused the internal organs of



laboratory rats to melt. If the development of the genetically modified brussels sprouts is successful Dr Nick Riviera envisages that thousands of people may want to invest in the venture.

Advise Dr Nick Riviera about the most suitable type of company for his brussels sprouts project.

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.



## Chapter 4

# Constitution and replaceable rules

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## Key points

- A company's corporate governance and internal administration may be governed by replaceable rules contained in the *Corporations Act 2001* (Cth) (*Corporations Act*) or by a constitution or by a combination of both.

- A company has the legal capacity and powers of both an individual and a body corporate. Acts of a company are not invalid just because they are contrary to or beyond any objects stated in its constitution.
- According to s 140(1), a company's constitution (if any) and any applicable replaceable rules have effect as a contract between:
  - the company and each member;
  - the company and each director and secretary; and
  - a member and each other member.
- Subject to certain restrictions, a company's constitution may be modified or repealed if its members pass a special resolution to that effect: s 136(2). A company may adopt by special resolution constitutional provisions that displace or modify any or all applicable replaceable rules: s 135(2).
- There are several limits on the right of a company to alter its constitution. The courts have been particularly protective of members where an alteration is made for the purpose of expropriating or compulsorily acquiring a member's shares. The *Corporations Act* allows compulsory acquisitions in certain cases provided specified procedures are followed.

## Rules governing internal management

**[4.05]** Companies have considerable flexibility in deciding the rules that govern their internal relationships and processes. Typically, these rules deal with such matters as the appointment and powers of directors, procedure of meetings of directors and shareholders, rights of shareholders and the share transfer process.

A company's internal administration may be governed by replaceable rules or by a constitution or by a combination of both.

A company's internal administration may be governed by replaceable rules contained in the *Corporations Act 2001* (Cth) (*Corporations Act*) or by a constitution or by a combination of both: s 134.

## Replaceable rules

**[4.10]** The *Corporations Act* contains a set of rules called “replaceable rules” that govern the internal administration and corporate governance of companies. The replaceable rules, contained in the *Corporations Act*, apply to companies formed after July 1998 and those companies formed before that date which have repealed their constitutions: s 135(1)(a) (i) and (ii). As the name suggests, the rules are replaceable, in that they are default rules that will apply to a company unless the company chooses to adopt alternative rules. A company may be registered with a constitution that replaces or modifies any one or all of the replaceable rules: s 135(2). For example, in *Wambo Coal Pty Ltd v Sumiseki Materials Co Ltd* [2014] NSWCA 326, it was held that the replaceable rule contained in s 254U, which confers the usual discretion on directors to determine that a dividend is payable, did not apply as it had been replaced by a constitutional provision that made payment of a dividend to a particular shareholder mandatory.

The replaceable rules are also subject to any provisions contained in a shareholder joint venture agreement. In *Eastone Mining Pty Ltd v Eastone Holding Pty Ltd* [2019] NSWSC 1850, it was held that the removal of a director could only occur in accordance with a shareholder agreement, despite the replaceable rule in s 203C. Similarly, the agreement, which required the attendance of a nominee director to constitute a quorum, also displaced the replaceable rule in s 248F which requires any two directors to be present at directors' meetings. The agreement stood as if part of the company's constitution as it was adopted by all the members, and so displaced the replaceable rules.

The replaceable rules do not apply to a company formed prior to 1998 which has retained its constitution. They apply to a pre-1998 company only if it has repealed its constitution and has not replaced it with another: s 135(1)(a)(ii). There is therefore no direct reference in the legislation to the position of a pre-1998 company which has repealed only part of its constitution. While it is not entirely clear, it would appear that in such a case, the replaceable rules would not apply at all and the constitution of such a company would comprise the remaining provisions contained in its constitution (known as “articles of association” prior to 1998), and any gaps not otherwise provided for are deemed to be governed by the provisions of the default articles of association contained

in the former Table A, which have not been modified or excluded. The historical effect of Table A and its repeal are discussed at [4.35].

The heading of a section specifies whether it is a replaceable rule.

The heading of a section containing a replaceable rule specifies whether that section is a replaceable rule. The headings of relevant replaceable rule sections also indicate the type of company to which a particular replaceable rule applies.

Most replaceable rules apply to both public and proprietary companies. However, according to s 135, some replaceable rules apply only to proprietary companies. For example, the replaceable rule in s 194, which deals with proprietary company directors voting at board meetings on matters involving directors’ personal interests, is a proprietary company replaceable rule. Some sections are regarded as replaceable rules for proprietary companies but are mandatory rules for public companies. For example, s 249X, which deals with the appointment of proxies, is a replaceable rule for proprietary companies but mandatory for public companies. A mandatory rule overrides any contrary provision in a public company’s constitution.

According to s 135(3), a failure to comply with applicable replaceable rules is not of itself a contravention of the *Corporations Act*. As a result, the provisions in the *Corporations Act* regarding criminal liability, civil liability and statutory injunctions do not apply to breaches of the replaceable rules. Consequently, a person affected by a contravention of a replaceable rule does not have standing to apply for a statutory injunction under s 1324 (see [24.305]–[24.325]) as this section only applies to contraventions of the *Corporations Act*. However, an injunction may be sought on the basis of a breach of the statutory contract established by s 140: *Smolarek v Liwszyc* [2006] WASCA 50.

Table of replaceable rules

[4.15] Section 141 contains the following table which lists the provisions of the *Corporations Act* that apply as replaceable rules.

Table 4.1: Provisions that apply as replaceable rules

|   | OFFICERS AND EMPLOYEES                                                     |      |
|---|----------------------------------------------------------------------------|------|
| 1 | Voting and completion of transactions – directors of proprietary companies | 194  |
| 2 | Powers of directors                                                        | 198A |
| 3 | Negotiable instruments                                                     | 198B |
| 4 | Managing director                                                          | 198C |
| 5 | Company may appoint a director                                             | 201G |
| 6 | Directors may appoint other directors                                      | 201H |
| 7 | Appointment of managing directors                                          | 201J |
| 8 | Alternate directors                                                        | 201K |
| 9 | Remuneration of directors                                                  | 202A |

|     |                                                                                                      |         |
|-----|------------------------------------------------------------------------------------------------------|---------|
|     | <b>OFFICERS AND EMPLOYEES</b>                                                                        |         |
| 10  | Director may resign by giving written notice to company                                              | 203A    |
| 11  | Removal by members – proprietary company                                                             | 203C    |
| 12  | Termination of appointment of managing director                                                      | 203F    |
| 13  | Terms and conditions of office for secretaries                                                       | 204F    |
|     | <b>INSPECTION OF BOOKS</b>                                                                           |         |
| 14  | Company or directors may allow member to inspect books                                               | 247D    |
|     | <b>DIRECTORS' MEETINGS</b>                                                                           |         |
| 15  | Circulating resolutions of companies with more than 1 director                                       | 248A    |
| 16  | Calling directors' meetings                                                                          | 248C    |
| 17  | Chairing directors' meetings                                                                         | 248E    |
| 18  | Quorum at directors' meetings                                                                        | 248F    |
| 19  | Passing of directors' resolutions                                                                    | 248G    |
|     | <b>MEETINGS OF MEMBERS</b>                                                                           |         |
| 20  | Calling of meetings of members by a director                                                         | 249C    |
| 21  | Notice to joint members                                                                              | 249J(2) |
| 22  | When notice by post or fax is given                                                                  | 249J(4) |
| 22A | When notice under paragraph 249J(3)(cb) is given                                                     | 249J(5) |
| 23  | Notice of adjourned meetings                                                                         | 249M    |
| 24  | Quorum                                                                                               | 249T    |
| 25  | Chairing meetings of members                                                                         | 249U    |
| 26  | Business at adjourned meetings                                                                       | 249W(2) |
| 27  | Who can appoint a proxy [ <i>replaceable rule for proprietary companies only</i> ]                   | 249X    |
| 28  | Proxy vote valid even if member dies, revokes appointment etc                                        | 250C(2) |
| 29  | How many votes a member has                                                                          | 250E    |
| 30  | Jointly held shares                                                                                  | 250F    |
| 31  | Objections to right to vote                                                                          | 250G    |
| 32  | How voting is carried out                                                                            | 250J    |
| 33  | When and how polls must be taken                                                                     | 250M    |
|     | <b>SHARES</b>                                                                                        |         |
| 33A | Pre-emption for existing shareholders on issue of shares in proprietary company                      | 254D    |
| 33B | Other provisions about paying dividends                                                              | 254U    |
| 34  | Dividend rights for shares in proprietary companies                                                  | 254W(2) |
|     | <b>TRANSFER OF SHARES</b>                                                                            |         |
| 35  | Transmission of shares on death                                                                      | 1072A   |
| 36  | Transmission of shares on bankruptcy                                                                 | 1072B   |
| 37  | Transmission of shares on mental incapacity                                                          | 1072D   |
| 38  | Registration of transfers                                                                            | 1072F   |
| 39  | Additional general discretion for directors of proprietary companies to refuse to register transfers | 1072G   |

## One-person proprietary companies

**[4.20]** As a practical matter, a proprietary company with a single shareholder who is also the sole director does not need formal rules governing its internal administration. Section 135(1) recognises this, providing that the replaceable rules do not apply to such companies. These companies also do not need a constitution.

Instead of a constitution or replaceable rules, the *Corporations Act* has a number of rules that apply specifically to single director/shareholder proprietary companies. These include the following:

- The business of the company is to be managed by or under the direction of the director who may also exercise all the powers of the company such as the power to issue shares, borrow money and issue debentures: s 198E(1).
- The director may execute a negotiable instrument: s 198E(2).
- The director may appoint another director by recording the appointment and signing the record: s 201F.
- The director is to be paid any remuneration for being a director that the company determines by resolution: s 202C.

These rules apply only while the company is a single director/shareholder proprietary company. The replaceable rules become applicable as soon as the company issues shares to another person or appoints additional directors.

## Companies limited by guarantee

**[4.25]** Many replaceable rules, such as those that deal with dividends or transfer and transmission of shares, are not applicable to a company limited by guarantee. Consequently, the internal administration of these types of companies cannot be governed solely by the replaceable rules, and such companies require a constitution.

While companies limited by guarantee require a constitution, their internal rules may be governed by a combination of both the rules in their constitution as well as selected replaceable rules.

## No liability companies

**[4.30]** The internal administration of a no liability company cannot be governed solely by the replaceable rules. Section 112(2) requires a no liability company to have a constitution that states that:

- its sole objects are mining purposes; and
- the company has no contractual right to recover calls made on its shares from a shareholder who fails to pay them.

While no liability companies must have a constitution providing for these requirements, their internal rules may be governed by a combination of the rules in their constitution as well as selected replaceable rules.



## Repeal of Tables A and B

**[4.35]** Prior to 1998, companies other than companies limited by guarantee were deemed to have adopted the regulations in Table A of Sch 1 of the pre-1998 legislation as their articles of association unless they were specifically excluded or modified by their own constitutions. Table B of Sch 1 of the pre-1998 legislation contained the equivalent provisions for no liability companies.

The regulations in Tables A and B were repealed in 1998. Companies formed after 1998 are no longer deemed to have adopted the Table A or Table B articles as their default constitutions. However, if a pre-1998 company adopted Table A or B articles, those regulations still apply if it has not subsequently repealed its constitution.

## The company's constitution

**[4.40]** Prior to July 1998, all companies were required to have a constitution consisting of two documents – the memorandum of association and the articles of association. If a pre-1998 company has retained its memorandum and articles, these documents are still regarded as comprising the company's constitution.

Companies formed after July 1998 have a choice regarding the rules governing their internal administration. Under s 134, those rules may comprise a constitution specifically drafted to suit a company's particular needs, or the replaceable rules in the *Corporations Act* or a combination of both. The constitution of a post-1998 company consists of a single document rather than the previous division of the constitution into two documents. In particular, the requirement to have a memorandum of association has been abolished. Most of the information that previously was required to be contained in the memorandum is now set out in a company's application for registration. This is discussed at [2.410].

## Statutory requirements

**[4.45]** Companies may adopt a constitution in any one of the following three ways:

- a new company may adopt a constitution on registration if the persons named in the application for the company's registration as having consented to become members agree in writing to the terms of the constitution before the application is lodged (s 136(1)(a)); or
- a company that is registered without a constitution may adopt one by passing a special resolution (s 136(1)(b)); or
- a court order is made under s 233 (the oppression remedy, discussed at [24.15]–[24.280]) that requires the company to adopt a constitution: s 136(1)(b).

Public companies that have a constitution are required to lodge a copy with ASIC. A copy of the constitution and relevant special resolutions must be lodged within 14 days of the company adopting or modifying the constitution: s 136(5). If a member makes a written request, a company must send a copy of its constitution to that member within seven days: s 139.

## Contents of constitution

**[4.50]** Except in the case of certain types of companies, the *Corporations Act* does not prescribe what information must be contained in a company's constitution. Typically, a constitution sets out the rules governing matters such as the rights of members, the conduct of members' and directors' meetings, powers of directors and their appointment, removal and remuneration. The replaceable rules listed at [4.15] serve as an indication of the type of rules that are usually contained in a company's constitution.

If a company limited by guarantee wishes to omit the word "Limited" in its name, s 150(1) provides that the company must be a registered charity as defined in s 25-5(5) of the *Australian Charities and Not-for-profits Commission Act 2012* (Cth), and its constitution must:

- prohibit the company paying fees to its directors; and
- require the directors to approve all other payments the company makes to directors.

Section 112 requires the constitution of a no liability company to state that its sole objects are mining purposes and that the company has no contractual right to recover calls made on its shares from a shareholder who fails to pay them.

Listed companies must have a constitution that is consistent with the ASX Listing Rules: *ASX Listing Rule* 15.11. For example, a listed company's constitution must contain provisions that facilitate electronic share trading and the CHES electronic settlement and transfer system that the ASX operates. This is discussed at [9.225]. Other examples include provisions in a constitution that:

- the company has only one class of ordinary shares (*ASX Listing Rule* 6.2); and
- shareholders have one vote per share on a poll (*ASX Listing Rule* 6.9).

## Interpretation of constitution

**[4.55]** Constitutions are regarded by the courts as business documents that are to be interpreted objectively, by reference to what a reasonable business person, in the position of the parties, would have understood the constitution to mean. The courts interpret their provisions in a similar way to commercial contracts so as to give them a "business like interpretation": *Dome Resources NL v Silver* [2008] NSWCA 322.

Courts are reluctant to imply further terms or permit evidence of an intention to depart from or add to the written provisions as this increases uncertainty and detracts from the entitlement of shareholders and others to rely on the written constitution as containing the full and complete constitution: *Lion Nathan Australia Pty Ltd v Coopers Brewery Ltd* [2006] FCAFC 144. In this case, it was held that a shareholder could not rely on pre-emptive rights contained in the company's constitution to prevent a share buy-back from proceeding because the pre-emptive rights did not extend to share buy-backs. This was despite a clear statement in the constitution which prohibited any transfers of shares by shareholders and the registration of such transfers by the directors without compliance with the pre-emptive rights.

## Objects clause

**[4.60]** A company's constitution may contain an objects clause that identifies and restricts the businesses and activities in which the company may engage: s 125(2).

Prior to 1984, all companies had to have an objects clause in their constitution. Some companies formed before 1984 may have retained their objects clause. This requirement is now optional although some companies formed after 1984 may still choose to include objects in their constitutions. This may be because the company was formed for particular purposes such as to carry out a joint venture or a not-for-profit purpose and its members did not want the company to depart from these purposes.

While no longer compulsory, a statement of a company's objects in its constitution may serve a useful function for some companies as it indicates to members the nature of its activities and purposes and prevents the directors departing from them.

## Legal capacity and powers of a company

**[4.65]** Historically, companies were regarded as having limited legal capacity. They were once legally capable of engaging only in those businesses and activities specified in the objects clause of their constitutions. Companies no longer have limited legal capacity and now have the same legal capacity as a human being: s 124.

### Section 124

**[4.70]** A company has the legal capacity and powers of an individual: s 124(1). This means that it is able to engage in any business or activity and may acquire and exercise rights in the same way as a natural person.

Section 124(1) also gives a company certain applicable powers. It has all the powers of a body corporate, including the power to:

- issue and cancel shares (this power does not apply to a company limited by guarantee);
- issue debentures;
- grant options over unissued shares in the company;
- distribute any of the company's property among members, in kind or otherwise;
- grant a security interest in uncalled capital; and
- grant a circulating security interest over the company's property.

A company's legal capacity to do something is not affected by the fact that the company's interests are not served by doing a particular thing: s 124(2). This section aims to protect outsiders by enabling them to enforce contracts with a company even though the contract involved an abuse of power by the company's directors or controlling shareholders.

## Abolition of doctrine of ultra vires

[4.75] Historically, a company's objects clause was regarded as the most important part of its memorandum of association – a key component of its constitution. Companies were once regarded as being capable of legally engaging only in those businesses and activities set out in the objects clause. Any company contract or transaction that was not within the scope of one of its objects was referred to as *ultra vires*, or beyond the power of the company. The doctrine of *ultra vires* stated that such contracts or transactions were void and had no legal effect: *Ashbury Railway Carriage & Iron Co v Riche* (1875) LR 7 HL 653.

Under the doctrine of *ultra vires*, companies were once legally capable of engaging only in those activities set out in the objects clause.

The doctrine of *ultra vires* operated together with the doctrine of “constructive notice”. This meant that people dealing with a company were regarded as being aware of a company's objects merely because they were set out in its constitution, which was lodged with the registering authority and hence available for inspection by the public. The doctrine of constructive notice has been abolished in most respects by s 130. A person is not taken to have information about a company merely because the information is available to the public from ASIC.

The original purpose of the doctrine of *ultra vires* was to protect a company's shareholders and creditors. Shareholders were considered to have a right to expect that their capital would be used only for the objects specified in the company's constitution. The doctrine aimed to protect creditors by ensuring that their loans to the company would only be used for the purposes of its stated objects. Despite these aims, a strict application of the *ultra vires* doctrine often resulted in the intention of the parties to a contract being thwarted by the application of a technical, unrealistic rule. It enabled both the company and the other contracting party to avoid an *ultra vires* contract and so effectively promoted commercial uncertainty.

The doctrine of *ultra vires* has been abolished by the combined effect of ss 124 and 125. The doctrine could only have application to a company whose constitution contained an objects clause or other self-imposed restriction or prohibition on the exercise of its powers. The *Corporations Act* no longer requires a company to have an objects clause in its constitution. Indeed, as a result of 1998 amendments, a company does not even need a constitution as the replaceable rules may entirely govern its internal administration. All companies have the legal capacity and powers of an individual: s 124(1).

A contract is now not void merely because it is contrary to or beyond any of the company's objects.

If a company has an objects clause, s 125(2) provides that an act is not invalid merely because it is contrary to or beyond any of its objects. Further, if a company's constitution contains an express restriction or prohibition on the exercise of any of its powers, the exercise of such a power is not invalid merely because it is contrary to such an express restriction or prohibition: s 125(1).

In *Hillig v Darkinjung* [2006] NSWSC 594, Austin J drew a distinction between restrictions on the exercise of powers by a company and restrictions imposed on the company's directors or members in a general meeting. In this case, a special majority vote was required under the constitution to remove directors. Several directors were removed without the requisite majority. It was held that the provision in the constitution was a restriction on the powers of the members in a general meeting, and so s 125(1) did not apply to validate the removal of the directors because this concerned the internal rules of the company. Section 125(1) only operates in the context of the abolition of the *ultra vires* doctrine in relation to dealings between a company and outsiders.

Contraventions of a company's constitution may have other consequences even though they cannot affect the validity of the company's contracts. Allegations that a company acted contrary to its objects or other restrictions or prohibitions in the company's constitution may be an element in a legal action against the company's directors for breach of duty. A failure to comply with the constitution may also be contrary to the interests of members as a whole or oppressive and allow a member to seek a remedy under s 233: see [24.15]. It may also allow a member to obtain an order for the winding up of the company on the just and equitable ground (s 461(1)(k)): see [24.360].

## Effect of constitution and replaceable rules

### Contractual effect

[4.80] Section 140(1) provides that a company's constitution (if any) and any replaceable rules that apply to a company have effect as a contract between:

- the company and each member (s 140(1)(a)); and
- the company and each director and company secretary (s 140(1)(b)); and
- a member and each other member (s 140(1)(c));

under which each person agrees to observe and perform the constitution and rules as far as they apply to that person.

The construction of the constitution is an objective exercise in which the general principles of construction of commercial contracts applies: *Donaldson v Natural Springs Australia Ltd* [2015] FCA 498.

The s 140(1) statutory contracts have certain features that depart from ordinary principles of contract law. The construction of commercial contracts generally takes into account the understanding of what a reasonable person would have taken the contract to mean. This may require consideration of the surrounding circumstances and a determination of the purpose and object of the transaction: *Pacific Carriers Ltd v BNP Paribas* (2004) 218 CLR 451. The construction of a company constitution primarily focuses on the objective intention discernible from the language used: *HNA Irish Nominee Ltd v Kinghorn* [2010] FCAFC 47. It involves less consideration of surrounding circumstances than is normally the case with commercial contracts because outsiders are more reliant on the written document and will often have no knowledge of the surrounding circumstances: *Lion Nathan Australia Pty Ltd v Coopers Brewery Ltd* [2006] FCAFC 144.

Ordinarily, contracts cannot be altered without the consent of all the parties. This is not the case with the s 140(1) contracts. A company may modify or repeal its constitution, or a provision of its constitution, by special resolution of its members: s 136(2). This means that the terms of the s 140(1)(a) and (c) contracts are alterable, and the alteration will bind even those members who voted against the alteration. Similarly, the terms of the s 140(1)(b) contract can be altered by a special resolution of members, and the alteration will bind the company's directors and secretary: *NRMA Ltd v Snodgrass* [2001] NSWSC 76.

The main purpose of s 140 is to provide a way for the parties to the statutory contracts to enforce compliance with a company's constitution (if any) and any replaceable rules that apply. For example, shareholders can assert a breach of the s 140(1)(a) contract if a company does not comply with provisions in its constitution that apply to shareholders. While damages are the usual remedy sought for breach of contract, this is not the case with the s 140(1) contracts. The appropriate remedy is usually a court injunction or declaration to enforce compliance with the constitution or applicable replaceable rules.

The contractual rights under s 140(1) do not apply to by-laws made under a power conferred by the constitution: *Wilcox v Kogarah Golf Club Ltd* (1996) 14 ACLC 415. By-laws are detailed rules by which particular constitutional powers are implemented but do not have the same status under s 140(1) as the company's constitution.

## Contract between company and members

**[4.85]** Section 140(1)(a) provides that a company's constitution (if any) and any applicable replaceable rules have effect as a contract between the company and each member. One consequence of this is that the company can take action against its members to force them to comply with the provisions in the constitution or applicable replaceable rules where they are unwilling to do so voluntarily. This was the situation in *Hickman v Kent or Romney Marsh Sheep-Breeders' Assoc* [1915] 1 Ch 881.

*Hickman v Kent or Romney Marsh Sheep-Breeders' Assoc* [1915] 1 Ch 881

**[4.90]** Hickman was a member of the Kent or Romney Marsh Sheep-Breeders' Association, an incorporated non-profit-making company. He began a court action complaining of various irregularities in the affairs of the association. Clause 49 of the association's constitution, however, provided that disputes between it and its members should be referred to arbitration. Relying on this clause, the association sought to prevent Hickman's court case from proceeding. The court upheld the association's case and stayed Hickman's court case. Astbury J held that by virtue of the statutory contract in the English equivalent of s 140(1)(a) of the *Corporations Act*, cl 49 was binding on Hickman and he was therefore obliged to refer his disputes to arbitration.

## Enforcement of constitution

**[4.95]** While *Hickman v Kent* illustrates the situation where a company enforces provisions in its constitution against a member, s 140(1)(a) also has contractual effect on the

company so that a member is able to force the company to comply with the provisions of its constitution.

Not all provisions in a company's constitution have contractual effect.

Only those provisions in a constitution or replaceable rules that confer rights on members in their capacity as members are enforceable as a contract. This is discussed at [4.100]–[4.110].

The replaceable rule in s 250E is an example of a rule that applies to members. According to s 250E(1), at a meeting of members of a company with a share capital, each shareholder has one vote on a show of hands and, on a poll, one vote for each share they hold. Members have the right to enforce provisions in a constitution that give them the right to have their votes counted at a general meeting: *Pender v Lushington* (1877) 6 Ch D 70. Similarly, they have the right to enforce payment of a declared dividend: *Wood v Odessa Waterworks Co* (1889) 42 Ch D 636.

Section 1322(2) reinforces the right of members to enforce the constitution. It enables the court to invalidate a procedural irregularity that causes substantial injustice. In *Chew Investment Australia Pty Ltd v General Corp of Australia Ltd* (1988) 6 ACLC 87, it was held that a rejection of a valid demand for a poll constituted appropriate circumstances to invalidate resolutions passed at the meeting under the predecessor of s 1322(2). This power of the court is discussed in Chapter 21.

In *Associated World Investments Pty Ltd v Aristocrat Leisure Ltd* (1998) 16 ACLC 455, it was held that a shareholder was bound by a provision in the company's constitution which allowed the directors to require a member to dispose of shares in circumstances where the company's business was endangered.

## Outside capacity

**[4.100]** In *Hickman v Kent or Romney Marsh Sheep-Breeders' Assoc* [1915] 1 Ch 881, it was held that members may enforce only those constitutional provisions that confer rights on members in their capacity as members. Section 140(1) expresses this limitation when it says that the persons referred to in s 140(1)(a), (b) and (c) agree to observe and perform the constitution and rules so far as they apply to that person.

Members cannot enforce provisions in the constitution that purport to give them rights in some other capacity than that of a member, such as a solicitor or employee.

*Eley v Positive Government Security Life Assurance Co* (1875) 1 Ex D 20

**[4.105]** The company's constitution, drafted by Eley, provided that he was to be its permanent solicitor and could only be dismissed for misconduct. He acted as solicitor for some time, though no separate employment contract was entered into. Eley also received an allotment of shares in consideration of the work he did in forming the company. Subsequently, the company ceased to employ him as its solicitor. Eley brought an action for breach of contract against the company but



failed. It was held that the constitution conferred no rights on a member where the member seeks to enforce a right in a capacity other than as a member. Eley was seeking to assert a right in his capacity as solicitor of the company. In order to do so, he should have entered into a separate contract independent of the constitution.

**[4.110]** Section 232, discussed at [24.15]–[24.280], enables members to enforce rights where the constitution or applicable replaceable rules have been breached even though the member may be affected in an outside capacity. Under that provision, a member need only show that the breach is contrary to the interests of members as a whole, or is oppressive or unfair, in order to gain a remedy under that section.

## Non-members

**[4.115]** A constitution does not have the effect of an enforceable contract between a company and non-members even if the constitution purports to give them rights.

*Forbes v New South Wales Trotting Club Ltd* [1977] 2 NSWLR 515

**[4.120]** A committee of the New South Wales Trotting Club decided to exclude Forbes, a professional punter, from admission to the racetracks controlled by the club. Forbes tried to overturn this exclusion on the basis that in making its decision, the committee did not comply with procedures in the company's constitution for exclusion. The court held that Forbes could not force the Club to comply with its constitution, as he was not a member of the New South Wales Trotting Club Ltd. The only rights Forbes had were that of a spectator.

## Contract between members

**[4.125]** Section 140(1)(c) provides that the constitution and applicable replaceable rules have effect as a contract between a member and each other member.

The s 140(1)(c) contract applies, for example, where a company's constitution contains a pre-emption or pre-emptive rights provision. Such provisions give shareholders rights of first refusal to buy other shareholders' shares or to sell their own shares to the remaining shareholders. Registration of transfers of shares that breach a pre-emption provision are generally void, and the register may be corrected under s 175: *Carew-Reid v Public Trustee* (1996) 14 ACLC 1106. Where the constitution sets out requirements in relation to pre-emption clauses, those requirements must be adhered to. In *Gibbins Investments Pty Ltd v Savage* [2011] FCA 527, the constitution of a company contained a pre-emption clause that imposed conditions on members' rights to transfer their shares. The constitution provided that all the members could by written agreement waive compliance with the pre-emption clause. The members made an informal unwritten agreement to allow a transfer of shares. Subsequently, an attempted transfer of shares was invalid because the informal agreement did not constitute a written agreement to waive compliance with the pre-emption clause as required by the constitution.



Section 1322(4)(a) allows a court in certain circumstances to validate an act, matter or thing that contravenes the constitution of a company. The court can only make such an order if the act, matter or thing is essentially of a procedural nature, the persons concerned in, or party to, the contravention acted honestly, or it is just and equitable that the order be made. The order must not cause, or be likely to cause, substantial injustice. In *Re QBiotics Ltd* [2016] FCA 873, a large number of share transfers over a period of six years contravened a pre-emptive rights provision in a company's constitution. The constitution provided that any purported transfer of shares in contravention of the pre-emptive rights provision would be ineffective and invalid. The company sought a court order validating the share transfers despite the contravention of the constitution. It was held that the contravention was inadvertent and the board was not dishonestly attempting to deprive the shareholders of their rights. In these circumstances, it was just and equitable to validate the share transfers to fulfil the expectations of the parties and to provide certainty as to the accuracy of the share register. In the absence of any complaints from shareholders, no substantial injustice would be caused if the validating order was made.

*Re Caratti Holding Co Pty Ltd* [1975] 1 ACLR 87

**[4.130]** One of the clauses in the company's constitution empowered the majority shareholder to compulsorily acquire the shares of a minority shareholder. The Supreme Court of Western Australia held that there was a contractual right under the predecessor of s 140(1)(c) to enforce the compulsory acquisition. Further, that clause could be enforced against the minority shareholder by either the company or the majority shareholder himself. The compulsory acquisition, however, was ultimately disallowed for other reasons, including that it was oppressive. Oppression under s 232 is discussed at [24.15]–[24.280].

Pre-emption rights replaceable rule.

**[4.135]** The proprietary company replaceable rule in s 254D contains another type of pre-emption clause. It gives pre-emption rights to existing shareholders on the issue of additional shares. Under s 254D(1), before issuing shares of a particular class, the directors of a proprietary company must offer them to existing holders of shares of that class. As far as practicable, the number of shares offered to each shareholder must be in proportion to the number of shares of that class that they already hold. Non-compliance with s 254D would be a breach of the s 140(1)(a) contract and not the s 140(1)(c) contract because the shares are issued by directors on the company's behalf.

As is the case with the s 140(1)(a) contract, only those provisions in the constitution (if any) or applicable replaceable rules that apply to members in their capacity as members have effect as a contract and are hence enforceable by them.

Some disputes between members, even if related to their respective obligations as members, may fall outside s 140.

*Andy Kala Pty Ltd v EJ Doherty (Northcote) Pty Ltd* (1995) 13 ACLC 1630

**[4.140]** A dispute between members of a professional body relating to unethical poaching of clients did not come within s 140(1)(c) so as to create a legally enforceable agreement constituted by the constitution of the professional body. The dispute did not involve issues concerning the nature or incidence of the members' relationships.

## Contract between the company and its directors and secretary

**[4.145]** Section 140(1)(b) provides that a company's constitution (if any) and any replaceable rules that apply to the company have effect as a contract between the company and each director and company secretary.

As is the case with the s 140(1)(a) and (c) contracts, not every replaceable rule or provision in a company's constitution has effect as a contract between the company and its directors and secretary. Only those provisions in a company's constitution that apply to such officers have effect as a contract under s 140(1)(b). The replaceable rules in ss 198A, 201G, 201H and 202A dealing with the appointment, powers and remuneration of directors are examples of rules that apply to directors and therefore have effect as a contract under s 140(1)(b). Similarly, the s 204F replaceable rule applies to a company secretary and therefore has effect as a contract between the company and the secretary.

### *Directors' contracts of service*

**[4.150]** It is quite common for directors to enter into separate contracts of service that are independent of the company's constitution and applicable rules. Such contracts are most frequently made when a managing director or executive director is appointed.

If the constitution contains provision for the appointment of a specified person as a director for a nominated period, this has the effect of a contract between the company and that director under s 140(1)(b). However, a company cannot be prevented from altering its constitution or displacing applicable replaceable rules as long as the correct procedure for alteration is followed. The shareholders at general meeting may therefore pass a special resolution removing the provision appointing the director, and the director will be unable to enforce their appointment under the constitution. There will be a breach enforceable by the director if the company purported to terminate the appointment and the correct removal procedures were not followed.

If the constitution does not adequately provide a procedure for removal, the members can resolve to alter the constitution under s 136(2) to allow for removal without exposing the company to liability for wrongful dismissal.

*Shuttleworth v Cox Bros & Co (Maidenhead) Ltd* [1927] 2 KB 9

**[4.155]** The company's constitution contained a provision that appointed a person director for life. Certain grounds for removal were specified. The company altered

its constitution to add an additional ground for removal, enabling a director to be removed upon a written request signed by all other directors. Such a request was signed, and the director dismissed. The court rejected the argument that the clause in the constitution appointing the director created a contract that could not be varied without his consent. The court held that the clause appointing him as a director for life was subject to the statutory power given to companies to alter their constitution. In this case, the director had no separate contract independent of the constitution.

**[4.160]** It is usual for executives and other paid directors to enter into separate contracts with the company. In such cases, the company cannot avoid its contractual obligations under the separate contract by altering its constitution: *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656. Sections 203C and 203D confirm that while a company has the power to remove a director, this does not deprive the director of any rights to compensation or damages.

## Remedies

**[4.170]** An issue that may arise concerns the appropriate remedy that can be obtained if the company breaches an employment contract constituted by a replaceable rule such as s 201G or a provision in the constitution. Ordinarily, an injunction or declaration is the appropriate remedy where the complaint involves breach of either the s 140(1)(a) or (c) contract. This is because the member seeks to have the constitution or replaceable rule observed. However, the equitable remedies of injunction and specific performance are not generally granted to enforce employment contracts on unwilling parties. If this is true under s 140(1)(b), it means that directors cannot prevent the company from terminating their appointment but can only obtain damages for wrongful dismissal.

In *Southern Foundries (1926) Ltd v Shirlaw* [1940] AC 701, Lord Porter stated:

A company cannot be precluded from altering its articles thereby giving itself power to act upon the provisions of the altered articles – but so to act may nevertheless be a breach of contract if it is contrary to a stipulation in a contract validly made before the alteration. Nor can an injunction be granted to prevent the adoption of the new articles, and in that sense they are binding on all and sundry, but for the company to act upon them will nevertheless render it liable in damages if such action is contrary to the previous engagements of the company.

# Alteration of constitution and exclusion of replaceable rules

## Statutory requirements

**[4.175]** Shareholder approval is required to alter a constitution or displace a replaceable rule. A company may displace or modify any one or more of the replaceable rules that applies to it by adopting a constitution: s 135(2). A company adopts a constitution if it passes a special resolution to that effect: s 136(1)(b). A special resolution is also required to modify or repeal a constitution or a provision of a constitution: s 136(2). It was held

in *Re Peninsula Kingswood Country Golf Club* [2014] VSC 437 that an ordinary resolution directing the board of directors to act in contravention of the constitution was invalid as the constitution must be complied with and can only be altered by special resolution. If the entire constitution is repealed, the company's internal management is governed by the replaceable rules.

Shareholders may alter a constitution or displace a replaceable rule by passing a special resolution.

Section 9 defines a “special resolution” as a resolution passed by at least 75 per cent of the votes cast by members entitled to vote on the resolution. In addition, s 249L(1)(c) requires the notice of the meeting at which a special resolution is proposed to set out an intention to propose the special resolution and state the resolution.

Unless a different date is specified, a special resolution adopting, modifying or repealing a company's constitution takes effect on the date the resolution is passed: s 137(a). There are different dates of effect of special resolutions to change a constitution that involve a change of name (s 157(3)), a change of company type (s 164(5)) or a variation or cancellation of class rights: s 246D.

Section 136(5) requires a public company to lodge with ASIC a copy of a special resolution adopting, modifying or repealing its constitution within 14 days after it is passed. ASIC may direct a company to lodge a consolidated copy of its constitution: s 138. This ensures that ASIC's database contains a complete and up-to-date constitution and enhances comprehension of a constitution where there have been numerous changes.

## Limits on right to alter constitution

**[4.180]** As discussed at [4.185], shareholders have the power to alter the replaceable rules and their company's constitution by passing a special resolution to that effect. This means that s 140(1) contracts can be altered, and the change will be binding on all members even if they opposed the special resolution. While members can generally vote to alter the replaceable rules and the constitution in any way they see fit, their power to do so is not unlimited. Both the *Corporations Act* and the common law impose certain limits and restrictions that seek to protect individual members and ensure that the shareholders who voted in favour of the special resolution do not abuse their powers.

### *Under the Corporations Act*

#### Entrenching provisions

**[4.185]** Section 136(3) recognises that a company's constitution may contain provisions that further restrict the company's ability to modify or repeal its constitution by imposing requirements for such alterations in addition to a special resolution (sometimes referred to as “entrenching provisions”). Examples of such further requirements include a greater majority than 75 per cent and obtaining the consent of a particular person. An entrenched provision may itself also be entrenched: s 136(4).

There may be a number of reasons why a constitution would contain entrenching provisions. For example, the founder of a company may wish to ensure they retain control after its formation. The constitution of such a company could contain an entrenching provision that confers weighted voting rights on a particular person or the holder of a particular class of shares.

### Section 140(2)

[4.190] Under s 140(2), a member is not bound by a modification of the constitution made after becoming a member so far as the modification:

- requires the member to take up additional shares; or
- increases the member's liability to contribute to the share capital of, or otherwise to pay money to, the company; or
- imposes or increases a restriction on the right to transfer the shares already held by the member.

A member is bound by such a modification to the constitution only where this is agreed to in writing.

In *Gambotto v WCP Ltd* (1995) 182 CLR 432 (*Gambotto*), the High Court held that the predecessor of s 140(2)(c) did not apply to an alteration of a company's constitution that forced minority shareholders to sell their shares to the majority shareholder. Such an alteration did not impose or increase restrictions on the right to transfer the shares already held by the minority shareholders. This case is further discussed at [4.220] and [4.235].

### Variation of class rights

[4.195] A further limitation on the power to alter a company's constitution occurs when its share capital is divided into shares of different classes. Frequently, the rights attached to the various classes are set out in the company's constitution. Section 254A(2) states that a company can issue preference shares only if certain rights attached to those shares are set out in the company's constitution (if any) or have been otherwise approved by a special resolution. Sections 246B–246G, discussed at [8.155]–[8.195], are designed to restrict majority shareholders from varying or cancelling class rights. As a general rule, class rights can be varied or cancelled only with the approval of a special resolution of both the company and the holders of the affected class: s 246B.

### Oppression remedy

[4.200] Section 232 enables members to apply to the court for a remedy if the majority votes in favour of a resolution altering the constitution or replaceable rules that is contrary to the interests of the members as a whole, oppressive, unfairly prejudicial or unfairly discriminatory to members. Section 232 is discussed at [24.15]–[24.280].

## Common law

### Why are restrictions imposed?

[4.205] The courts have also imposed restrictions on altering a constitution. In deciding where to draw the line between valid and invalid alterations of the constitution, the courts

attempt to strike a balance between the interests of majority and minority shareholders. The High Court in *Gambotto* explained:

On the one hand, the courts have recognised that the proprietary rights attaching to shares are subject to modification, even destruction, by a special resolution altering the articles and that the power to vote is exercisable by a shareholder to his or her own advantage. On the other hand, the courts have acknowledged that the power to alter the articles should not be exercised simply for the purpose of securing some personal gain which does not arise out of the contemplated objects of the power.

### **Alteration valid unless beyond any contemplated purpose or oppressive**

[4.210] Early cases, such as *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656, held that an alteration of the constitution was valid unless the court was satisfied that it was not “*bona fide* for the benefit of the company as a whole”. However, the High Court in *Gambotto* rejected “the benefit of the company as a whole” test and applied different tests depending on whether or not an alteration involved “an actual or effective expropriation of shares or of valuable rights attaching to shares”. It was held that an alteration which did not involve an expropriation of shares was valid unless it was either beyond any purpose contemplated by the constitution or oppressive. The High Court provided no illustrations of how this test would apply.

### **Expropriation of shares**

[4.215] On registration, a company's constitution may provide for the expropriation or compulsory disposal of a member's shares. If this power is exercised reasonably, the shareholder's rights are limited by the constitution and the shareholder may not have the right to be heard: *Associated World Investments Pty Ltd v Aristocrat Leisure Ltd* (1998) 16 ACLC 455. The position is different where the expropriation of shares is to be achieved by means of an alteration to the constitution.

An alteration that involves an expropriation of shares is valid only if the expropriation is for a proper purpose and is fair.

*Gambotto v WCP Ltd* (1995) 182 CLR 432

[4.220] After a successful takeover bid of WCP, the bidder acquired over 99 per cent of its share capital and sought to alter the company's constitution so as to allow any member entitled to over 90 per cent of the issued shares to compulsorily acquire all other issued shares. This alteration was justified by the bidder on the grounds of the potential taxation and administrative cost savings.

The High Court held that where an alteration of a constitution involved an expropriation of the shares owned by the minority, the alteration was valid only if the majority of shareholders proved it is:

- for a proper purpose; and
- fair in all the circumstances.

The High Court was of the opinion that an expropriation to secure taxation and administrative advantages for the majority shareholders of WCP was not for a proper purpose in relation to the expropriation of Gambotto's shares. For this reason, it held that the alteration of WCP's constitution was invalid.

The High Court decided that an expropriation of shares would be for a proper purpose if it prevented the company from suffering significant detriment or harm. For example, an expropriation may be justified in the case of a shareholder that is competing with the company or where this is necessary to meet legislative requirements in relation to shareholders' maximum holdings.

*Grey Eisdell Timms Pty Ltd v Combined Auctions Pty Ltd* (1995) 122 FLR 253

**[4.225]** The directors of Combined Auctions, a company that was an auction house for pawnbrokers, were concerned that Grey Eisdell Timms (GET), a competitor, was trying to take over the company by buying shares from its non-pawnbroker members. They convened a shareholders' meeting, and a special resolution was passed amending the company's constitution so as to limit shareholdings (apart from the managing director's shares) to no more than 10 per cent of the issued capital and to expropriate shares held by non-pawnbrokers. The court applied the decision in *Gambotto* and held that the expropriation would only be justified if the minority's continued shareholding would be detrimental to the company and expropriation was a reasonable means of eliminating this detriment. In these circumstances, the expropriation was not justified because the fact that significant numbers of current members were not pawnbrokers meant that the alteration was not needed to protect the company's business. Further, it was oppressive because it was a means of ensuring that the managing director obtained a controlling shareholding in the company.

*Bundaberg Sugar Ltd v Isis Central Sugar Mill Co Ltd* [2006] QSC 358

**[4.230]** The constitution of a company which conducted a sugar mill business as a co-operative was altered to provide for the forfeiture of shares of shareholders who ceased to be suppliers of sugar to the company. The main purpose of the forfeiture provisions was to enable the company to retain its co-operative status from which it derived considerable taxation advantages. It was held that a forfeiture of shares under the constitution was an expropriation within the *Gambotto* principle because the directors were able to act differentially between different classes of shareholders: those who were suppliers to the company and those who were not. An expropriation can occur when rights are extinguished, as occurs when forfeited shares are cancelled, as well as when shares are compulsorily transferred. In this case, the expropriation by forfeiture would have been valid if compensation was paid to the shareholder whose shares were forfeited as it would have been detrimental to the company to have lost its co-operative status by retaining non-supplier shareholders.



However, because the shares were forfeited without proper compensation, this was oppressive to the shareholder whose shares were forfeited and the forfeiture was invalid.

## Fairness

[4.235] An alteration of a constitution that involves an expropriation of shares must be fair as well as for a proper purpose: *Gambotto*. Fairness in this context involves two elements:

- The process of the expropriation must be fair. This element requires the majority to disclose all relevant information leading up to the alteration. It also requires the shares to be valued by an independent expert.
- The second element of fairness is concerned with the price to be paid to the expropriated shareholders. If the price is less than the market price, it is *prima facie* unfair. However, the current market price is not necessarily the sole criterion of fairness. A fair price should take into account a variety of factors, including assets, market value, dividends and the nature of the corporation and its likely future.

The *Gambotto* requirements regarding alteration of a constitution that involve expropriations of shares also apply to alterations that attempt to remove or restrict shareholders' voting rights: *Shears v Phosphate Co-operative Co of Australia Ltd* (1989) 7 ACLC 812.

The decision in *Gambotto's* case creates significant obstacles for majority shareholders seeking to expropriate the shares of a minority shareholder and conversely, it strengthens the position of small minority shareholders, in some cases, enabling them to extract excessive amounts from the majority shareholders. This is sometimes referred to as "greenmail".

The compulsory acquisition provisions of Pts 6A.1 and 6A.2 allow a successful takeover bidder, who has acquired at least 90 per cent of a target's shares, to compulsorily acquire the minorities' shares at a fair value. This mechanism enables an acquirer, who controls nearly all the shares of the target, to buy out the remaining small shareholdings and so gain the benefits of full ownership of the target. These provisions are discussed at [25.140]–[25.165].

## Tutorial questions

1. The directors of Lipton-Herzberg Ltd and Robinson and Saunders Ltd agreed to start a new business to be owned by a new company, New Edition Pty Ltd, whose share capital would be divided into two classes as follows:

Ordinary shares – \$1 issue price

- 400,000 – Lipton-Herzberg Ltd
- 200,000 – Robinson and Saunders Ltd

Preference shares – \$2 issue price

- 100,000 – Phillip (director and 50 per cent shareholder of Lipton-Herzberg Ltd)



- 100,000 – Abe (director and 50 per cent shareholder of Lipton-Herzberg Ltd)
- 100,000 – Catherine and Ben (directors and 50 per cent shareholder of Robinson and Saunders Ltd)

It was agreed that Phillip, Abe Catherine and Ben would be the first directors of New Edition, with Catherine also appointed as secretary. Lipton-Herzberg Ltd and Robinson and Saunders Ltd also agreed that the internal governance rules of New Edition Pty Ltd should provide that:

- A person nominated by Robinson and Saunders Ltd must be the chair of New Edition Pty Ltd and that the chair should have both a vote as well as a casting vote at directors' meetings.
- A person nominated by Lipton-Herzberg Ltd must be the managing director of New Edition Pty Ltd and that the person so appointed cannot be removed from that position unless Lipton-Herzberg Ltd specifically agreed.
- New Edition Pty Ltd's ordinary shareholders would have six votes per share and preference shareholders, one vote per share at shareholders' meetings.
- A New Edition Pty Ltd shareholder can only transfer their shares to existing shareholders. The transfer price must be the market price as determined by an independent valuer.

Should New Edition Pty Ltd rely on the replaceable rules in the above circumstances or would a constitution be more appropriate? Explain fully.

2. Ozzie and Sharon were the directors of Osborne Productions Pty Ltd and owned 70 per cent of the shares. Kelly owned the remaining shares. The company's constitution provided that Kelly was to be the company's senior music video producer.

Recently, the company decided to fire Kelly from her position as senior music video producer. Kelly disagrees with this. What can she do? Can she argue that the constitution is a contract between her and the company?

3. Mick, Keith, Charlie, Bill and Brian were directors and equal shareholders of Big Lips Music Pty Ltd. Brian resigned his directorship as a result of differences with Mick, Keith, Bill and Charlie. The others then wanted to get rid of Brian as a shareholder. However, Brian told them that he would never sell his shares in Big Lips Music. A general meeting of Big Lips Music Pty Ltd's shareholders is called at which there is a motion to insert a new clause in the company's constitution that gives Mick, Keith, Bill and Charlie the right to compulsorily acquire Brian's shares for their issue price.

What is the process for inserting a new clause in the company's constitution? Can Brian prevent the new clause being inserted even though the other shareholders passed a special resolution to that effect? Explain.

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.

## Chapter 5

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# The company's relations with outsiders

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## Key points

- A company is a legal entity separate and distinct from its members and directors, however it can only be represented by, or act through, individuals, either by application of the organic theory or the law of agency.
- A company is comprised of two organs: the general meeting of shareholders and the board of directors. The organic theory holds that the acts of these organs that are authorised by the company's constitution, or applicable replaceable rules, are acts of the company itself.
- The organic theory also identifies individuals who are the "directing mind and will of the company". They correspond to the "brains" of the company and have the power to act independently with full discretion to make company decisions without relying on instructions from superiors. The acts, knowledge or intentions of those who represent the directing mind and will of the company are attributed to the company itself.
- Companies can enter into contracts only through the intervention of individuals. In some cases, the company enters into a contract directly, such as where its common seal is affixed to a document, but usually companies contract via an agent acting with the company's authority who makes contracts on the company's behalf.
- Whether a company is bound by a contract made on its behalf is determined by the law of agency and the assumptions of regularity contained in the *Corporations Act*.
- Under the *Corporations Act*, a person who has dealings with a company is entitled to rely on one or more of the seven assumptions of regularity of the dealings and the company is not permitted to assert that the assumptions are incorrect.
- A person who has dealings with a company cannot rely on an assumption if that person either knew or suspected that the assumption was incorrect.

## Introduction

[5.05] One of the effects of registration is that a company is regarded as a legal entity separate and distinct from its members. However, due to the abstract nature of the corporate personality, a company can only be represented by, or act through, individuals. This creates conceptual difficulties in the context of the company's relationships with outsiders.

A company is represented by, or acts through, individuals.

In some situations, the law must determine the company's state of mind. This is particularly important in determining a company's liability for a criminal offence. A successful prosecution for most serious criminal offences requires proof of criminal intent or mens rea. While a company cannot be imprisoned, it can be fined. The *Criminal Code*, in the *Criminal Code Act 1995* (Cth), sets out the requirements necessary to establish the mens rea or criminal intent of a company for purposes of criminal responsibility under Commonwealth legislation, such as the *Corporations Act*. This is discussed at [5.90].

Companies are usually formed to carry on business ventures. This inevitably requires the company to enter into contracts with outsiders. The question then arises as to which individuals are authorised to contract for the company? This is discussed at [5.110]–[5.230].

A company may be contractually bound by the authorised acts of individuals in two situations. The first involves the “organic theory” where the company contracts directly in its own name. This is discussed at [5.10]. The second and more usual mechanism for determining authority of persons authorised to contract on behalf of a company involves applying the principles of the law of agency or the statutory assumptions contained in s 129.

We see, at [12.95], that a company comprises two constituent parts or organs: the board of directors and the general meeting of members. Typically, wide powers of management are conferred on the board of directors. Accordingly, under the organic theory, when the board exercises those powers, its acts are regarded as the acts of the company. In other instances, the acts of the members in general meeting are regarded as the acts of the company. Sometimes, the board of directors delegates some of its powers to particular individuals, such as the managing director or other senior officers, and their acts may also be acts of the company. The organic theory seeks to attribute to the company the actions, state of mind, knowledge or purposes of its senior officers.

In practice, outsiders rarely deal directly with the board of directors or the members in general meeting. More frequently, their relationship with the company involves dealings with its agents, officers or employees. Companies are capable of being bound by the acts of their agents in the same way as natural persons: s 126. This involves the application of the principles of agency law, in particular the question arises whether those who purport to act on the company's behalf have the authority to do so. Agency law has several distinct features in its application to companies.

## The directing mind and will of a company

### Organic theory

**[5.10]** As is the case with any principal, a company can act through its officers or agents provided they have the requisite authority. Where agents have actual or apparent authority, those actions within the scope of their authority bind the company. However, the organs of a company – its board of directors and the members in general meeting – are more than mere agents. When they act within the ambit of the powers conferred on them by the company's constitution or replaceable rules, they are treated as acting as the company itself. This is the “organic theory” of corporate personality. The acts of the organs of a company are the acts of the company itself, and their state of mind is the state of mind of the company. The organ is regarded as the directing mind and will of the company: its ego.

The actions of the organs of a company are the actions of the company itself, and their state of mind is the state of mind of the company.

The organic theory is an extension of the law of agency. The person who has actual or apparent authority in some cases may be regarded as not only acting as an agent of the company but acting as the company itself.

The organic theory is a legal fiction that allows the state of mind and actions of a company to be identified with the individuals who control it.

#### *Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd* [1915] AC 705

**[5.15]** The expression “directing mind and will of the company” stems from the judgment of Viscount Haldane LC in this case. Lennard's Carrying Co Ltd owned a ship. Lennard was the active director of the company and took an active role in the management of the ship. The ship carried oil owned by Asiatic Petroleum and, because it was in an unseaworthy state, it caught fire and its cargo was destroyed. Under marine legislation, the owner of a British ship was not liable for “any loss or damage happening without his actual fault or privity”. The company sought to avoid liability to Asiatic Petroleum under this provision, claiming that the loss arose not from its default but rather the default of Lennard himself. The House of Lords rejected this argument and held that Lennard's default was attributed to the company and hence it could not rely on the legislative exclusion. Viscount Haldane LC described Lennard's position with the company in the following terms:

A corporation is an abstraction. It has no mind of its own any more than it has a body of its own; its active and directing will must consequently be sought in the person of somebody who for some purposes may be called an agent, but who is really the directing mind and will of the corporation, the very ego and centre of the personality of the corporation ... For if Mr Lennard was the directing mind of the company, then his action must, unless a corporation is not to be liable at all, have been an action which was the action of the company itself ...

*Meridian Global Funds Management Asia Ltd v Securities Commission* (1995) 13 ACLC 3245

[5.20] The company's chief investment officer caused the company to contravene the New Zealand substantial shareholder provisions and concealed this from the company's directors. It was held that because he had authority to enter into share transactions, his knowledge of the breach was attributed to the company. The Privy Council considered that this decision was in accordance with the policy of the legislation, as otherwise a company could claim lack of knowledge as a result of its failure to properly monitor its officers and employees.

By attributing the directing mind and will of individuals to companies, the courts, in effect, lift the corporate veil to examine who is behind the company.

## Who is the directing mind and will?

[5.25] Whether a particular person represents the directing mind and will of a company depends on the circumstances.

### *The "brains" of the company*

[5.26] A company may be likened to a human being. It has a brain that controls what it does. It also has hands which act in accordance with directions from the brain.

*HL Bolton (Engineering) Co Ltd v TJ Graham & Sons Ltd* [1957] 1 QB 159

[5.30] Denning LJ suggested that a company could be seen as a metaphor for a human being.

One of the issues raised was whether a company could be said to have formed an intention to occupy certain premises for its own business. The intentions of the general meeting or the board of directors could not be attributed to the company in this case as these organs had not formally met to consider the question. The company's business was, however, managed by various directors. The court held that their intention was in fact the intention of the company. Denning LJ explained:

A company may in many ways be likened to a human being. It has a brain and nerve centre which controls what it does. It also has hands which hold the tools and act in accordance with directions from the centre. Some of the people in the company are mere servants and agents who are nothing more than hands to do the work and cannot be said to represent the mind or will. Others are directors and managers who represent the directing mind and will of the company, and control what it does. The state of mind of these managers is the state of mind of the company and is treated by the law as such ... So here the intention of the company can be derived from the intention of its officers and agents. Whether their intention is the company's intention depends on the nature of the matter under consideration, the relative position of the officer or agent and the other relevant facts and circumstances of the case.

## *Directors and senior management*

**[5.35]** Directors and senior managers may be regarded as the directing mind and will of the company, and their knowledge may be attributed to the company.

### *Re HIH Insurance Ltd [2016] NSWSC 482*

**[5.36]** The financial statements of HIH Insurance Ltd, a holding company that went into liquidation, contained misleading and deceptive representations in that certain reinsurance arrangements were wrongly accounted for and consequently the group operating profits were overstated. This constituted misleading or deceptive conduct and a contravention of s 1041H which is discussed at [26.190]–[26.220]. Shareholders who suffered loss as a result of this contravention brought an action against two HIH subsidiaries which were both parties to the reinsurance arrangements and wrongly accounted for the reinsurance arrangements in their financial statements. The financial statements of the subsidiaries were incorporated into the consolidated accounts of HIH. In order to be liable as accessories it was necessary to show that the subsidiaries were involved in the contravention in that they participated in, assisted or encouraged the contravention and they had actual knowledge of the essential matters that constituted the contravention. It was held that the knowledge of a corporation can be established by the knowledge of a director, employee or agent acting within their actual or apparent authority. The directors of the subsidiaries, who were also the chief executive officer and chief financial officer of HIH, authorised and released the subsidiaries' financial statements knowing that they would be included in the consolidated accounts of HIH, so that the HIH accounts were misleading. The knowledge of the directors was imputed to the subsidiaries who were taken to have been knowingly concerned in or party to the contraventions of s 1041H and liable as persons involved in the contraventions.

### *Tesco Supermarkets Ltd v Natrass [1972] AC 153*

**[5.40]** The House of Lords indicated that the directing mind of a company can be employees to whom managerial powers have been delegated. However, only those managers who are entrusted with a significant degree of freedom from supervision of higher authority are so regarded.

In this case the company owned a chain of supermarkets. At one store, a large advertisement was displayed stating that a particular item was on sale at a reduced price. A customer saw the advertisement and tried to buy the item at the reduced price but the sales staff refused to sell at the lower price.

The company was prosecuted under consumer protection legislation which prohibited the making of false or misleading statements with respect to the price of goods. It was a defence under the legislation if the company could show that:



- the commission of the offence was due to the act or default of another person; and
- it had taken all reasonable precautions and exercised all due diligence to avoid the commission of the offence.

The main issue in the case was whether the store manager was “another person” who was at fault for purposes of the defence.

The House of Lords held that the store manager did not have the necessary responsibility or control of the company's operations to be identified as the controlling mind and will of the company. For this reason, the company was not liable for the act or default of one of its subordinate managers after it had done all it could to implement a proper system. While it may sometimes be difficult to determine whose mind and will is attributable to the company, it would generally include the board and senior management and also delegates of the board who have full discretion to act independently.

[5.45] *Tesco Supermarkets Ltd v Nattrass* [1972] AC 153 has been criticised because it takes a narrow approach in imposing criminal liability on companies. The *Criminal Code*, discussed at [5.90], seeks to impose greater responsibility on companies by attributing criminal liability where a company authorises or permits the commission of an offence. This may occur where the corporate culture led to the non-compliance with a particular statutory provision, rather than having to attribute the requisite mind and will of an officer, or someone in senior management, to the company.

### *Company secretary*

[5.50] The acts of a company secretary are regarded as acts of the company where the secretary acts in relation to the company's day-to-day administrative affairs. The customary authority of a company secretary is discussed at [5.350]–[5.360].

### *Change in control*

[5.60] Where control of the company changes, the company may be taken to have changed its mind and adopted the intention and purpose of its new controllers who become its directing mind and will: *FC of T v Whitfords Beach Pty Ltd* (1982) 150 CLR 355.

### *The mind and will of more than one person*

[5.70] Ascertaining who is the directing mind and will of a large corporation is generally more difficult than in the case of a company with few directors and shareholders. In large corporations, control of the company's business is typically delegated to many executives and managers in an organisational hierarchy. The actions and intentions of senior management are relevant to determining the state of mind of a corporation, and more than one person may be regarded as its directing mind and will.

The actions and intentions of senior management are relevant to determining the state of mind of a corporation.

*Brambles Holdings Ltd v Carey* (1976) 15 SASR 270

**[5.75]** The company was engaged in a carrying business. Responsibility for ensuring that the company's vehicles complied with the relevant legislation had been delegated to three employees: the company's main driver, the heavy haulage supervisor and the operations manager. The company was charged with offences relating to excessive loads on its vehicles.

The company raised the defence of honest and reasonable mistake. It claimed that it had reasonable grounds for believing that its vehicles had not breached the relevant legislation. This was based on evidence that its heavy haulage supervisor honestly believed the vehicles were correctly loaded. On the other hand, the company's operations manager knew, or ought to have known, that proper loading instructions had not been given to the drivers. The issue was therefore whose knowledge and belief could be attributed to the company. The court decided that the operations manager was the directing mind of the company. In some cases, more than one person's mind and will can be attributed to the company, such as successive holders of a particular office, or where a person is temporarily replaced by someone during an absence.

### *Aggregated knowledge*

**[5.80]** In some situations, separate pieces of information known by several people can be aggregated and attributed to their company even though no one person knew all the various pieces of information: *Brambles Holdings Ltd v Carey* (1976) 15 SASR 270.

The knowledge of various company officers may not be aggregated where information has been received by chance and had not been communicated to a company officer in the normal way. It may become important to ascertain precisely when the information is communicated within the company so that the company is taken to possess knowledge of the aggregated information at the relevant time.

## **Criminal liability of companies**

**[5.90]** Companies are subject to the criminal law in much the same way as individuals. At common law, a company could be liable for criminal offences in either one of two ways. It may assume primary criminal liability where an offence is committed by its directing mind and will, and it may also commit a criminal offence through vicarious liability where the company assumes the criminal liability of an officer, agent or employee of the company.

The common law dealing with corporate criminal liability was cumbersome and raised technical difficulties in criminal prosecutions of companies particularly where it

had to be shown that the company had the requisite mens rea, meaning that it had the intention to commit a criminal act or had the knowledge that the act was unlawful. The common law rules limited the criminal liability of companies to those cases where senior people had their mind and will attributed to the company. The *Criminal Code* in the *Criminal Code Act 1995* (Cth) has replaced the common law in relation to offences under Commonwealth legislation. The *Criminal Code* codifies the principles of criminal responsibility under Commonwealth legislation including the *Corporations Act*.

Under s 12.1(2) of the *Criminal Code*, a body corporate may be found guilty of any offence, including one punishable by imprisonment. While a company cannot be imprisoned, it can be fined. Section 4B of the *Crimes Act 1914* (Cth) enables a fine to be imposed for offences that only specify imprisonment as a penalty.

An offence under the Criminal Code consists of physical elements and fault elements.

Section 3.1(1) of the *Criminal Code* specifies that a criminal offence consists of physical elements (defined in ss 4.1–4.3) and fault elements (defined in ss 5.1–5.6). A physical element of an offence includes conduct or the result of conduct. A fault element for a particular physical element may be intention, knowledge, recklessness or negligence.

#### Physical element of offence

Under s 12.2 of the *Criminal Code*, a physical element of an offence is attributed to a company if it is committed by an employee, agent or officer of the company acting within the actual or apparent scope of their employment or within their actual or apparent authority. This is wider than the *Tesco Supermarket* directing mind and will principle which limits a company's liability where the physical element of a criminal offence was committed by a senior manager who is its directing mind and will.

#### Fault element of offence

A fault element in relation to a physical element of an offence must be attributed to a company that expressly, tacitly or impliedly authorised or permitted the commission of the offence: *Criminal Code*, s 12.3(1). The means by which such authorisation or permission may be established are set out in s 12.3(2) and include:

- proving that the board of directors or a high managerial agent intentionally, knowingly or recklessly carried out the relevant conduct or expressly, tacitly or impliedly authorised or permitted the commission of the offence;
- proving that a corporate culture existed within the body corporate that directed, encouraged, tolerated or led to non-compliance with the relevant provision (“Corporate culture” means an attitude, policy, rule, course of conduct or practice existing within the body corporate generally or in that part of it in which the relevant activities take place); and
- proving that a body corporate failed to create and maintain a corporate culture that required compliance with the relevant provision.

Section 3.1(2) recognises that a law that creates an offence may provide that there is no fault element for one or more physical elements. The *Corporations Act* contains numerous offences that are characterised as either offences of strict liability or absolute liability.

Strict liability offence.

A strict liability offence is one that has no fault elements for any of the physical elements: *Criminal Code*, s 6.1(1)(a). The defence of mistake of fact under s 9.2 is available for strict liability offences: s 6.1(1)(b).

A mistake of fact defence arises if, at the time of the conduct constituting the physical element, the accused person was under a mistaken but reasonable belief about those facts and had those facts existed, the conduct would not have constituted an offence.

Under s 12.5(1) a company can only rely on the mistake of fact defence if:

- the employee, agent or officer of the company who carried out the conduct was under a mistaken but reasonable belief about the facts that, had they existed, would have meant that the conduct would not have constituted an offence; and
- the company proves that it exercised due diligence to prevent the conduct. A failure to exercise due diligence may be evidenced by the fact that the prohibited conduct was substantially attributable to inadequate corporate management, control or supervision of the company's employees, agents or officers or the failure to provide adequate systems for conveying relevant information to relevant people in the company.

Absolute liability offence.

An absolute liability offence is one that has no fault elements for any of the physical elements and the defence of mistake of fact is unavailable: s 6.2(1).

## Review of corporate criminal responsibility regime

**[5.92]** The Australian Law Reform Commission (ALRC) reviewed the corporate criminal responsibility regime and issued its report *Corporate Criminal Responsibility* ALRC Report 136 (April 2020). Its 20 recommendations included:

- corporations should be subject to a criminal offence only when the breach is serious;
- infringement notices should not be available for criminal offences;
- the law should contain one clear method of determining when a corporation is responsible for a crime. A corporation should be criminally responsible for the conduct of the person acting on its behalf;
- a corporation should be considered at fault when an employee, officer or agent has the relevant state of mind for the particular criminal offence. A corporation should have a “reasonable precautions” defence;
- there should be new criminal laws that address systems of conduct or patterns of behaviour that result in multiple contraventions of civil penalty provisions;

- the law should require courts to consider specified factors when sentencing; and
- courts should be able to impose various non-monetary penalties such as publication, community service, corrective action, prohibiting certain commercial activities and winding up.

A summary of this Report is on the ALRC website which is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## Protection for whistleblowers

**[5.93]** The protection and encouragement of whistleblowers who disclose corporate crime or misconduct is seen as an important aspect of detecting and proving criminal conduct. In many cases, corporate crime is only discovered because of individuals who disclose it and “blow the whistle”, often at great personal risk. A whistleblower protection regime recognises the critical role played by whistleblowers in reporting misconduct and such protections play an important role in improving corporate compliance and promoting a more ethical corporate culture.

Whistleblower protection laws, introduced in 2004, were designed to encourage officers, employees and others to report suspected breaches of the *Corporations Act* to ASIC; Australian Prudential Regulation Authority; a relevant Commonwealth authority; the company’s auditor; other appropriate senior people within the company such as a director, secretary or senior manager; or a person authorised by the company to receive whistleblower disclosures. This attempt to protect whistleblowers was criticised as largely ineffective because it restricted the circumstances where it provided protection and was overly complex. The *Treasury Laws Amendment (Enhancing Whistleblower Protections) Act 2019* (Cth) addressed these criticisms and rewrote the whistleblower protection provisions.

Under the new regime, all corporate and financial sector whistleblowers are covered by the same legislation, providing for consistent protection across all corporate and financial sectors. A disclosure of information by an individual is protected if the discloser is an “eligible whistleblower” and the disclosure is made to a regulatory body such as ASIC or to an “eligible recipient”: s 1317AA(1) and (2). An eligible whistleblower includes a present or former officer, employee or supplier: s 1317AAA. An eligible recipient includes an officer or senior manager, an auditor or a person authorised to receive disclosures that may qualify for protection: s 1317AAC(1). A disclosure of information by an individual qualifies for protection if the whistleblower has reasonable grounds to suspect that it concerns misconduct or an improper state of affairs and indicates that conduct has occurred which constitutes a contravention of the *Corporations Act* or other specified legislation: s 1317AA(4) and (5). Protection is also afforded where the discloser does not have reasonable grounds to believe that action has been taken to address the matters raised by the disclosure, and the discloser has reasonable grounds to believe that making a further disclosure of the information is in the public interest: s 1317AAD(1). Provision is made for emergency disclosure to a member of Parliament or a journalist where the discloser has reasonable grounds to believe that the information concerns a substantial and imminent danger to the health or safety of individuals or to the natural environment: s 1317AAD(2).

Whistleblower protection does not extend to a disclosure of information that concerns a personal work-related grievance of the discloser that does not involve victimisation: ss 1317AADA(1) and 1317AC.

Whistleblowers are protected in a number of ways. For example, the identity of a whistleblower cannot be disclosed (s 1317AAE) and whistleblowers cannot be subjected to civil, criminal or administrative liability for making the disclosure. Nor can the whistleblower be sued for breach of contract because of the disclosure: s 1317AB(1)(a) and (b). Whistleblowers are not, however, protected from liability for illegal conduct in which they have been involved. They have qualified privilege in relation to their disclosures and therefore have no liability for defamation: s 1317AB(2). Whistleblowers are also protected from being victimised because of their disclosures: s 1317AC.

A public company and certain proprietary companies must have a policy that sets out, among other things, information about: the protections available to whistleblowers; to whom disclosures that qualify for protection under this Part may be made, and how they may be made; how the company will support whistleblowers and protect them from detriment; and how the company will investigate disclosures that qualify for protection under this Part: s 1317AI. The policy must be made available to officers and employees of the company.

ASIC has released Regulatory Guide 270 *Whistleblower policies* to assist organisations to implement and maintain a whistleblower policy that complies with the *Corporations Act*.

## Liability of companies in tort

**[5.95]** A company, like any employer, is vicariously liable for the torts committed by its employees in the course of their employment. Similarly, a company, as principal, is liable for the torts committed by its agents acting within the scope of their actual or apparent authority: *Lloyd v Grace Smith & Co* [1912] AC 716. Thus, a company may be vicariously liable for the negligence or fraud of its employees, committed in the course of their employment. It is on this basis that companies are usually liable in tort.

A company is vicariously liable for the torts committed by its employees in the course of their employment.

Damages in favour of a company may be reduced on the grounds of contributory negligence by the company where its directors or management were negligent.

*Daniels v Anderson* (1995) 37 NSWLR 438

**[5.100]** A company was awarded damages arising from the negligence of its auditors. The auditors obtained a reduction of damages because of the company's contributory negligence. It was held that the negligent acts of management should be treated as acts of the company for the purposes of a finding of contributory negligence.

This conclusion was reached on two grounds. The company was vicariously liable for the negligence of its management. It was also liable because its directors almost wholly delegated the task of setting up and operating a foreign exchange operation to management and failed to monitor and control this operation.

**[5.105]** Because a company may generally be held vicariously liable for torts, the courts have rarely found it necessary to hold a company directly liable for torts through the application of the organic theory. There is no reason in principle why the concept of the “directing mind” could not be applied to such cases.

## Contracts with the company

**[5.110]** A company, being an abstract entity, can enter into contracts only through the acts of humans such as the company's officers or employees. At common law, a company could contract directly by affixing its common seal to a contract in accordance with its constitution. While entering a contract in this way may still occur, s 123(1) provides that it is now optional for a company to have a common seal.

An individual acting with the company's express or implied authority may contract on its behalf.

Under s 126(1), a company's power to make a contract may be exercised by an individual acting with the company's express or implied authority and on its behalf. This power may be exercised without using a common seal.

The general rules of agency law are applicable in cases where an agent acts on behalf of a company. However, because of the nature of companies, the law of agency has particular rules which apply to company contracts.

At common law, contracts made by an agent could only bind the company as principal if the contract came within the objects of the company as stated in its constitution. Contracts outside the scope of the company's objects are *ultra vires* and were once not binding on either the company or the other contracting party. Section 125(2), however, provides that an act of a company is not invalid merely because it is outside any objects in the company's constitution. This is discussed at [4.75].

Outsiders dealing with a company do not usually know whether the officer or agent acting on the company's behalf, had acted in accordance with the company's constitution. Outsiders were able to assume that the internal proceedings of a company had been properly carried out, even though this may in fact not have been the case. This rule, known as the rule in *Turquand's* case, prevented a company from relying on an internal irregularity to avoid a contract. This rule was subject to certain exceptions where the outsider possessed contrary knowledge or should have been put on inquiry.

The rule in *Turquand's* case has been replaced by the various statutory assumptions an outsider is entitled to make under s 129: see [5.235]–[5.360]. Some of these assumptions are based on the common law rule and are subject to the limitations contained in s 128(4):



see [5.365]–[5.375]. These limitations are based upon the common law exceptions to the rule in *Turquand's* case but differ in some respects.

## Execution of documents

**[5.115]** A company is able to enter into a contract directly by executing a contractual document. This involves directors or other authorised persons signing the document as an act of the company. The signature requirement may be satisfied electronically: s 110A.

A company can make a contract directly by executing a document.

In *195 Crown St Pty Ltd v Hoare* [1969] 1 NSW 193, Asprey JA explained that:

The execution of a document by a company ... resembles the execution of a document by a natural person who cannot write except through the medium of someone else who signs the disabled person's name at his request and direction. An authorised signatory of a company's document when acting under this section is the company's amanuensis.

A company may execute a document in accordance with the requirements of s 127, either by fixing its common seal to the document or without using a common seal. 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 s 127: s 127(3). Whether a document is expressed to be “executed as a deed” is determined by reading the document in its entirety and the exact words need not be included in the document. “The purpose of s 127 is to move away from these [common law] formalities and look to substance and intention”: *Gibbons v Pozzan* [2007] SASC 99.

### Common seal

**[5.120]** The execution of a document by a company is an act of the company itself and has similar effect as the signature of a person. Once a company could only execute a document by affixing its common seal in accordance with its constitution. Since 1998, common seals have been optional: s 123(1).

A company may execute a document by affixing its common seal witnessed by the appropriate officers.

Under s 127(2), a company with a common seal may execute a document by affixing its common seal to the document and the fixing of the seal is witnessed by the appropriate officers. These are:

- two directors of the company; or
- a director and a company secretary; or
- for a proprietary company that has a sole director who is also the sole company secretary – that director.

For the purposes of s 127(2), the fixing of the common seal to a document is taken to have been witnessed by a person referred in that section if that person observes, by



electronic means (such as video conferencing) or by being physically present, the fixing of the seal; the person signs the document; and a method is used to indicate that the person observed the fixing of the seal to the document: s 127(2A).

Company constitutions often set out provisions regarding the use of the company seal. Typically, a constitution will provide that the seal may be used only with the authority of the company's board of directors.

If a company has a common seal, it must set out the company's name and its Australian Company Number or its Australian Business Number: s 123(1).

If the company seal is affixed to a contract and the affixing or witnessing of the seal does not comply with the company's constitution, the contract may still bind the company.

#### *MYT Engineering Pty Ltd v Mulcon Pty Ltd [1999] HCA 24*

**[5.125]** The company seal was affixed to a deed of company arrangement and witnessed by one person even though the company's constitution required the affixing of the seal to be witnessed by a director and countersigned by another director or secretary. It was held that the deed was validly executed by the company because the shareholders and members of the board authorised the director to do so and agreed the instrument should be executed.

**[5.127]** The affixing of the seal may be void or unenforceable if the attesting directors or secretary act without authority. The circumstances where this may occur are discussed at [5.270].

### *Execution without common seal*

**[5.135]** A company may also execute a document without using a common seal if two directors or a director and a company secretary sign the document: s 127(1). As a result of 2022 amendments, electronic signatures are permitted: s 110A. Further, that section does not require a person to sign on the same form of the document as another person or use the same method to sign as another person: s 110A(4).

### *One-person proprietary companies*

**[5.140]** A sole director may witness the fixing of the seal of a proprietary company that has only one director who is also the sole secretary: s 127(2). Similarly, under s 127(1), a proprietary company with a sole director who is also the sole secretary may execute a document without using a common seal by that person signing the document on the company's behalf. Either a physical or electronic signature is allowed.

### *Operation of s 127*

**[5.145]** If a company executes a document that appears to be in accordance with s 127(1) or (2), persons dealing with the company are entitled to make the assumptions of due execution set out in s 129(5) or (6). The s 129(5) and (6) assumptions are discussed at [5.270].

## Contracts made by agents

**[5.150]** Section 126 allows a company to contract through an agent and under agency law, a company will be bound by the acts of its agents in the same way as any other principal. The law of agency is supplemented by overlapping statutory rules contained in ss 128–130. These statutory rules deal with matters such as the effect of non-compliance with the company's constitution, whether an officer or agent of a company had the requisite authority to bind the company, whether a document apparently executed by a company could be taken by a person dealing with the company to have been validly executed or the validity of a contract in circumstances where the directors have breached their duties. Agency in the context of company contracts is discussed at [5.165]–[5.230].

An agency relationship, under which an agent's acts bind the principal to a contract with an outsider, may arise in several ways. The most important that concern us here are agency created by:

- actual authority; and
- apparent or ostensible authority.

Agency created by ratification of contracts entered into before registration of the company is discussed at [6.70]–[6.80].

### *Actual authority*

**[5.155]** An agent who makes a contract on the principal's behalf binds the principal to the contract with the third party if the contract is within the scope of the agent's express or implied actual authority.

Actual authority requires a consensual agreement between the principal (the company) and the agent and arises when a principal grants and the agent accepts authority for the agent to perform specific tasks on behalf of the principal. In the absence of express agreement, the conduct of the parties may allow an inference that authority has been conferred on the agent: *Equiticorp Finance Ltd v Bank of New Zealand* (1993) 32 NSWLR 50.

In the case of actual authority there are two relationships – the agency relationship between the principal and the agent, and a contract between the principal and outsider. There is no contractual relationship between the agent and the outsider. In deciding whether a person has actual authority, agency law focuses on the relationship between the principal and the agent. Having brought the principal and outsider into a contractual relationship, the agent drops out of the picture.

An agent binds the principal to a contract if the making of the contract is within the scope of the agent's express or implied actual authority.

An agent's actual authority may be express actual authority or implied actual authority. Express actual authority occurs when a principal expressly gives the agent authority to enter into particular contracts on the principal's behalf.

Implied actual authority arises from the conduct of the principal and the agent and the surrounding circumstances. Implied actual authority arises when the principal appoints

an agent to a particular position and such a position usually carries with it authority to do certain things. For example, an agent who is appointed to manage a business has implied authority to make all those contracts that a manager in such a position customarily has: *Hely-Hutchinson v Brayhead Ltd* [1968] 1 QB 549.

The grant of actual authority by the principal may be implied where the authority could be validly granted by express agreement and the existence of the authority is contemplated by the company's constitution: *Freeman and Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480 (*Freeman and Lockyer*). The implication of authority and its scope requires consideration of not just the office held by the person acting as agent, but also the circumstances of the relationship between that person and the board of directors: *Hely-Hutchinson v Brayhead Ltd* [1968] 1 QB 549. In *Crabtree-Vickers Pty Ltd v Australian Direct Mail Advertising & Addressing Co Pty Ltd* (1975) 33 CLR 72, it was held that an agent cannot have implied actual authority to inform an offeror that an offer has been accepted when no decision has been made by the principal to accept that offer. As discussed at [5.210]–[5.230], the principal may still be bound if the agent had apparent authority.

In *Brick & Pipe Industries Ltd v Occidental Life Nominees Pty Ltd* [1992] 2 VR 279, a director was taken to have implied actual authority to act as the company because he held a controlling shareholding and even though he had not been appointed as managing director, he assumed the role of managing director with the acquiescence of the other directors. Further, the director often entered into transactions on behalf of the company without prior reference to the board and no attempt was made by the other directors to interfere with this assertion of control.

In *Left Bank Investments Pty Ltd v Ngunya Jarjum Aboriginal Corporation* [2020] NSWCA 144, it was held that implied actual authority could not be inferred in the case of a chief executive officer who was not a director, as the circumstances indicated that the officer did not have broad powers to conduct the business of the corporation, including the power to bind the corporation to a lease agreement.

## Apparent or ostensible authority

**[5.160]** An agent's apparent or ostensible authority (the terms "apparent" and "ostensible" authority have the same meaning) arises if a principal gives the impression to an outsider that an agent has authority to act on the principal's behalf. It does not depend on any agreement between principal and agent.

An agent's apparent authority arises if a principal gives the impression that an agent has authority to contract on the principal's behalf.

It is quite rare for an outsider to know whether an agent has actual authority and the extent of that authority. Usually, all the outsider relies on is the appearance of authority. Depending on the circumstances, the extent of an agent's apparent authority may be the same as the agent's actual authority or it may exceed the scope of the agent's actual authority. In some situations, a person may have apparent authority to enter contracts for a principal because the principal has represented this to the outsider even though that person does not have actual authority to contract.

If an agent's apparent authority can be proved, it creates an agency by estoppel under which the principal is prevented (or estopped) from asserting that the agent lacked authority. An agency by estoppel creates a contract between the principal and outsider in the same way as a contract is created by an agent with actual authority.

Apparent authority arises when:

- the principal represents or holds out to the outsider that the agent has the requisite authority to make particular contracts on the principal's behalf; and
- the outsider relies on the principal's representation to enter into the contract with the agent who is purportedly acting on the principal's behalf.

A principal is not bound by a contract merely on the representations of the agent.

The principal must make the representation of the agent's authority to the outsider. A principal is not committed to a contract merely because the agent has represented that they have authority.

The principal may expressly make the representation to the outsider. However, it is more usual for the representation to arise by the principal's conduct. A representation by conduct may take either one of two forms:

- It may arise when the principal permits the agent to occupy a particular position. In such cases, the principal represents or holds out that the agent has the customary authority of a person in such a position. In this respect it is similar to an agent with implied actual authority resulting from the position occupied.
- It may also arise when the principal's conduct permits the agent to carry out particular tasks on the principal's behalf that are beyond the scope of the agent's customary authority. For example, a bookkeeper in an accounting firm would act beyond the job's customary authority by purchasing office equipment. But if the employer holds out to the equipment supplier that the bookkeeper had such authority, the employer would be liable as principal in respect of such purchases.

## Authority of the company's agents

**[5.165]** A company may enter into a contract either through an organ such as its board of directors or by means of an authorised agent such as an officer or employee. Where a contract is entered into directly by the board and the constitution or replaceable rules authorise the board to act in this way, questions of authority of the board to enter into the contract may arise if there was an irregularity, such as a failure to comply with the constitution or replaceable rules. This may occur if, for example, the particular meeting of the board was not properly convened, a quorum was not present, members of the board were not properly appointed or the required officers did not attest the company seal.

Where such irregularities occur, a balance of interests arises. An outsider dealing with a company is generally protected where an irregularity arises which is internal to the company because the outsider generally has no way of knowing of the irregularity. However, in some cases such protection may unduly facilitate fraud at the expense of innocent shareholders and creditors of the company.

Where the board has delegated its powers to a managing director, a committee of directors or another officer or agent, a question may arise whether the particular contract was within the authority of the person to whom the power was delegated.

### *Abolition of the doctrine of constructive notice*

[5.170] The constitutions of public companies must be lodged with ASIC: s 136(5). One consequence of this requirement is that the constitutions of public companies are available for public inspection. If the constitution contained a limitation on the authority of the company's organs, officers or agents, the common law deemed this limitation to be known by an outsider dealing with the company, whether or not the outsider was actually aware of the limitation. This was known as "the doctrine of constructive notice".

The doctrine of constructive notice has been abolished by s 130(1), and a person is not taken to have information about a company, such as the content of its constitution, merely because the information is available to the public from ASIC.

### *The rule in *Turquand's case**

[5.175] Prior to its abolition, the doctrine of constructive notice imposed difficulties on outsiders dealing with companies because it imputed knowledge of the company's constitution to the outsider even if the outsider had not read the constitution. However, under the rule in *Turquand's case*, constructive notice did not operate where the constitution had not been complied with, and this was not apparent from a reading of the constitution or other public documents of the company. For example, the constitution of a company may specify the number of shareholders who constitute a quorum. An outsider will generally have no means of knowing whether a quorum was present at a particular meeting because attendance at shareholder meetings is not publicly available. This irregularity of a meeting proceeding without the required number to constitute a quorum would not be apparent on the face of the constitution.

The rule in *Turquand's case* stated that even though persons dealing with a company were taken to have constructive notice of the contents of the company's public documents, they need not go further to ensure that the internal proceedings of the company have been properly carried out. They can assume that these proceedings were properly carried out, even though this was not in fact true. Lord Simonds in *Morris v Kanssen* [1946] AC 459, explained that the rule was "designed for the protection of those who are entitled to assume, just because they cannot know, that the person with whom they deal has the authority which he claims".

The company cannot rely upon the rule as its purpose is to protect outsiders, not the company: *Hughes v NM Superannuation Pty Ltd* (1993) 29 NSWLR 653.

*Royal British Bank v Turquand* (1856) 6 E & B 327; 119 ER 886

[5.180] The deed of settlement (the equivalent of the constitution of a company) empowered the board of directors to borrow such sums as were authorised by a resolution of the general meeting of the shareholders. The company borrowed

money from a bank on the authority of two of its directors who authenticated the company's common seal. There was no authority given by the general meeting. 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 company was still bound to the bank because the passing of the resolution was a matter internal to the company.

[5.185] The rule in *Turquand's* case has been adopted by s 129(1), under which anyone who has dealings with a company may assume that the company's constitution and any applicable replaceable rules have been complied with: see [5.240]–[5.245]. Aspects of the rule in *Turquand's* case also form the basis of other statutory assumptions contained in s 129.

### *Exceptions to the rule in Turquand's case*

[5.190] The rule in *Turquand's* case was subject to several exceptions. The most significant of these arose where the outsider had actual knowledge of the irregularity or was put upon inquiry by the circumstances of the case and failed to make inquiries. Where these exceptions applied, the outsider lost the protection of the rule and therefore could not assume that the constitution had been complied with and enforce any contract. The exceptions contained in s 128(4) are worded differently to the common law exceptions to the rule in *Turquand's* case, although in many cases they have a similar operation: see [5.365]–[5.375].

The rule in *Turquand's* case did not apply if the person dealing with a company had actual knowledge of an irregularity or was put on inquiry by the circumstances and failed to make inquiries.

The rule in *Turquand's* case and its exceptions sought to strike a balance between two broad competing interests. On one hand the rule protected innocent outsiders dealing with a company and thereby promoted business convenience because it is impractical to expect outsiders to conduct investigations into the company's internal proceedings. On the other hand, outsiders and company officers who exceeded their authority were not be able to use this protection to commit fraud at the expense of shareholders and creditors. Even though the rule in *Turquand's* case has now been replaced by provisions in the *Corporations Act*, these policy considerations still remain applicable to the balance struck by the s 129 assumptions and s 128(4) exceptions discussed at [5.235] onwards.

#### *Northside Developments Pty Ltd v Registrar-General* (1990) 170 CLR 146

[5.195] Although this High Court case was decided under common law rules that no longer apply, it represents a useful fact situation that illustrates the problems which can arise where an irregularity occurs in the internal proceedings of a company.

The common seal of Northside was affixed to a mortgage document that secured a loan from Barclays to a company controlled by Sturgess, a director and shareholder

of Northside. The mortgage was over land owned by Northside which was its only major asset. The common seal was affixed and signed by Sturgess as director and by his son who purported to sign as the company secretary. The son had not been appointed under the constitution although lodged documents named him as the company secretary. The other two directors, who were also the remaining shareholders, did not know of or authorise the execution of the mortgage, nor did they know of the purported appointment of the secretary. They had no interest in the borrowing company and Northside derived no benefit from the transactions.

The High Court considered the validity of the mortgage and in particular whether it had been executed by Northside. It held that Northside was not bound by the mortgage because the affixing of the common seal was invalid. Although the rule in *Turquand's* case enabled Barclays to assume that the common seal was properly affixed and the internal proceedings of the company had been properly carried out in accordance with its constitution, the circumstances of the case should have put Barclays upon inquiry. Because Barclays failed to make further inquiries as to whether the common seal was properly affixed it was unable to rely on the rule in *Turquand's* case and Northside was not bound by the mortgage.

The circumstance that put Barclays upon inquiry was that the mortgage secured Northside's major asset where the transactions were outside its usual business and not for its benefit. Barclays was prevented from relying on the rule in *Turquand's* case because it ought to have suspected an irregularity. Barclays did not have actual knowledge of the lack of authority of Sturgess and his son to affix the company seal.

There would be a different outcome if the court decided this case under the s 129 statutory assumptions (see [5.235] onwards). While the assumptions of due execution in s 129(5) and (6) are essentially the same as the rule in *Turquand's* case, the statutory assumptions do not have a "put on inquiry" exception. Section 128(4) provides that a person cannot rely on any of the s 129 assumptions if the person actually knew or suspected the assumption was incorrect but can rely on the assumptions otherwise. Section 128(4) is discussed at [5.365]–[5.375].

### *Actual authority of company agents*

**[5.200]** Where an outsider contracts with an agent of a company, the company is bound by the contract, if the agent has actual authority, in the same way as any other principal is bound by the act of an agent.

|                           |
|---------------------------|
| Express actual authority. |
|---------------------------|

An agent's actual authority may arise expressly, where the agent is appointed by the principal for a particular purpose, or by implication. It arises by implication when a company appoints the agent to occupy a particular position. Unless expressly limited, the agent's implied actual authority extends to all those acts that are customarily done by persons occupying that position. For example, the replaceable rule in s 201J permits the directors to appoint a managing director for the period, and on the terms (including remuneration), as they see fit. In addition, under the replaceable rule in s 198C the



directors may confer on a managing director any of the powers that the directors can exercise. The express actual authority of a managing director will consist of the powers specifically conferred on that person by the board. A managing director's implied actual authority will also consist of the customary powers and authority of persons occupying the office of managing director, provided those customary powers are not inconsistent with the managing director's express actual authority.

The customary authority of managing directors and other officers of a company is discussed at [5.330]–[5.360].

#### Implied actual authority.

An agent's implied actual authority may arise as a result of acquiescence by the board to a course of behaviour. For example, generally the power of management is vested in the board to be exercised collectively; however, if a board of directors stands by while a single director enters into transactions that would normally be outside the director's authority, the board's acquiescence in that course of dealing can constitute the grant of implied actual authority to the director to enter into those transactions: *Junker v Hepburn* [2010] NSWSC 88. Similarly, in *Brick & Pipe Industries Ltd v Occidental Life Nominees Pty Ltd* [1992] 2 VR 279 it was held that a dominant, de facto managing director had implied actual authority to manage the business of the company, where that person acted with the acquiescence of the board to bind the company. This conferral of implied actual authority may be informal and based on previous dealings between the parties. Just because a director acts in a dominant way does not necessarily mean that actual authority has been conferred. There must be some indication that the board knew of, and acquiesced, to the course of dealing.

#### *National Australia Bank Ltd v Sparrow Green Pty Ltd* [1999] SASC 280

[5.205] One of a company's directors executed finance deeds as sole director and company secretary notwithstanding that the company's constitution required deeds to be executed by at least two directors and the affixing of the company seal required the signatures of two directors or a director and secretary. Soon after, the company went into liquidation. The court held that the company was not bound by the finance deeds because the director who executed them did not have actual or apparent authority to bind the company. In the circumstances of this case, actual authority to execute deeds vested in the board, not a single director.

### *Apparent authority of company agents*

[5.210] We saw at [5.160] that for apparent authority to arise, the principal must represent or hold out to the outsider that the agent had authority in relation to the contract and the outsider was induced by this representation of authority to enter into the contract.

The rules relating to apparent authority have special features when the principal is a company. This is because a company, as an artificial entity, can only act through humans,



and its agents may be company officers whose authority to act as agents stems from their appointment as an officer. The question arises: who can hold out for the company, by making representations of authority to outsiders on the company's behalf, so as to bind the company?

Who can hold out as the company?

In the usual case where full management powers are bestowed on the board of directors by the constitution or replaceable rules, the board is the organ that is capable of acting as the company and making the necessary representations of authority. Outsiders, however, rarely negotiate contracts directly with the full board. They usually deal with persons to whom the board has delegated the necessary authority, for example the managing director. When this is the case, the managing director possesses actual authority to do those things concerned with management, and also has apparent authority to bind the company to contracts within the scope of the management powers. The representation by the company, through its organ, the board of directors, is established by the fact that the company has appointed a person to occupy the position of managing director with all the customary powers that accompany that office.

In some instances, an outsider may deal with a person who acts as a managing director but who has not actually been appointed to that position or whose appointment is defective in some way. The defect in the appointment may arise because the resolution of the board making the purported appointment was invalid for some reason, such as where there was no quorum present at the meeting where the appointment was made or the term of appointment has expired and the person is allowed to continue to act as the managing director.

A representation by a company that an agent has authority to contract on its behalf must be made by someone who had “actual” authority to manage the company's business.

*Freeman and Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480

[5.215] Kapoor and Hoon formed a company for the purpose of developing a property. They each held half the issued shares and together with a nominee of each, comprised the board of directors. The quorum of the board was four, but at all material times, Hoon was overseas. Kapoor acted as managing director with the approval of the board, even though he had not been appointed to that position.

Kapoor engaged a firm of architects and surveyors on behalf of the company. The firm brought an action claiming payment for work carried out when the company refused to pay its fees. It was held that the company had held out that Kapoor was its managing director and was therefore bound by his actions. He had apparent authority to employ the architects because this was within the customary authority of a managing director of a property development company. Because the outsiders had relied on the apparent authority of the managing director, they did not have

to examine the company's constitution or inquire whether the managing director had been properly appointed.

The court examined the law of agency as it applies to contracts with companies where the agent does not have actual authority. Diplock LJ stated:

(There are) four conditions which must be fulfilled to entitle a contractor to enforce against a company a contract entered into on behalf of the company by an agent who had no actual authority to do so. It must be shown: (a) that a representation that the agent had authority to enter on behalf of the company into a contract of the kind sought to be enforced was made to the contractor; (b) that such representation was made by a person or persons who had "actual" authority to manage the business of the company either generally or in respect of those matters to which the contract relates; (c) that he (the contractor) was induced by such representation to enter into the contract, that is, that he in fact relied on it; and (d) that under its memorandum or articles of association the company was not deprived of the capacity either to enter into a contract of the kind sought to be enforced or to delegate authority to enter into a contract of that kind to the agent. (Condition (d) does not apply in Australia: s 125(2).)

In the *Freeman and Lockyer* case, the representation that Kapoor had authority to act as managing director was made by the board, which had actual authority to manage the affairs of the company. This was so, even though the board had made no formal decision to appoint Kapoor as managing director. The representation arose because the board failed to prevent him from acting as if he were the company's managing director.

**[5.220]** In some instances a representation that someone has authority to act on behalf of a company may be made by a person who lacks actual authority to make such a representation. The representation then may not be sufficient to create an agent's apparent authority because it was not a representation made by the company.

*Crabtree-Vickers Pty Ltd v Australian Direct Mail Advertising & Addressing Co Pty Ltd*  
(1975) 33 CLR 72

**[5.225]** The High Court applied the reasoning of Diplock LJ in *Freeman and Lockyer* and held that a person who merely has apparent authority is not capable of making representations for the company. The only persons who had actual authority to make the necessary representation in the *Crabtree-Vickers* case were either a three-man committee or the full board itself and there was no evidence that either had made any representations to the outsider. This decision can be criticised on the basis that it disregards commercial practice as it was almost impossible for an outsider dealing with Crabtree-Vickers to discover who had actual authority to make representations for the company.

[5.230] It seems anomalous that a company is bound by a contract entered into by a de facto managing director – as occurred in *Freeman & Lockyer* – but not bound by representations of the de facto managing director that someone else has apparent authority.

A representation that an agent was authorised to contract on the company's behalf cannot come from the agent.

In *National Australia Bank Ltd v Sparrow Green Pty Ltd* [1999] SASC 280, the facts of which are described at [5.205], the director concerned did not have actual or apparent authority to bind the company. As in the *Crabtree-Vickers* case, the director did not have apparent authority because a representation as to authority was not made by someone with actual authority, such as the board or a duly appointed managing director. A person cannot confer authority on themselves by their own words or conduct: *NCR Australia Pty Ltd v Credit Connection Pty Ltd* [2004] NSWSC 1.

A company may hold out that a person occupies a particular position in the company. The extent of that person's authority will be limited to the customary authority of a person occupying such a position. A company will not be bound by contracts made by officers or agents who exceed their customary authority unless the holding out extends their customary authority. The customary authority of directors and secretaries is discussed at [5.330]–[5.360].

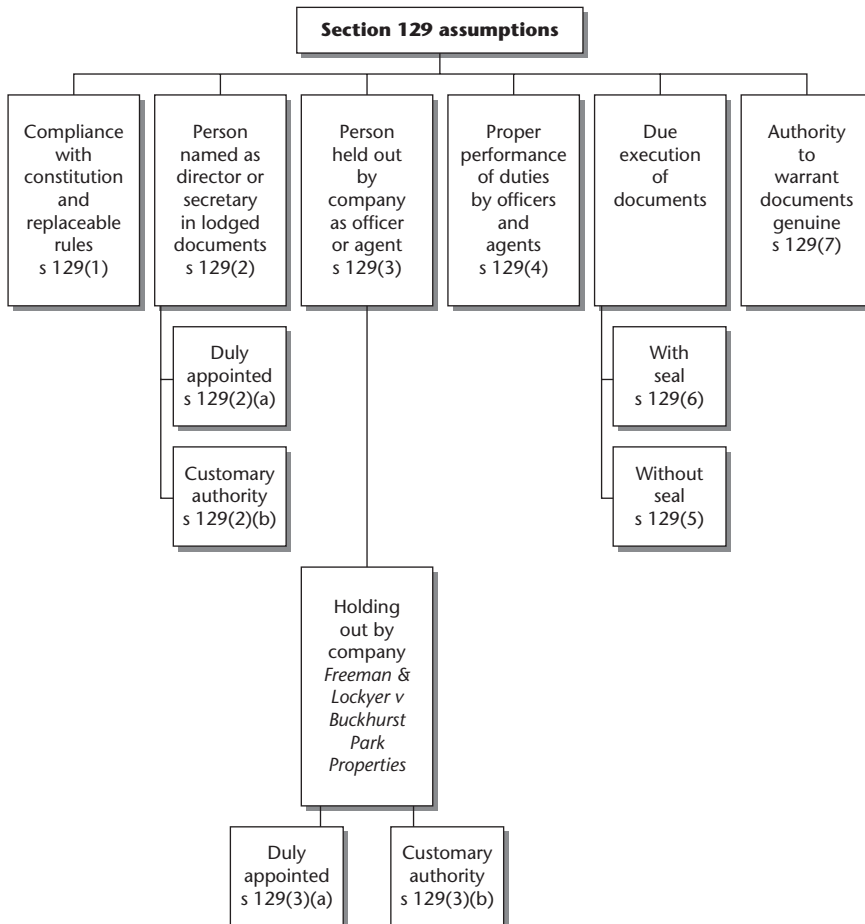
## The statutory assumptions: s 129

[5.235] A person dealing with a company is entitled to make the assumptions of regularity set out in s 129 in relation to those dealings. If one or more of the s 129 assumptions apply, the company is not able to assert that the assumptions are incorrect: s 128(1). The right to make these assumptions is lost where a person knew or suspected that the assumptions were incorrect: s 128(4). The purpose behind the s 129 assumptions is to protect outsiders who deal in good faith with persons who can reasonably be expected to have authority to act for the company.

A person is entitled to make certain assumptions of regularity in relation to dealings with a company.

Several assumptions codify and clarify the rule in *Turquand's* case, which is discussed at [5.175]. The entitlement to make the assumptions, together with the limitations in s 128(4), attempts to balance the competing interests referred to by Mason CJ in *Northside Developments Pty Ltd v Registrar-General* (1990) 170 CLR 146, discussed at [5.190].

Figure 5.1: Section 129 assumptions



## Dealings with a company

[5.236] The s 129 assumptions apply in relation to “dealings” with a company. In *Australia and New Zealand Banking Group Ltd v Frenmast Pty Ltd* [2013] NSWCA 459, the bank sought to enforce a guarantee that appeared to be signed by two directors, but where one of the signatures was forged. It was held that despite the forgery, the bank had dealings with the company. The director who signed the guarantee was acting on behalf of the company as he had apparent authority to sign and return finance documents which constituted dealings between the bank and the company. The director had the necessary authority to act on behalf of the company in those dealings because of previous communications with the bank on the company’s behalf. For there to be dealings by an outsider with a company, the person with whom the outsider has the dealings must have actual or apparent authority to undertake some negotiation. However, that person is not also necessarily required to have actual or apparent authority to enter into the particular transaction that is the subject of the negotiation.

Despite the use of the plural “dealings” in s 128, the section may also apply to a single transaction: *Advance Bank Australia Ltd v Fleetwood Star Pty Ltd* (1992) 10 ACLC 703.

Dealings with a company includes situations of forgery and purported dealings.

In *Story v Advance Bank Australia Ltd* (1993) 31 NSWLR 722, a bank took a mortgage over property owned by a company whose directors and shareholders were a husband and wife. The wife permitted the husband to have de facto control of the conduct of the company's business. The husband forged his wife's signature as director to the affixing of the company's common seal without her knowledge of the mortgage transaction. It was held that because part of the loan moneys was in fact applied for the purposes of the company, the bank's negotiations with the husband constituted “dealings” with the company. The concept of having dealings with a company extends beyond dealing with someone who has actual authority and includes situations where a document is forged and extends to purported dealings.

Each of the s 129 assumptions is separate and discrete: *Brick & Pipe Industries Ltd v Occidental Life Nominees Pty Ltd* [1992] 2 VR 279. This means that if an outsider cannot rely on one assumption, they may still rely on any of the other assumptions. While the assumptions are discrete, they may overlap and an outsider may rely upon more than one assumption: *Bank of New Zealand v Fiberni Pty Ltd* (1994) 12 ACLC 48.

The effect of s 129(8) is to give cumulative operation to the assumptions: *Sunburst Properties Pty Ltd v Agwater Pty Ltd* [2005] SASC 335. For example, a person may assume that an officer properly performs their duties under s 129(4) and in order to make this assumption may rely on the assumption under s 129(3) that the officer has been duly appointed and has the authority to perform those duties. It is not necessary for an outsider to have actually made these assumptions in order to later rely upon them: *Lyford v Media Portfolio Ltd* (1989) 7 ACLC 271.

In *Australian Capital Television Pty Ltd v Minister for Transport and Communications* (1989) 86 ALR 119, it was held that a predecessor of s 128(1) allowed the s 129 assumptions to be made only in relation to assertions by the company that an assumption was incorrect. Where an assertion of non-compliance with the constitution is made by a third party, the statutory assumptions do not apply because there must be dealings with a company, but the rule in *Turquand's* case and its limitations may still operate.

## Compliance with the constitution

**[5.240]** A person may assume, in relation to dealings with a company, that its constitution and any applicable replaceable rules have been complied with: s 129(1). Section 129(1) does not require the person to have knowledge of the constitution or replaceable rules: *Oris Funds Management Ltd v National Australia Bank Ltd* [2003] VSC 315. Under s 128(4), a person is not entitled to make this assumption if at the time of the dealing he or she knew or suspected that there had been non-compliance with the constitution or replaceable rules. Section 128(4) is discussed at [5.365]–[5.375].

A person may assume, in relation to dealings with a company, that its constitution and any applicable replaceable rules have been complied with.

*Oris Funds Management Ltd v National Australia Bank Ltd* [2003] VSC 315

**[5.245]** Oris Funds Management (OFM) was established to be the trustee of a master trust fund for a superannuation business conducted by another company, OFS Pty Ltd (OFS). As OFM needed additional capital it agreed with Tower Life Australia Ltd that Tower would be issued 40 per cent of the shares in OFM. As part payment for the shares, Tower gave OFM two cheques for \$150,000 each. Stanley, an OFM director, endorsed the cheques and purportedly authorised payment of the proceeds to OFS. The cheques were deposited into OFS's account with the National Australia Bank (NAB) which collected them and credited the account with the proceeds.

OFM's constitution provided that any two directors could endorse cheques but that the directors could determine that a cheque could be endorsed in a different way other than by two directors.

OFM subsequently sued NAB for the proceeds of the cheques. It argued that as Stanley did not have OFM's authority to endorse the cheques OFM remained their true owner. NAB's collection of the cheques constituted the tort of conversion and NAB was liable to pay damages to OFM.

It was held that NAB could rely on the s 129(1) assumption. A person dealing with a company can assume that action taken by the company was in accordance with its constitution. Therefore, NAB was entitled to assume that OFM's constitution had been complied with even if a single director endorsed the cheques. The court also held that the s 129 assumptions were cumulative. This meant that NAB could assume not only that the endorsement of the cheques was in accordance with OFM's constitution, it was also entitled to rely on s 129(4) and assume that Stanley had properly performed his duties to OFM when he endorsed the cheques. Section 129(4) is discussed at [5.265].

*Person named as officer in public documents*

**[5.255]** Under s 129(2), a person may assume, in relation to their dealings with a company, that anyone who appears, from information provided by the company that is available to the public from ASIC, to be a director or a company secretary:

- has been duly appointed; and
- has authority to exercise the powers and perform the duties customarily exercised or performed by a director or company secretary of a similar company.

Assumptions in relation to persons named as directors and secretary in ASIC-lodged documents.

Under s 128(4) a person is not entitled to make this assumption if at the time of the dealing he or she knew or suspected that the director or secretary had not been duly appointed or that the director or secretary did not have the authority to exercise the powers and perform the duties customarily exercised or performed by a director or secretary of a similar company. Section 128(4) is discussed at [5.365]–[5.375].

For the purpose of s 129(2), the information regarding directors and secretaries provided by a company that is available to the public from ASIC includes a s 205B notice of the personal details of directors and secretaries and responses under s 346C regarding changes to officers' details set out in the company's annual statement.

A person may rely on the s 129(2) assumption even if the person was unaware of the information contained in the ASIC notices or returns lodged by the company: *Lyford v Media Portfolio Ltd* (1989) 7 ACLC 271. The assumption enables outsiders to assume the accuracy of information in ASIC's publicly accessible national database.

By naming particular people as directors and secretary in documents lodged with ASIC, a company in effect holds out that the named people occupy the stated positions and have the authority that is customary for such officers. In this respect, there is an overlap between the s 129(2) and (3) assumptions.

Under s 129(2), an outsider must establish that the officer acted within the scope of the customary powers of such an officer of a similar company. The customary powers of directors and secretaries are discussed at [5.330]–[5.360].

The assumption in s 129(2) applies whether the persons named as directors or secretaries have been improperly appointed or not appointed at all. In both cases, the outsider is protected.

### *Person held out as officer or agent*

**[5.260]** Section 129(3) entitles a person to assume, in relation to dealings with a company, that anyone who is held out by the company to be an officer or agent has been duly appointed and has the authority to exercise the powers and perform the duties customarily exercised or performed by that kind of officer or agent of a similar company.

Assumptions in relation to persons who the company holds out are its officers or agents.

Under s 128(4) a person is not entitled to make this assumption if at the time of the dealing he or she knew or suspected that the officer or agent had not been duly appointed or that the officer or agent did not have the authority to exercise the powers and perform the duties customarily exercised or performed by that kind of officer or agent of a similar company. Section 128(4) is discussed at [5.365]–[5.375].

Section 9 defines the term “officer of a corporation”. It includes the directors and company secretary as well as executives who hold senior positions below board level: see [13.20]. An “officer of a corporation” is defined as a person:

- who makes or participates in making decisions that affect the whole or a substantial part of a company's business; or
- who has the capacity to affect significantly the company's financial standing; or
- in accordance with whose instructions or wishes the directors are accustomed to act.

A person dealing with a company has the onus of proving each element of s 129(3) before being entitled to rely on the assumption contained in it. This means the outsider must establish two things:



- a holding out by the company that a person is an officer or agent; and
- that the particular power exercised by the person so held out is within the scope of the powers customarily exercised or performed by an officer or agent of a similar company.

Where a company has held out that a person is an officer or agent, persons dealing with the company need not establish that the officer or agent has in fact been appointed. Section 129(3) allows them to assume that this is the case even if it is not true. In this respect, there is no difference between a defective appointment and a non-existent appointment.

A holding out by the company that someone is an officer or agent must come from a person who has actual authority.

Section 129(3) requires proof that a company has held out a particular person to be an officer or agent. This raises the same question as arises in connection with the general agency rules of apparent authority. Who can make a holding out for the company? Section 129(3) restates the agency rules in this respect. As discussed at [5.210]–[5.230], under agency rules, a holding out by the company can be made only by a person who has actual authority “to manage the business of the company either generally or in respect of those matters to which the contract relates”: *Freeman and Lockyer*.

In *Australia and New Zealand Banking Group Ltd v Australian Glass and Mirrors Pty Ltd* (1991) 9 ACLC 702, it was held that a company had held out two persons to be a director and secretary respectively. The holding out occurred because lodged documents named the two persons as its directors and they had previously conducted negotiations and signed documents as if they were directors. Similarly, in *Re Madi Pty Ltd* (1987) 5 ACLC 847 (*Re Madi Pty Ltd*) a company held out a person as its secretary by naming that person as its secretary in a document lodged with ASIC. The company was bound by the act of this person even though he had not been appointed at the time. The outsider dealing with the company in both these cases may also have been able to rely on the assumption contained in s 129(2) discussed at [5.255].

*Re Madi Pty Ltd* indicates that s 129(3) modifies the agency law of apparent authority as stated in *Freeman and Lockyer*. One of the common law requirements for the existence of apparent authority is that the outsider relies on the representation made by the company. In *Re Madi Pty Ltd*, there was no reliance on the representation as the creditor was unaware of the information contained in the company’s return and so could not be said to have relied on the information contained in it.

Under s 129(3), the person entitled to make the assumption must also establish that the disputed power exercised by the “held out” officer or agent is within the ambit of those powers customarily exercised or performed by that kind of officer or agent of a similar company. The customary powers of directors and secretaries are discussed at [5.330]–[5.360].

### *Officers and agents properly perform their duties*

**[5.265]** A person may assume, in relation to dealings with a company, that the officers and agents of the company properly perform their duties to the company: s 129(4). The



conduct with which s 129(4) is concerned is not whether acts are authorised or not but whether the acts involve a breach of duty. Therefore, the statutory assumption contained in s 129(4) is insufficient to overcome a lack of authority: *Great Investments Ltd v Warner* [2016] FCAFC 85. Under s 128(4), a person is not entitled to make this assumption if at the time of the dealing they knew or suspected that the officer or agent did not properly perform their duties to the company. Section 128(4) is discussed at [5.365]–[5.375].

The duties to which s 129(4) refer include properly performing an officer's statutory and fiduciary duties. Section 129(4) also applies even where officers or agents act within the scope of their authority.

*Pico Holdings Inc v Wave Vistas Pty Ltd* [2005] HCA 13

[5.266] Dominion Capital borrowed US\$1 million from Pico Holdings. Voss, Dominion Capital's chairman and managing director, promised that another company, Wave Vistas, would provide Pico Holdings with a second mortgage over Wave Vistas' land, to secure the loan to Dominion Capital. Voss was Wave Vistas' sole director. Dominion breached its loan agreement and Pico Holdings initiated legal proceedings against Wave Vistas to enforce its rights as second mortgagee. The High Court held that under s 129(4) Pico Holdings was entitled to assume that Voss properly performed his duties to Wave Vistas and that therefore Voss had actual authority to make the promise to provide the mortgage security. Under s 128(1) Wave Vistas was not permitted to assert that the s 129(4) assumption was incorrect. The High Court also rejected the argument that Voss could not have been exercising his authority as a director of Wave Vistas because the grant of the second mortgage security over Wave Vistas' land was of no benefit to Wave Vistas. The High Court held that s 129(4) permitted Pico Holdings to assume that Voss properly performed his duties to Wave Vistas and hence complied with his duty of care and diligence as well as his duty to act in good faith and in the best interests of Wave Vistas. Section 128(4) did not apply as Pico Holdings did not know or suspect that the s 129(4) assumption was incorrect.

## Document duly executed

[5.270] A company may execute a document with or without fixing its common seal to the document. Section 129(5) sets out an assumption of due execution where a document is executed without a seal, and s 129(6) sets out the equivalent assumption of due execution where a document is executed with a seal. As with the other assumptions, a person is not entitled to make an assumption under either s 129(5) or (6) if he or she knew or suspected that the assumption was incorrect: s 128(4).

|                                           |
|-------------------------------------------|
| Assumptions that documents duly executed. |
|-------------------------------------------|

Section 129(5) provides that a person may assume, in relation to dealings with a company, that a document has been duly executed by the company if the document appears to have been signed in accordance with s 127(1): see [5.135]. A person may also assume under

s 129(5) that anyone who signs the document and states next to their signature that they are the sole director and secretary of the company, occupies both offices. As a result of 2022 amendments, the requirement to sign may be satisfied electronically: s 110A.

Section 129(5) focuses on the appearance of the document, so this indicates that the entitlement to make this assumption is determined with reference to the objective appearance of the face of the document. This can be established by the placement of signatures above the words “director” and “secretary”: *Soyfer v Earlmaze Pty Ltd* [2000] NSWSC 1068. It is unnecessary that the person seeking to rely on the s 129(5) assumption must establish a link with the assumptions in s 129(2) or (3). The assumption in s 129(5) does not require the person seeking to rely upon it to ascertain from information available from ASIC that the signatures on the document appear to be those of directors or the secretary of the company: *Caratti v Mammoth Investments Pty Ltd* [2016] WASCA 84.

As discussed at [5.135], s 127(1) provides that a company may execute a document without using its common seal if two directors or a director and company secretary sign the document. In the case of a proprietary company that has a sole director, the company may execute a document if that director signs it.

Under s 129(6) a person may assume that a document has been duly executed if:

- the company’s common seal appears to have been fixed to the document in accordance with s 127(2); and
- the fixing of the common seal appears to have been witnessed in accordance with s 127(2): see [5.120].

A person may also assume that anyone who witnesses the fixing of the common seal and states next to their signature that they are the sole director and secretary of the company occupies both offices: s 129(6).

A person may assume that a company has duly executed a document if it “appears” to have been signed in accordance with s 127(1) or the fixing of the company’s common seal “appears” to have been witnessed in accordance with s 127(2). A document will “appear” to have been signed or witnessed in accordance with s 127(1) and (2) if the appropriate officer signs or witnesses the document and states next to their signature that they are either:

- a director or secretary; or
- in the case of a one-person proprietary company, the sole director.

*Vero Insurance Ltd v Kassem* [2010] NSWSC 838

**[5.275]** Vero was a creditor of a company in voluntary administration. A creditors’ meeting was convened to consider the adoption of a deed of company arrangement. The court held that the chair of the meeting was entitled to reject Vero’s proxy appointing a representative to vote against the motion because the proxy form was not executed in accordance with s 127(1). As a result, Vero could not rely on the s 129(5) assumption. Vero’s executive manager signed the proxy form and while s 127(4) permits a company to execute documents in other ways, Vero failed to inform the chair of the meeting that the executive manager had actual authority to

execute documents on its behalf. The company failed to put in place a system that allowed for an effective means of determining and proving the authority of officers. Vero also failed to lead evidence that signing proxy forms was within the executive manager's customary authority for purposes of the s 129(3) assumption.

**[5.280]** The s 129(5) and (6) assumptions may apply even if the officer who signs or witnesses a document does not occupy the designated position.

*Brick & Pipe Industries Ltd v Occidental Life Nominees Pty Ltd* [1992] 2 VR 279

**[5.285]** A company fixed its seal to a guarantee witnessed by two directors, one of whom was incorrectly described as the company secretary as that person had not been appointed as secretary. It was held that under a predecessor of s 129(6) the other party to the guarantee could assume the guarantee was duly executed notwithstanding the incorrect designation. The court also held that the guarantor company had held out that the director who incorrectly signed as secretary was the secretary.

**[5.290]** Since the witnesses to fixing Brick & Pipe's seal to the guarantee were designated as a director and secretary, the document "appears" to have been witnessed in accordance with s 127(2)(b). The incorrect designation of the office of one of the witnesses would still entitle the other party to the guarantee to assume it was duly executed. However, if that person knew or suspected that the witness did not occupy the designated position, then under s 128(4) they could not rely on the due sealing assumption.

**[5.300]** Section 129(6) recognises the execution of documents by one-person companies. A document executed by such a company will "appear" to be executed in accordance with s 127(2) only if the company is a proprietary company and the signatory states next to their signature that they are the sole director.

*Myers v Aquarell Pty Ltd* [2000] VSC 429

**[5.305]** The Supreme Court of Victoria held that a person was entitled to assume that a mortgage was duly executed under s 129(6) as the company seal was affixed in the presence of its sole director and secretary in compliance with s 127(2), even though the company's constitution required that the company should have a minimum of two directors and that fixing the seal was to be witnessed by at least one director and countersigned by the company secretary.

**[5.310]** Under the assumptions contained in s 129(5) and (6), there is no requirement that the persons signing the document or witnessing the fixing of the seal need to be held out or named by the company as relevant officers. It is sufficient if the document appears on its face to have been signed, or the company seal witnessed, by the required officers.

## Warranting documents genuine

[5.315] Under s 129(7), a person, in relation to dealings with a company, may assume that an officer or agent of the company who has authority to issue a document or a certified copy of a document on its behalf also has authority to warrant that the document is genuine or is a true copy. Therefore, a company secretary may be assumed to have the requisite authority to warrant that a share certificate is genuine. At common law, it was doubtful whether a company secretary had authority to warrant that a document was genuine, and generally companies were not bound by forged certificates and other documents. The customary authority of a company secretary is discussed at [5.350].

## Customary authority of officers

[5.330] We saw earlier that under s 129(2) and (3), an officer or agent of a company only binds the company to contracts with outsiders if he or she exercises the powers and performs the duties customarily exercised or performed by an officer or agent of a similar company. The question then arises: what are the customary powers and duties of particular officers or what is their customary authority?

### Individual directors

[5.335] We see in Chapter 12 that the constitution or replaceable rules usually confer powers of management on the directors collectively as a board: see [12.75]. However, frequently, individual directors are given the power to:

- witness the fixing of the company's common seal (s 127(2)); and
- sign the company's negotiable instruments, including cheques (s 198B).

An individual director does not have customary authority to make contracts on the company's behalf.

An individual director does not have customary authority to make contracts on the company's behalf just because the person has been appointed as a director. In *Northside Developments Pty Ltd v Registrar-General* (1990) 170 CLR 146, Dawson J stated:

The position of director does not carry with it an ostensible authority to act on behalf of the company. Directors can act only collectively as a board and the function of an individual director is to participate in decisions of the board. In the absence of some representation made by the company, a director has no ostensible authority to bind it.

While the customary authority of individual directors is limited, they will nevertheless bind their company if they have actual authority or have been held out as having greater authority than is customary for individual directors. This may often arise in the case of small proprietary companies where management is effectively conducted by a particular director with the acquiescence of the other directors.

In *Brick & Pipe Industries Ltd v Occidental Life Nominees Pty Ltd* [1992] 2 VR 279, a dominant director was taken to represent the mind and will of the company and have

the authority of a managing director where the other directors acquiesced to this and did not involve themselves in transactions entered into by the dominant director.

In the absence of acquiescence of other directors, an individual director does not have customary authority to represent that someone else has been appointed as secretary: *Bank of New Zealand v Fibern Pty Ltd* (1994) 12 ACLC 48.

## Managing director

[5.340] A managing director has the customary authority to make contracts related to the day-to-day management of the company's business. This includes engaging persons to do work for the company (*Freeman and Lockyer*) and borrowing money on the company's behalf: *British Thomson-Houston Co Ltd v Federated European Bank Ltd* [1932] 2 KB 176. A managing director's customary authority may not include a purported sale of the entire business of the company: *Re Tummion Investments Pty Ltd* (1993) 11 ACLC 1139.

In *Re Qintex Ltd* (1990) 8 ACLC 811, it was held that a managing director did not have the customary authority to make "critical" decisions following the presentation of an application to wind up the company. In that case, the managing director did not have authority to appoint solicitors to oppose the application.

## Chair

[5.345] The chair has the same customary authority as any other individual director and consequently does not have the customary authority to contract on the company's behalf: *Hely-Hutchinson v Brayhead Ltd* [1968] 1 QB 549.

## Secretary

[5.350] The status of a secretary has, in the eyes of the courts, changed over the past century. So, too, has the secretary's customary authority. The early cases held that a secretary did not have customary authority to bind a company. A secretary now has customary authority to enter into contracts that are related to the administration of the company.

*Panorama Developments (Guildford) Ltd v Fidelis Furnishing Fabrics Ltd* [1971] 2 QB 711

[5.355] The present position with respect to a secretary's customary authority is illustrated in this case. The secretary of Fidelis, without authority, hired cars from Panorama, which he stated were for the purpose of carrying his company's important customers. The secretary, however, used the cars for his own purposes. When he failed to pay the hire charges Panorama sued Fidelis, arguing that the secretary had apparent authority to enter into that contract. The court upheld Panorama's claim and decided that a company secretary has the customary authority to enter into contracts connected to the administrative side of the company's affairs.

[5.360] The customary authority of a company secretary is not as wide as that of a director. A secretary's customary role is limited to matters of an administrative, internal nature

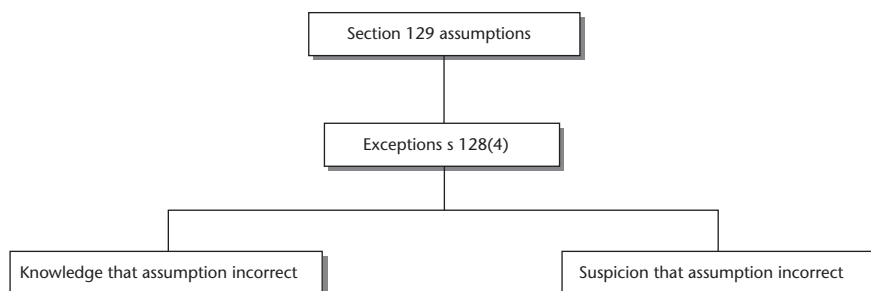
required for day-to-day running of the company's affairs, such as employing staff, and ordering cars. The customary powers of a secretary do not include authority to mortgage the company's land: *Northside Developments Pty Ltd v Registrar-General* (1990) 170 CLR 146.

## Limitations to the statutory assumptions: s 128(4)

[5.365] A person cannot rely on any of the assumptions set out in s 129 if the person knew or suspected that a particular assumption was incorrect at the time of the dealings: s 128(4). This is a subjective test, relating only to what a person actually knew or suspected. In order for a person to rely on the assumptions in s 129, it is not necessary to make inquiries to be certain that the assumptions are in fact correct.

Section 128(4) replaced the general law limits to the rule in *Turquand's* case. The rule in *Turquand's* case could not be relied upon where an outsider actually knew of the irregularity or the circumstances were such that they were put on inquiry: *Northside Developments Pty Ltd v Registrar-General* (1990) 170 CLR 146. Section 128(4) does not refer to an outsider being “put on inquiry”, meaning that there is no obligation on an outsider to make reasonable inquiries if faced with suspicious or irregular circumstances: *Sunburst Properties Pty Ltd v Agwater Pty Ltd* [2005] SASC 335.

**Figure 5.2: Exceptions to section 129 assumptions**



### *Knew assumption incorrect*

[5.370] Under s 128(4), a person is not entitled to make an assumption in s 129 if at the time of the dealing they knew that the assumption was incorrect. This exception is not concerned with constructive knowledge or constructive suspicions. Therefore a person would not be regarded as knowing a piece of information just because the information was on the public record or a reasonable person would have known the information: *Oris Funds Management Ltd v National Australia Bank Ltd* [2003] VSC 315, the facts of which are outlined at [5.245]. Knowledge or suspicion acquired at a time later than the dealing does not deprive the person dealing with a company of the protection under s 128(4): *Correa v Whittingham* [2013] NSWCA 263.

In *Brick & Pipe Industries Ltd v Occidental Life Nominees Pty Ltd* [1992] 2 VR 279, the Full Court of the Supreme Court of Victoria thought that the expression “actual knowledge” meant what it said and did not lend itself to further definition or elaboration. The expression “actual knowledge” was used in a predecessor of the current s 128(4) and

probably means the same as the word “knew”. However, it still depended on the facts and circumstances in a particular case and the inferences they allow. In this case the court indicated that it might be prepared to impute to the lender, the actual knowledge of its solicitor. This means that the knowledge of an agent may be taken to represent the actual knowledge of the outsider.

What does a company know?

Where the person dealing with a company is itself a company, the question may arise as to what it knew or suspected for purposes of s 128(4). As discussed at [5.10]–[5.20], a company is regarded as having the knowledge and suspicions of its directing mind and will. Sometimes, a company and another company dealing with it may have common directors. This raises the question whether the knowledge of the shared directors is attributed to their respective companies. This question has not been answered by the courts.

### *Suspected assumption incorrect*

**[5.375]** A person cannot rely on the s 129 assumptions if at the time of the dealing they suspected that the assumption was incorrect: s 128(4).

There are at least two possible interpretations of the suspicion exception in s 128(4). On one interpretation, s 128(4) prevents a person from making a s 129 assumption only if circumstances surrounding the dealing result in the person actually suspecting the assumption is incorrect. Consequently, a person could still rely on a s 129 assumption if the person did not in fact form such suspicions, even though a reasonable person would have. This interpretation appears to have been generally applied.

In *Oris Funds Management Ltd v National Australia Bank Ltd* [2003] VSC 315, the facts of which were outlined at [5.245], the court explained that to suspect “that something exists is more than a mere idle wondering whether it exists or not; it is a positive feeling of actual apprehension or mistrust, amounting to a slight opinion, but without sufficient evidence”.

A company has the burden of proving that a person had the subjective knowledge or suspicion that an assumption was incorrect.

Criticisms of the exception.

The wording of this exception can be criticised because it does not expressly provide for an objective test where the person dealing with a company should act reasonably to make further inquiries when faced with suspicious circumstances. The absence of such an objective test may tend to encourage banks and other outsiders dealing with a company to “don blinkers” when faced with warning signs. It may “encourage ignorance and condone dereliction of duty” where lenders fail to make reasonable inquiries: *Morris v Kanssen* [1946] AC 459. By failing to make reasonable inquiries, a person dealing with a company may wittingly or unwittingly assist company officers in breaching their duties and acting without authority to the detriment of the company, its shareholders and creditors.



## The effect of fraud or forgery

**[5.380]** A person may rely on the assumptions in s 129 even if an officer or agent of the company acts fraudulently or forges a document in connection with the dealings: s 128(3). An agent of the company in this context means that the person has some legitimate role on behalf of the company in relation to the particular dealings: *Soyfer v Earlmaze Pty Ltd* [2000] NSWSC 1068. Section 128(3) covers the situation where a company seal or signatures attesting its application are not genuine but are forged: *Story v Advance Bank Australia Ltd* (1993) 31 NSWLR 722.

This provision restates the common law rule that a company or employer is liable for the fraudulent acts of its officers, agents or employees where they have acted within their actual or apparent authority. It also overrules a principle stated in *Ruben v Great Fingall Consolidated* [1906] AC 439 that a forgery is a nullity and cannot bind a company.

## Tutorial questions

1. The directors of Ardvaark Ltd instructed the company's stockbroker to buy 10,000 shares in BHP Billiton Ltd on the company's behalf. After the purchase was finalised, BHP Billiton Ltd sent Ardvaark Ltd a banking form to enable BHP Billiton dividends to be credited directly into a bank account that Ardvaark Ltd nominated. The banking form had to be signed by either two directors or a director and the company secretary as follows:

|       |                                                                     |
|-------|---------------------------------------------------------------------|
| ..... | Signature of Director                                               |
| ..... | Signature Director/Secretary [strike out whichever is inapplicable] |

Instead of inserting Ardvaark Ltd's bank account details on the form, Anthony, Ardvaark Ltd's secretary, filled in his own bank account details and signed the form as the company's secretary. Anthony's wife, despite not being an Ardvaark Ltd director, signed as director. Anthony then posted the banking form to BHP Billiton Ltd. Several weeks later, BHP Billiton dividends were credited to Anthony's account. Not long afterwards Anthony resigned as secretary and left Australia without telling anyone where he had gone.

About 18 months later, Ardvaark Ltd's internal auditor noticed that its BHP Billiton dividends had not been deposited into Ardvaark Ltd's bank account and reported the matter to the company's managing director, who discovered what Anthony had done. When informed about this, BHP Billiton Ltd agreed to credit Ardvaark Ltd's bank account for future dividend payments but would not reimburse Ardvaark Ltd for the dividends that had been deposited into Anthony's bank account previously.

Explain whether Ardvaark Ltd may validly argue that it did not sign the bank account form that Anthony sent to BHP Billiton Ltd.



2. Financial Investment Consultants Ltd (FIC) operates an investment counselling business specialising in advising its clients on how to invest their retirement benefits.

While attending a conference, Abe, one of FIC's non-executive directors, introduced himself to Catherine, the managing director of Client Contact Pty Ltd (CC), a direct marketing company, and handed her his business card. Catherine told Abe that her company was negotiating an agreement to sell its innovative direct financial marketing system to FIC's main competitor.

Abe was particularly impressed with CC's direct financial marketing system. He believed FIC should move quickly and acquire the system before it went to FIC's competitor. Abe offered Catherine \$3 million for the system. Catherine gave Abe a sale agreement which he signed, "Abe, for and on behalf of FIC".

Ben, FIC's managing director, recently learned what Abe had done. He was not as enthusiastic as Abe about the direct financial marketing system and believed FIC was not bound by the agreement Abe signed, as the matter had not been approved by Ben or the full board of FIC.

Explain whether Client Contact Pty Ltd can enforce the sale agreement against Financial Investment Consultants Ltd. Would your answer be different if the agreement had been entered into by:

- Ben, managing director, for and on behalf of Financial Investment Consultants Ltd; or
- Sherlyn, the marketing manager of Financial Investment Consultants Ltd.

3. Fawltly Trucks Pty Ltd carries on an interstate trucking business. It has two directors: Basil, the managing director, and his wife Sybil, who is also the company's secretary. Apart from its fleet of trucks, the company also owns the house where the directors live.

Basil and Sybil's marriage has broken down and they have separated. Sybil continues to live at the house and is not involved in the day-to-day operations of the company's business. Basil lives in a hotel with his son, Manuel.

Three months ago Basil, without telling his wife, borrowed \$100,000 from Eastpac Bank. The money was for his own use. The loan was secured by a first mortgage over Fawltly Trucks Pty Ltd's house, occupied by Sybil. The mortgage was executed under the company's seal, witnessed by Basil as director and Manuel as company secretary. However, contrary to the company's constitution, board approval had not been obtained for the mortgage. At the time the mortgage was executed, Basil told the Eastpac Bank manager who approved the loan that Sybil had resigned as company secretary and that Manuel had been appointed to that position. Basil then took the \$100,000 and disappeared with Manuel to Barcelona.

Sybil has now been made aware that Basil mortgaged the house. She tells Eastpac Bank that Fawltly Trucks Pty Ltd was not bound by the mortgage.

Explain whether Eastpac Bank can rely on the assumptions in s 129. Which assumptions are relevant?

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.

## Chapter 6

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# Promoters and pre-registration contracts

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## Key points

- A promoter is a person who is involved, actively or passively, in forming a company, raising its capital and establishing its business.
- Promoters owe fiduciary duties to their company similar to directors. These duties require the promoter to act in the best interests of the company, disclose their interests in contracts with the company and not make undisclosed profits.
- The nature and extent of a promoter's interests in the company's formation and any property acquired by it must also be disclosed in a prospectus if the company seeks to raise capital from the public.
- Pre-registration contracts may be enforced by the outside contracting party against the company after its registration or against a person who entered into the contract for the company.

## Introduction

**[6.05]** A promoter is a person involved in the formation of a company. The term “promoter” includes those who actively undertake the formation of a company. The common law imposes fiduciary duties on persons involved in the setting up or floating of companies. A person who enters into a contract on behalf of a company before it is registered is sometimes also referred to as a promoter. Pre-registration contracts are discussed at [6.65]–[6.80].

## Promoters

### Who is a promoter?

**[6.10]** The term “promoter” encompasses a person who “undertakes to form a company with reference to a given project and to set it going, and who takes the necessary steps to accomplish that purpose”: *Twycross v Grant* (1877) 2 CPD 469.

### Active promoters

**[6.15]** A person who actively undertakes the formation of a company by carrying out the procedure necessary for incorporation is a promoter. A promoter will usually form a company as part of an entrepreneurial scheme. Incorporation may include, among other things, registering the company, paying registration and legal fees, preparing the company’s constitution, appointing directors and shareholders, raising capital, negotiating preliminary agreements and acquisitions of assets and preparing a prospectus. Promoters may form large companies that seek stock exchange listing or small proprietary companies that are formed to purchase a business previously run by a sole trader, as occurred in *Salomon v A Salomon & Co Ltd* [1897] AC 22 discussed at [2.50].

While persons who actively take the required steps to form a company and cause it to acquire assets are clearly promoters, those acting merely in a professional capacity on behalf of a promoter are not. Therefore, solicitors and accountants who do no more than carry out the instructions of a promoter and take no further part in the enterprise are not promoters. Similarly, where a company becomes a promoter due to the activities of an officer, the officer does not become a promoter because they do not stand to personally gain from the promotion. An officer who represents the directing mind and will of the promoter company may be regarded as a promoter: *Aequitas v AEFC* [2001] NSWSC 14. Directing mind and will is discussed at [5.10]–[5.80].

### Passive promoters

**[6.20]** A person who takes no active part in the formation of a company and the raising of its share capital, but leaves this to others on the understanding that they will profit from the enterprise, may also be a promoter: *Tracy v Mandalay Pty Ltd* (1953) 88 CLR 215.

## Duties of promoters

### *Fiduciary duties*

**[6.25]** Where a promoter forms a company for the purpose of selling particular property to the company and arranges for the shares of the company to be taken up by others, a conflict of interest arises, and there is the possibility that the promoter may misuse their position to gain a personal profit, or cause detriment to the company and its shareholders. Because promoters may be tempted to misuse their positions in this way, the courts, in a series of late 19th century cases, applied the principle that a promoter stands in a fiduciary relationship with the company and is therefore under an obligation to the promoted company to act in good faith and to avoid conflicts of interest with the company.

A promoter has a fiduciary relationship with the company.

The fiduciary obligations arise automatically once a person is identified as a promoter. It is not necessary to find a specific undertaking of a kind that would constitute a fiduciary relationship in the particular circumstances: *Aequitas v AEFC* [2001] NSWSC 14. These fiduciary duties also apply to directors in relation to their companies. If a promoter becomes a director, their duties as a promoter overlap with their duties as director. Directors' duties are discussed in Chapters 13–18.

The fiduciary duties of promoters are owed for the entire period during which a person is a promoter. It is a question of fact in each case precisely when a person becomes or ceases to be a promoter. The person may become a promoter before the company is formed. That person remains a promoter for as long as the formation of the company continues. This process could include the issue of a prospectus, the raising of funds from the public and the performance of contracts imposed upon the company by the promoters. A person may continue to be a promoter even after the appointment of a board of directors where the directors are passive and act in the interests of the promoters: *Twycross v Grant* (1877) 2 CPD 469.

### *Disclosure of interests in a contract*

**[6.30]** As part of a promoter's fiduciary obligations to a company, a promoter must ensure that full disclosure is made of their interest in any contract entered into by the company.

Promoters must fully disclose their interests in contracts with the company they are promoting.

Non-disclosure is a breach of the promoter's duty towards the company. This is so whether or not the promoter was acting honestly, or even whether or not a profit was made. Promoters are under a duty to provide the company with an independent board

of directors to whom full disclosure of the promoters' interests in contracts with the company must be made. The directors would then be able to exercise an independent and reasoned judgment on the transaction: *Erlanger v New Sombrero Phosphate Co* (1878) 3 App Cas 1218.

## Undisclosed profits

**[6.35]** In addition to disclosing their interest in a contract with the company, promoters also have a duty to disclose all personal profits that may arise from their position. All promoters who share secret profits are severally liable for the full amount, with a right of contribution from their co-promoters. This is analogous to the liability of partners: *Gluckstein v Barnes* [1900] AC 240.

**[6.38]** These cases illustrate that a promoter should appoint and then make disclosure to an independent board of directors. In some cases, however, a company formed for the purpose of purchasing the assets of its promoter may have directors who are not independent of the promoter. As stated in *Gluckstein v Barnes* [1900] AC 240, it is insufficient for a promoter to disclose to directors who are also involved in the venture. In such a case, a promoter should make full disclosure to an independent board if this is possible. If this is not practicable, full disclosure should be made to the shareholders. It may also be necessary to make disclosure to potential shareholders in a disclosure document under Ch 6D of the *Corporations Act*. The fundraising requirements are discussed in Chapter 7.

Apart from an obligation not to make secret profits, there is also an obligation not to disclose confidential information. A promoter must also avoid taking up a contract or opportunity that in equity belongs to the company. Promoters will breach this duty if, during the course of a promotion, they purchase property that ought to have been acquired by the company. A breach of duty also occurs if, during the promotion, promoters buy property with the intention of selling it to the company at a profit.

## Fundraising disclosure

**[6.40]** The fundraising provisions in Ch 6D of the *Corporations Act* require companies that seek to raise funds by the offer of their shares or other securities, to provide investors with a disclosure document, a copy of which has been lodged with Australian Securities and Investments Commission. A prospectus is the main type of disclosure document that is required: s 709. Among other matters, s 711(2) requires a prospectus to set out the nature and extent of the interests that a promoter has in:

- the formation or promotion of the company;
- property acquired or proposed to be acquired by the company in connection with its formation or promotion or the offer of securities; or
- the offer of the securities.

The prospectus must also set out the amount paid or agreed to be paid for the promoter's services in connection with the formation or promotion of the company or the offer of securities: s 711(3).

The fundraising provisions are discussed in Chapter 7.

## Remedies for breach of duties

[6.45] The remedies for breach of a promoter's fiduciary duty are available to the company and not its shareholders. In circumstances where promoters control the company, whether through control of the board of directors or the general meeting, the company will not usually choose to exercise any rights available to it against its promoters. In such instances, minority shareholders may have rights, as discussed in [24.285]–[24.300].

### Rescission

[6.50] If a promoter breaches the fiduciary duties owed to the company, for example, because of failure to disclose a personal interest in a contract with the company, the company may rescind the contract.

The company may rescind a contract if promoters fail to disclose their personal interest in it.

It is irrelevant that the promoter made no profit or had no dishonest motive in respect of the contract. Under contract law, however, the right to rescind is unavailable if:

- the company does not rescind reasonably promptly after becoming aware of the misrepresentation;
- the company, after becoming aware of the misrepresentation, does something which indicates that it has affirmed the contract;
- *restitutio in integrum* is impossible, that is, it is not possible to restore the parties to their original positions. For example, if the property purchased from the promoter has undergone a substantial alteration in the hands of the company, it could not be said that the return of that property to the promoter restores the company to its pre-contract position; or
- prior to the rescission of the contract, innocent third parties acquire some interest in the property.

If the right to rescind is properly exercised, the result is that the promoter must return any consideration received and the company must return the property as happened in *Erlanger v New Sombrero Phosphate Co* (1878) 3 App Cas 1218, discussed at [6.32].

If the misrepresentation is fraudulent as opposed to innocent, the company may obtain damages as well as rescind the contract. In *Re Leeds and Hanley Theatres of Varieties Ltd* [1902] 2 Ch 809, it was held that the promoters had fraudulently omitted to disclose a profit made by them on the sale of property to the company. The appropriate measure of damages was the promoter's profit on the sale.

In some cases, equitable compensation may be combined with an order for rescission. In *Tracy v Mandalay Pty Ltd* (1953) 88 CLR 215, the order for rescission was accompanied by orders which enabled the company to recover various costs such as taxes, rates and other losses which were ancillary to the primary remedy of rescission and which ensured that restitution occurred.

If a promoter sells property to the company that was acquired by the promoter prior to becoming a promoter and the company elects not to rescind but to proceed with the contract with the promoter, it is not permitted to recover the secret profit made by the promoter: *Tracy v Mandalay Pty Ltd* (1953) 88 CLR 215. In cases where the right to rescind is lost in relation to prior acquired property, it is unclear whether other remedies such as account of profits and equitable compensation are available. Austin J suggested that these remedies should be available in order to prevent injustice: *Aequitas v AEFC* [2001] NSWSC 14.

### *Recovery of secret profits and constructive trust order*

**[6.55]** In some cases, the secret profit may be separate from the contract price. *Gluckstein v Barnes* [1900] AC 240, discussed at [6.37], is an illustration of such a situation. There, the court ordered that the company could recover the secret profit even though it chose not to rescind the contract. The liability of promoters is joint and several. A promoter who is found liable may recover contributions from the other promoters.

Where the promoter during the course of promotion acquires property for personal gain instead of for the company, the company may obtain a constructive trust order and require the promoter to hand it over at cost. This is because a promoter is taken to have acquired the property for the benefit of the company, which gains an equitable interest in it. Constructive trusts as a remedy for breach of directors' duties is discussed at [19.90]–[19.115].

### *Liability under Corporations Act*

**[6.60]** In certain circumstances, promoters in breach of their fiduciary duties may incur statutory liability. For example, s 711(2) and (3) requires a prospectus to set out certain information with respect to a promoter's interest in the formation, promotion or property acquired by the company. Misstatements or omissions in relation to that information contravenes s 728(1). If a promoter is involved in that contravention, then any person who suffers loss or damage may recover that loss or damage from the promoter under s 729. Liability for misstatements and omissions in disclosure documents is discussed at [7.195].

Promoters come within the definition of "related entity" in s 9. Consequently, a promoter may be liable to a liquidator under the voidable antecedent transaction provisions. These are discussed at [32.475] and onwards.

## **Pre-registration contracts**

### **Common law position**

**[6.65]** Prior to its registration, a company did not exist as a legal person. This proposition resulted in the common law rule that a company cannot enter into a binding contract until after it is registered, nor can it appoint an agent. A company also could not ratify pre-incorporation contracts after it was registered because under agency rules ratification has retrospective effect dating back to the time of the purported contract when the company did not yet exist. As discussed at [6.70], s 131 changes the common law rule.



## Operation of s 131

**[6.70]** The difficulties that arise at common law with respect to pre-registration contracts have been overcome by s 131, which replaces the common law rules with respect to pre-registration contracts: s 133. An outsider dealing with a company before its registration is now in a more certain position as regards enforcing a contract.

A person may enforce a pre-registration contract against a company if it ratifies the contract after it is registered.

Section 131 enables the outsider to enforce a pre-registration contract against the company if it ratifies the contract after it is registered. However, if registration does not occur or the company does not ratify the pre-registration contract, the person who entered the contract on its behalf becomes personally liable to pay damages to the other contracting party.

Section 131 only applies to contracts made before a company is registered. It does not apply where a company was registered at the time a contract was made and later changed its name: *Commonwealth Bank of Australia v Australian Solar Information Pty Ltd* (1987) 5 ACLC 124.

### *Ratification after registration*

**[6.75]** Section 131(1) changes the common law rule that a company cannot ratify a pre-registration contract. Under that section, a company becomes bound by and is entitled to the benefit of a pre-registration contract entered into on its behalf or for its benefit if the company is registered and ratifies the contract within either an agreed time or within a reasonable time after the contract is entered into. A pre-registration contract is formed on the date it is ratified rather than on the date when it was initially entered into: *Keswick Developments Pty Ltd v Kevroy Pty Ltd* [2009] QSC 176. A contract is ratified within an “agreed” time under s 131(1) if there is a mutual understanding between the parties to a contract, but the agreement does not have to be part of the contract nor even contractually binding: *Aztech Science Pty Ltd v Atlanta Aerospace (Woy Woy) Pty Ltd* [2005] NSWCA 319.

Meaning of ratification.

**[6.78]** Ratification means that a company adopts or confirms the pre-registration contract. Its meaning in s 131 derives from agency law and may be expressed or implied by conduct. For example, a company ratifies a contract if it signs a document to that effect or its directors pass a resolution ratifying the contract.

Under s 126(1) a company's power to ratify may also be exercised by an individual acting within the company's express or implied authority and on behalf of the company. This power may be exercised without using a common seal. Ratification may also be implied from the company's conduct. For example, if a pre-registration contract involved a purchase of goods, then payment of the purchase price or use of the goods by the company after it is registered would constitute evidence that it has ratified the contract.

Section 131(1) applies where a person such as an agent or trustee enters into a contract “on behalf of” a company before it is registered. By using the expression “for the benefit of”, s 131(1) also applies where a person enters a pre-registration contract in the name of a company.

In some situations, the name of the proposed company, in whose name a pre-registration contract is entered into, may not be the actual name of the company when it is registered. For example, the proposed company name may be unavailable. Section 131(1) still applies in such cases as long as the company that is registered is reasonably identifiable with the one identified in the pre-registration contract.

### *Liability where company not registered or fails to ratify*

**[6.80]** Under s 131(2), the person who enters into a pre-registration contract is liable to pay damages to the other contracting party if the company is not registered within either an agreed time or a reasonable time after the contract is entered into. That person is also liable if the company is registered but does not ratify the contract or does not enter into a substitute contract within this time period. The person who enters into a pre-registration contract will not be liable for damages if the other contracting party signs a release to that effect: s 132(1).

A person who makes a pre-registration contract for a proposed company is liable to pay damages to the other contracting party if the company is not liable.

The amount of damages for which a person may be liable under s 131(2) is the amount the company would be liable to pay if it had ratified the contract but did not perform it at all. This includes any lost profits the other contracting party expected to make on the contract as well as wasted expenditure incurred in reliance of the contract being performed.

Section 131(2) imposes a liability for damages only on the person who enters into the pre-registration contract on behalf of a company even though that person may have acted on behalf of others. For example, in *Bay v Illawarra Stationery Supplies Pty Ltd* (1986) 4 ACLC 429, an accountant, who was one of four promoters of a company, entered into a pre-registration contract for office supplies on behalf of a proposed company. When the company failed to ratify the contract, the supplier sued all four promoters under a predecessor of s 131(2). The Supreme Court of New South Wales held that only the accountant was liable, as he was the only one who signed the contract. The court noted, however, that the accountant would have a separate right to claim against the other promoters if he acted as their agent in relation to the contract.

But for s 132(2), a person who enters into a pre-registration contract as trustee for a proposed company may, under the rules of equity, have a right to be indemnified by the company for that person’s liability for damages under s 131(2). As this would be contrary to the intention of s 131, s 132(2) removes the right of indemnity against the company for such a liability despite any rule of law or equity.

Section 131(4) gives additional protection to outsiders who contract with non-existent companies. Under that section, if the company ratifies the pre-registration contract but

fails to perform all or part of it, the court may order the person who entered into the contract to pay all or part of the damages that the company is ordered to pay. This section is designed to prevent a person from deliberately setting up an assetless company to ratify a pre-registration contract and thereby avoiding a liability for damages under s 131(2).

A company may bear some liability to an outsider even if it does not ratify a pre-registration contract. Under s 131(3), if a person is sued for damages under s 131(2) because the company is registered but does not ratify the pre-registration contract or enter into a substitute for it, the court may do anything that it considers appropriate in the circumstances, including ordering the company to do one or more of the following:

- pay all or part of the s 131(2) damages;
- transfer to the other contracting party property that the company received because of the contract; or
- pay an amount to a party to the contract.

## Bibliography

Courtney W “Failed Pre-registration Contracts and the Statutory Remedy” (2007) 25 C&SLJ 226.

## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.



## Chapter 7

# Fundraising

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## Key points

- The fundraising provisions of the *Corporations Act* aim to balance the need for disclosure and investor protection against the need to facilitate an efficient and credible capital market that enables companies to raise capital without excessive regulatory requirements and costs.
- Offers of shares and other securities need disclosure to investors of relevant and accurate information unless an offer comes within a specific exemption. The exemptions recognise that not all investors need protection, and in the case of relatively small fundraisings, it would be commercially unrealistic to impose costly mandatory disclosure requirements. Some investors are financially sophisticated and do not need legislative protection as they are usually able to obtain their own information to make an informed choice about the securities they are being offered.
- Where an offer of securities needs disclosure to investors, the fundraising provisions require the offer and any application form for the securities to be accompanied by a prospectus or other disclosure document. In addition, a copy of the disclosure document must be lodged with ASIC before it is given to investors.
- The information that must be disclosed to investors depends on the type of disclosure document that is applicable to the fundraising. There are four different types of disclosure documents:
  - a prospectus;
  - a short-form prospectus;
  - a profile statement; and
  - an offer information statement.
- A prospectus contains more detailed information than the other types of disclosure documents. A prospectus must satisfy a general disclosure test as well as contain specified information.
- The fundraising provisions aim to ensure that a disclosure document does not contain misleading or deceptive statements or omits material information. This is achieved by imposing both criminal liability as well as personal liability to pay compensation on the various people involved in preparing a disclosure document.
- A separate regulatory framework applies to equity-based crowd-sourced funding by small unlisted public and proprietary companies. It sets out eligibility requirements for a company that wishes to make an offer under this regime and regulates such offers and intermediaries including rules dealing with defective disclosure documents and advertising restrictions.

## Introduction

**[7.05]** The most important feature of large companies, especially those listed on stock exchanges, is that they provide a mechanism for the pooling of funds from many investors who wish to participate in particular business ventures. A significant objective of the *Corporations Act 2001* (Cth) (*Corporations Act*) is to encourage such investment and to protect members of the investing public by requiring full and accurate disclosure of relevant information concerning the activities of the companies seeking to raise funds. These disclosure requirements complement various other disclosure obligations which arise annually, under the continuous disclosure rules or in particular events such as takeovers. These are discussed in Chapters 22 and 25 respectively.

In this chapter we consider the fundraising provisions in Ch 6D (ss 700–742). The fundraising provisions protect investors by requiring a corporation that seeks to raise funds by issuing shares or other securities, to disclose relevant information to enable prospective investors to make informed investment decisions and to provide remedies to investors where the information provided is inaccurate or incomplete.

Shares and debentures of a body are included in the definition of securities: ss 700(1) and 761A. Options to acquire, by way of issue, shares or debentures are also included in the definition. As discussed at [26.80], Pt 7.9 sets out similar disclosure requirements in relation to issues of other types of financial products.

## Overview of fundraising provisions

**[7.10]** The aim of the fundraising provisions is to balance the needs for investor protection with an efficient and credible capital market.

Aim of the fundraising provisions.

The investor protection objective aims to ensure that relevant, accurate and complete information is disclosed to investors so as to enable them to make an informed decision whether or not to accept an offer of securities. The information must be disclosed in a clear, concise and effective manner. The extent of the disclosure depends on the type of disclosure document. These are:

- a prospectus;
- a short-form prospectus;
- a profile statement; and
- an offer information statement (OIS).

The content requirements of each of these types of disclosure documents are discussed at [7.95]–[7.135].

The general prospectus content rule requires disclosure of all information that investors and their professional advisers would both reasonably require and reasonably expect to find in the prospectus to make an informed investment decision. This allows a prospectus to be tailored to meet the needs of the targeted investors. In addition, the

*Corporations Act* specifies further specific prospectus content requirements. The body issuing a disclosure document, its directors and advisers have the responsibility of ensuring that the disclosure document contains the required information. There is a separate regime for crowd-sourced funding (CSF) sought by relatively small companies and the general fundraising rules do not apply in relation to CSF offers: s 703B. The CSF regime is discussed at [7.210].

Section 717 has an overview of the procedure for offering securities. That section has a table that summarises what a person who wants to offer securities must do to make an offer of securities that needs disclosure to investors and provides signposts to relevant sections. The procedure includes the following requirements:

- Preparation of a disclosure document:
  - that sets out the required information (the contents requirements of disclosure documents are discussed at [7.95]–[7.120]);
  - that does not contain any misleading or deceptive statements (misleading or deceptive statements are discussed at [7.185]–[7.205];
  - that is dated and the directors consent to the disclosure document.
- The disclosure document is lodged with Australian Securities and Investments Commission (ASIC).
- The offer of securities is included in, or accompanies the disclosure document.
- If a lodged disclosure document is found to be deficient or a significant new matter arises, a supplementary or replacement document must be lodged or money returned to applicants.
- Application money must be held on trust prior to the issue of securities or it is returned.
- Securities are issued or transferred, making sure the application form was distributed with the disclosure document, and it is current and not materially deficient and the minimum subscription has been achieved. Misleading or deceptive statements are discussed at [7.185]–[7.205].

## Types of disclosure documents

**[7.15]** The fundraising provisions recognise several different types of disclosure documents.

Section 9 defines a disclosure document for an offer of securities as:

- a prospectus. This may be a full, unabridged prospectus or a short-form prospectus. Short-form prospectuses (see [7.125]) may be used for any offer. It may refer to material lodged with ASIC instead of being included in the disclosure document. Investors are entitled to receive a copy of the information lodged with ASIC, upon request;
- a profile statement (see [7.130]) that requires ASIC approval. A prospectus must still be prepared and lodged with ASIC and it must be made available to investors if requested; or
- an Offer Information Statement (OIS) (see [7.135]), for small-scale offerings.

The table in s 705 shows what disclosure documents should be used if an offer of securities needs disclosure to investors.



## When is disclosure to investors needed?

[7.20] The *Corporations Act* requires disclosure to investors in certain circumstances where an offer of securities is made. This is determined by means of a general rule requiring disclosure under either s 706 in relation to offers for the issue of securities, or s 707 in relation to offers for sale of securities in the circumstances described in s 707(2) and (3). These circumstances are discussed at [7.160] and [7.165] respectively. Sections 708 and 708AA contain specific exemptions that specify which offers of securities do not need disclosure to investors. These exemptions are discussed at [7.30]–[7.86].

For the purposes of Ch 6D, the word “securities” is defined in s 761A: s 700. Under this definition, “securities” includes shares, debentures, options and legal or equitable rights in relation to them.

The fundraising provisions apply to offers of securities of public companies. A proprietary company must not engage in any activity that would require disclosure to investors under Ch 6D except for an offer of its shares to existing shareholders or employees: s 113(3); see [3.80]. Proprietary companies that are “eligible CSF companies” can raise funds under the CSF provisions contained in Pt 6D3.A. These provisions are discussed at [7.210] onwards. ASIC may require a proprietary company to convert to a public company if it breaches the s 113(3) prohibition: s 165.

## General rule

[7.25] The *Corporations Act* sets out different disclosure rules for *issue offers* of securities (primary issues) and *sale offers* of securities (secondary trading). The disclosure requirements in relation to secondary trading are discussed at [7.155].

An offer of securities for issue needs disclosure to investors unless one of the exemptions in s 708 or s 708AA provides otherwise.

Under s 706, an offer of securities for issue needs disclosure to investors unless one of the exemptions in s 708 or s 708AA provides otherwise. While s 706 refers to “offering securities for issue”, s 700(2)(a) makes it clear that this term covers *offers* of securities in the contractual sense as well as invitations to treat.

The prohibitions in s 727 complement the general rule in s 706. A person is prohibited from making an offer of securities or distributing an application form for an offer of securities that needs disclosure unless a disclosure document for the offer has been lodged with ASIC: s 727(1). Further, under s 727(2) offers of securities that need disclosure to investors must be included in the appropriate disclosure document or accompanied by a copy of the disclosure document. Section 726 imposes a similar prohibition against offering securities of a body that has not been formed or does not yet exist. The s 726 prohibition applies even if it is proposed to form or incorporate the body.

Contravention of ss 726 and 727 is a criminal offence punishable by a fine of 200 penalty units or five years’ imprisonment or both: s 1311 and Sch 3.

|                        |
|------------------------|
| When is an offer made? |
|------------------------|

In *ASIC v Australian Investors Forum Pty Ltd (No 2)* [2005] NSWSC 267, Palmer J considered when an offer is made:

The circumstances in which particular offers of securities are made for the purposes of ss 727(1) and 708(10) will vary infinitely but the indicia of the making of such an offer will generally include:

- Identification of the company in which the securities are offered;
- What is the general nature of the securities offered;
- The price for which the securities may be acquired;
- The suggestion that the securities are available for acquisition by the person to whom the information is conveyed;
- The suggestion that the securities may be acquired now or at some specified future time, by the requisite payment.

In *ASIC v Maxwell* [2006] NSWSC 1052 the court held that a company contravened s 727(1) by offering securities that needed disclosure to investors under s 706, without a disclosure document. The company solicited loans from numerous investors and over 200 investors responded to the invitation and entered into agreements to lend money to the company. The loan agreements were “debentures” within the s 761A definition of “securities of a body”.

The general rule in s 706 applies to offers of securities that emanate from Australia. With the widespread use of the internet, it is increasingly common for Australian investors to be offered overseas shares or other investments. Such offers do not have to comply with the disclosure requirements of the *Corporations Act*, and consequently there is an increased danger that investors may not have adequate information to properly assess the merits of overseas offers.

ASIC Regulatory Guide RG 141 *Offers of securities on the internet* discusses when ASIC will regulate such internet offers. The Understanding Company Law website at <http://www.uclaw.com.au/resources/> has a link to RG 141.

The CSF provisions contained in Pt 6D.2 provide an additional funding option for small businesses and start-ups to access online, relatively small-scale financial contributions, from a number of individual investors. The requirements contained in ss 726–736 do not apply to CSF offers which are regulated by Pt 6D.2: ss 703B and 725A. The CSF legislation is discussed at [7.210]–[7.215].

The Understanding Company Law website at <http://www.uclaw.com.au/resources/> has links to the two CSF Acts, Explanatory Memoranda, a Corporations and Markets Advisory Committee Report, the Treasury Discussion Paper and the Consultation Paper.

## Offers that do not need disclosure

[7.30] The fundraising provisions exempt certain offers from the need to comply with the disclosure requirements. For example, financially sophisticated wholesale investors

have the ability to inform themselves about the merits of an offer of securities and do not generally rely upon disclosure documents. In the case of small offerings, it would be commercially unrealistic to impose disproportionately costly disclosure requirements.

Certain offers of securities do not need disclosure to investors.

Sections 708 and 708AA list situations where offers of securities do not need disclosure to investors.

### *Small-scale offerings*

**[7.35]** Section 708(1)–(7) contains the exemption for small-scale offerings of securities.

The *Corporations Act* takes the view that the high cost of preparing a disclosure document is not warranted for small-scale offers of securities. A small-scale offer is regarded as a private arrangement between the issuing company and a small number of investors. The exemption focuses on the number of issues of securities in a 12-month period and not the number of offers made. It also focuses on the amount raised from investors in a 12-month period.

Small-scale offers of securities do not need disclosure to investors.

Under s 708(1) to come within the small scale exception an offer of securities must be “personal” offers of securities where none of the offers results in a breach of the “20 investors ceiling” *and* the “\$2 million ceiling”. It is an offence to issue securities without disclosure to investors if the issue results in a breach of either of these ceilings: s 727(4).

#### **Personal offers**

**[7.40]** The small-scale offerings exclusion is limited to “personal” offers of securities meaning that the offers are made directly to a particular person who has some connection with the offeror or has indicated an interest in offers of that kind: s 708(2).

#### **The 20 investors ceiling**

**[7.45]** The 20 investors ceiling is breached if an offer to issue securities results in the number of people to whom securities have been issued exceeding 20 in any 12-month period: s 708(3)(a).

#### **\$2 million ceiling**

**[7.50]** The ceiling is breached if an offer to issue securities results in the amount raised by the issuing body exceeding \$2 million in any 12-month period: s 708(3)(b).

Securities issued and amounts raised as a result of offers that come under other s 708 exemptions are disregarded in counting the 20 investors ceiling and the \$2 million ceiling: s 708(5). Issues made under a disclosure document are also not counted.

Section 734(1) prohibits advertising or publicity for offers covered by the small-scale offerings exception in s 708(1).

Small-scale offerings can also be made under the CSF legislation which enables small companies and start-ups, including proprietary companies, to access funding with fewer disclosure requirements and restrictions. The CSF legislation is discussed at [7.210]–[7.215].

## *Sophisticated investors*

[7.55] Section 708(8) and (10) contains several exemptions from the disclosure requirements in relation to offers of securities to experienced, financially sophisticated or wealthy investors. The *Corporations Act* takes the view that such investors have sufficient means to obtain their own investment advice or have the bargaining power over the issuing body to obtain the necessary information without relying on mandatory disclosure documents.

Offers of securities to certain financially sophisticated and wealthy investors do not need disclosure.

## **Large offers**

[7.60] Under s 708(8)(a), an offer of securities does not need disclosure to investors if the minimum amount payable for the securities on acceptance of the offer is \$500,000 or more. Further, under s 708(8)(b), disclosure to investors is not required in the case of an investor who either accepts an offer of securities for at least \$500,000 payable by instalments over a period of time or tops up a previously accepted large offer. In calculating the amount payable or paid for securities under s 708(8)(a) or (b), any amount lent by the person offering the securities or their associate is disregarded: s 708(9).

The large offer exemptions are based on the assumption that people who invest such large amounts are presumed to have the ability to obtain the information necessary to decide whether or not to invest.

## **Offers to wealthy investors**

[7.65] Offers of securities made to “wealthy” investors do not require disclosure of information to them: s 708(8)(c). An offer comes within this exemption if a qualified accountant certifies that the investor had either a gross income over each of the previous two financial years of at least the amount specified in the *Corporations Regulations 2001* (Cth) (*Corporations Regulations*) (\$250,000) or had net assets of at least the amount specified in the *Corporations Regulations* (\$2.5 million).

“Wealthy” investor also includes a company or trust controlled by a person who satisfies the s 708(8)(c)(i) or (ii) requirements: s 708(8)(d).

## **Offers to experienced investors**

[7.70] Offers of securities made to certain “experienced” investors do not need disclosure to investors: s 708(10). An offer comes within this exemption if it is made through a financial services licensee: s 708(10)(a). Under s 708(10)(b), the licensee must be satisfied on reasonable grounds that the investor has previous experience in investing in securities

that allows them to assess such matters as the merits of the offer, the value of the securities, the risks involved in accepting the offer and the adequacy of the information given by the person making the offer. The investor must sign a written acknowledgment that the licensee has not given them a disclosure document in relation to the offer: s 708(10)(d).

### **Offers to professional investors**

[7.75] An offer of securities does not need disclosure to investors if it is made to a “professional investor”: s 708(11). Section 9 defines a professional investor to include a financial services licensee (for example, a stock broker), a body regulated by APRA (for example, a bank or insurance company) and a trustee of a superannuation fund that has net assets of at least \$10 million. Section 708(11) also excludes an offer of securities to a person who has, or controls, gross assets of at least \$10 million.

### *Senior managers*

[7.80] An offer of securities does not need disclosure to investors if it is made to a senior manager of the body or a related body or their spouse, parent, child, brother or sister: s 708(12). “Senior manager” is defined in s 9 to mean a person (other than a director or secretary) who makes, or participates in making, decisions that affect the whole, or a substantial part, of the business of the corporation. Section 708(12) also exempts offers of securities to a body corporate controlled by senior managers or their specified relatives.

### *Existing security holders*

[7.85] Certain offers of securities to existing security holders do not need disclosure to investors. For example, offers of fully paid shares to existing shareholders under a dividend reinvestment plan or bonus share plan do not need disclosure to the shareholders: s 708(13) (a). Similarly, disclosure to investors is also not required in the case of offers of a disclosing entity’s debentures for issue to existing debenture holders: s 708(14).

### *Rights issues*

[7.86] A rights issue enables companies to raise funds from their existing shareholders. According to s 9A a “rights issue” is an offer of securities for issue where the offer is made to existing shareholders in proportion to their holdings. The offer terms to each shareholder must be identical.

Under s 708AA, disclosure to investors is not required in the case of rights issues of quoted securities such as shares in ASX listed companies, if certain conditions are satisfied. To qualify for this exemption from the disclosure requirements, the listed company must give the ASX a notice (called a “cleansing notice”) that includes the following statements:

- it has complied with its financial reporting obligations under Ch 2M as well as the continuous disclosure obligations in s 674 (discussed at [22.140]); and
- the potential effect the issue of the shares will have on the control of the company and the consequences of that effect.

## Lodgment of disclosure documents

**[7.90]** A disclosure document used for an offer of securities must be lodged with ASIC: s 718. Further, s 727(1) makes it an offence for a person to offer securities or distribute an application form for an offer of securities that needs disclosure to investors unless the disclosure document for the offer has been lodged with ASIC.

Disclosure documents must be lodged with ASIC.

ASIC Regulatory Guide RG 254 *Offering securities under a disclosure document* explains the obligations of the fundraiser as well as ASIC's approach to scrutiny of disclosure documents lodged with it. RG 254 is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

Disclosure documents may be given to potential investors immediately after they have been lodged with ASIC. However, in the case of offers of non-quoted securities, s 727(3) imposes a seven-day waiting period after ASIC lodgment before applications for the non-quoted securities can be accepted. ASIC may extend the period to a maximum of 14 days.

The waiting period is designed to give ASIC and other interested parties an opportunity to consider the contents of the disclosure document before the non-quoted securities are processed. If the disclosure document is found to be deficient, ASIC or aggrieved parties have the ability to apply for injunctions to halt the fundraising. There is no waiting period for offers of quoted securities because they already have an established market price and are subject to ASX continuous disclosure obligations.

Under s 720 directors must give their consent to the lodgment of the disclosure document with ASIC.

ASIC maintains an internet accessible database called "Offer Notice Board" which contains a list of all disclosure documents for fundraising offers lodged with ASIC. Offer Notice Board aims to facilitate access to fundraising offer documents during the required exposure period of seven days. Information about Offer Notice Board and how to search it can be found on the ASIC website which is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## Contents of disclosure documents

**[7.95]** There are different content requirements for the various types of disclosure documents. More detailed information must be set out in a prospectus, which is regarded as a full disclosure document, than in the other types of disclosure documents.

The Understanding Company Law website at <http://www.uclaw.com.au/resources> has a link to the "Upcoming floats and listings" page on the ASX website. Companies seeking to float on the ASX often make their prospectuses available on their websites.

## Prospectuses

**[7.100]** A prospectus is the most common type of disclosure document. The *Corporations Act* requires a prospectus:

- to be worded and presented in a “clear, concise and effective” manner (s 715A);
- to include the information required by the general disclosure test (s 710);
- to make specific disclosures required by s 711; and
- not be misleading or deceptive (s 728(1)).

ASIC Regulatory Guide RG 228 *Prospectuses: Effective disclosure for retail investors* provides guidance on how to prepare a prospectus that satisfies the s 710 general disclosure test. RG 228 is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

### *Clear, concise and effective wording and presentation*

**[7.102]** The information in a prospectus and other disclosure documents must be worded and presented in a clear, concise and effective manner: s 715A. While contravention of s 715A is not an offence, ASIC may make a stop order to prevent further offers of securities being made. Stop orders are discussed at [7.185]. ASIC Regulatory Guide RG 228 *Prospectuses: Effective disclosure for retail investors* contains various suggestions for presenting information that meets the s 715A requirements. According to Section B of RG 228, a prospectus will generally be “clear, concise and effective” if it:

- highlights key information;
- uses plain language;
- is as short as possible;
- explains complex information, including any technical terms; and
- is logically ordered and easy to navigate.

### *General disclosure test*

**[7.105]** Under s 710(1), a prospectus must contain all the information that investors and their professional advisers would reasonably require to make an informed assessment of the matters set out in the table in that section. A prospectus must contain this information:

- only to the extent to which it is reasonable for investors and their professional advisers to expect to find the information in the prospectus; and
- only if the information is actually known or in the circumstances ought reasonably to have been obtained by making inquiries.

A prospectus must contain all the information that investors and their professional advisers would reasonably require to make an informed assessment about certain matters.

The table in s 710(1) specifies that the following information must be disclosed in relation to an offer to issue shares, debentures or interests in a managed investment scheme:

- the rights and liabilities attaching to the securities offered; and
- the assets and liabilities, financial position and performance, profits and losses and prospects of the body that is to issue the shares, debentures or interests.

In deciding what information should be included under the general disclosure test, s 710(2) specifies that regard must be had to such matters as the nature of the securities and the matters that likely investors may reasonably be expected to know.

Prospectuses generally contain information about the following matters:

- description of the business and its structure, strategy and plans;
- financial information;
- information about prospects;
- risks;
- description of important contracts;
- use of proceeds;
- background of senior managers and directors and details of their remuneration;
- dividend policy;
- major shareholders and related party transactions;
- taxation; and
- disclosure about material litigation.

ASIC Regulatory Guide RG 228 *Prospectuses: Effective disclosure for retail investors* recommends that the first substantive section of a prospectus should include an investment overview to help retail investors make an informed investment decision. The investment overview should highlight and provide:

- a meaningful summary of information that is key to a retail investor's investment decision; and
- a balanced disclosure of the benefits and risks.

RG 228 recommends that a prospectus should explain the company's business model. This may involve a substantive analysis of the main components of the business and how they relate to each other. The business model is designed to show investors how the company proposes to make money and generate income or capital growth and may include information about the nature of the company's business, important contracts, the company's strategy, its competitors and its capital management policies. According to RG 228 a prospectus should also explain the risks associated with the company's business model as well as the risks associated with the securities and the offer.

ASIC Regulatory Guide RG 228 *Prospectuses: Effective disclosure for retail investors* is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

A person who omits information required by the s 710 general disclosure test contravenes s 728(1). This is a criminal offence if the omission is materially adverse from the point of view of an investor: s 728(3). In addition, if an investor suffers loss or damage because of the omission they can recover compensation from directors, those who make statements in the prospectus and certain others listed in the table in s 729. The consequences of contravening s 728 are discussed at [7.185]–[7.205].



## Forecasts

**[7.110]** Profit, dividend and other financial forecasts in a prospectus can significantly influence a person's decision whether or not to invest. Among other things, the general disclosure test in s 710(1) requires a prospectus to disclose information regarding the financial performance and prospects of the body that is issuing securities. These requirements do not necessarily mean that a prospectus must include forward-looking statements such as financial forecasts. The decision whether or not to include forward-looking statements is left to the body issuing the prospectus.

Because predictions about the future are uncertain, there is always the possibility that forecasts and other forward-looking statements contained in a prospectus may not eventuate.

A forward-looking statement is misleading if the person making it does not have reasonable grounds for making the statement.

A disclosure document that contains a forward-looking statement is regarded as being misleading for purposes of the liability provisions if the person making it does not have reasonable grounds for making the statement: s 728(2). The onus of proving the absence of reasonable grounds rests on the person who alleges the forward-looking statement was misleading.

ASIC Regulatory Guide RG 170 *Prospective financial information* outlines ASIC's views on when prospective financial information can or should be disclosed and what are reasonable grounds for prospective financial information. This Regulatory Guide is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## Alternative disclosure test

**[7.115]** The general disclosure test for prospectuses of listed companies is not as detailed as the general disclosure test for unlisted companies because listed companies are subject to the continuous disclosure requirements of the *Corporations Act* and ASX Listing Rules. Continuous disclosure is discussed at [22.135]. Since listed companies are required, on a continuing basis, to disclose information to the ASX that would be likely to have a material effect on the price of their securities, much of the information that s 710(1) would normally require to be included in a prospectus is already known to the market.

As a consequence, s 713 sets out an alternative general disclosure test in the case of a prospectus for an offer of continuously quoted securities of a body. Continuously quoted securities are securities that are in a class of securities that were quoted ED (enhanced disclosure) securities at all times in the three months before the date of the prospectus: s 9. Under s 713(2), such prospectuses must contain all the information investors and their professional advisers would reasonably require in order to make an informed assessment of such matters as the effect of the offer on the body and the rights and liabilities attaching to the securities offered.

The alternative general disclosure test does not require the prospectus to contain information regarding the assets and liabilities, financial position and performance,

profits and losses and prospects of the issuing body. The market should already know this information because of the continuous disclosure and periodic reporting requirements imposed on listed disclosing entities.

### *Specific disclosures*

**[7.120]** Section 711 lists certain basic information that must be contained in every prospectus. This includes the terms and conditions of the offer, disclosure of conflicts of interest in relation to people involved in the offer, whether an application will be made for stock exchange listing and the expiry date of the offer.

## Short-form prospectuses

**[7.125]** A common complaint from retail investors is that prospectuses are often lengthy and overly complex documents. This is a particular concern for investors who are not experienced in reading and comprehending detailed financial information. This concern may be allayed by the use of short-form prospectuses.

A short-form prospectus refers to material in documents lodged with ASIC instead of that information being included in the prospectus.

A short-form prospectus is a disclosure document that refers to material in documents lodged with ASIC instead of that information being included in the prospectus. This is permitted by s 712(1). Referred documents are regarded as being part of the prospectus: s 712(3). The reference must identify the lodged document that contains the information and inform people of their right to obtain a copy free of charge on request. If the information is primarily of interest to people such as professional analysts, the reference must say so and include a description of the contents of the document.

## Profile statements

**[7.130]** Section 709(2) permits fundraisers to prepare a profile statement in relation to an offer in addition to a prospectus if ASIC has approved the use of profile statements in the making of offers of that kind. An approved profile statement may be sent to investors instead of the full prospectus: s 721(2). However, a free copy of the prospectus must be provided to an investor on request: s 721(3).

Section 714 sets out the contents of profile statements. Among other things, they must:

- identify the issuing body and the nature of the securities;
- state the nature of the risks involved in investing in the securities;
- give details of all amounts payable in respect of the securities (including fees, commissions or charges);
- state that a copy of the prospectus is available free of charge;
- state that a copy of the statement has been lodged with ASIC; and
- give any other information required by the *Corporations Regulations* or by ASIC.

Profile statements are rarely used in practice. They were originally intended to facilitate offers of interests in selected managed investment schemes such as units in cash management trusts and property trusts. Offers of such financial products are now regulated by the financial product disclosure regime contained in Pt 7.9 of the *Corporations Act*. This is discussed at [26.80].

## Offer information statements

**[7.135]** An OIS is designed to be a disclosure document for relatively small fundraisings.

An OIS may be used instead of a prospectus to raise \$10 million or less.

An OIS, disclosing minimal information, may be used instead of a prospectus if the amount of money to be raised by the issuer, when added to all amounts previously raised by it, its related bodies or controlled entities, is \$10 million or less: s 709(4). Amounts raised under an eligible employee share scheme are not counted for the purpose of the calculation of the total funds raised under an OIS.

The cost of preparing an OIS is considerably less than for a prospectus. This is because the OIS disclosure obligations do not require extensive due diligence inquiries to be made. Section 715 sets out the contents of an OIS. Among other things, an OIS must:

- identify the issuing body and the nature of the securities;
- describe the body's business and what the funds sought to be raised are to be used for;
- state the nature of the risks involved in investing in the securities;
- give details of all amounts payable in respect of the securities;
- state that a copy of the OIS has been lodged with ASIC; and
- state that the OIS has a lower level of disclosure requirements than a prospectus and that investors should obtain professional advice before investing.

Section 715(1)(i) also requires an OIS to include a copy of the body's financial report. The financial report must be prepared in accordance with accounting standards, be audited and be for a 12-month period with a balance date that occurred within six months before the securities were first offered under the OIS: s 715(2).

ASIC Regulatory Guide RG 254 *Offering securities under a disclosure document*, Section D sets out ASIC's policies regarding the financial reports that must accompany an OIS. The Understanding Company Law website at <http://www.uclaw.com.au/resources/> has a link to this Regulatory Guide.

## Restrictions on issue of securities

### Minimum subscription

**[7.140]** If a disclosure document states that the securities will not be issued unless applications for a minimum number of securities are received or a minimum amount is raised, the person making the offer must not issue any of the shares until that minimum

subscription condition is satisfied: s 723(2). Application money received from investors must be held in trust until the minimum subscription condition is fulfilled and the securities are issued: s 722.

The purpose of s 723 is to protect early subscribers where the company is later unable to raise the minimum amount it needs to be a viable concern. Without this protection, preliminary expenses would be met by a relatively small number of the investors in an under-capitalised company that was likely to fail.

Under s 724(2), if the minimum subscription condition is not satisfied within four months after the date of the disclosure document, the company must either repay the money received from the applicants or allow applications to be withdrawn within one month and repaid.

If securities are issued in contravention of s 724, applicants have the right to return the securities and have their application money repaid. This right applies even where the company is being wound up and therefore confers a priority on applicants in a liquidation: s 737(1).

Applicants may exercise this right by written notice to the company within one month after the date of the issue: s 737(2). The directors of the company are personally liable to repay the application money if it is not repaid by the company: s 737(3).

## Stock exchange listing

**[7.145]** If a corporation states in a disclosure document that it has applied, or will apply for stock exchange listing of its securities, it is generally important to prospective investors that their securities will be listed on a stock exchange. This gives their investment a much greater degree of marketability and ASX listing requirements afford additional protection to securities holders. If the securities are not listed within three months from the date of the disclosure document, the issue is void and the corporation must repay the money received by it pursuant to the disclosure document: s 723(3). During this three-month period, the application money received from investors must be held in trust: s 722.

The court has a broad discretion to extend the three-month period within which the securities must be admitted to listing under s 1322(4)(d) and the issue of shares may be validated under s 254E. The court may make such orders where the parties have acted honestly and their non-compliance was inadvertent, it is unlikely to cause any substantial injustice to any person, and it would fulfil the expectations and commercial interests of all parties concerned: *Re Solco Ltd* [2015] FCA 635.

## Expiration of disclosure document

**[7.150]** Disclosure documents must specify an expiry date which must be no later than 13 months after the date of the document: ss 711(6), 714(2) and 715(3). The securities may be issued to the applicant if the application was received on or before the expiry date: s 725(2). However, if the application is received after the expiry date, the company must, under s 725(3), either:

- repay the money received from the applicants;
- give the applicants a new disclosure document and one month to withdraw their application and be repaid; or
- issue the securities to the applicants and give them a new disclosure document and one month to return the securities and be repaid.

## Secondary trading

**[7.155]** The fundraising provisions are largely directed at offers of securities for issue (primary issues) and have limited application to subsequent offers for the sale of securities (secondary trading).

Only those sales of securities specified in s 707 need disclosure to investors. As a general rule, sale offers of listed securities quoted on the stock exchange do not require disclosure to investors.

### Sales by controller

**[7.160]** Under s 707(2) an offer of securities for sale needs disclosure to investors if the person making the offer controls the body whose securities are being offered and the securities are not quoted. Quoted securities offered for sale by a controller do not need a disclosure document if both the controller and the entity that issued the securities satisfy certain conditions. These include giving the ASX a “cleansing notice” that discloses:

- that there has been compliance with the financial reporting obligations under Ch 2M as well as the continuous disclosure obligations in s 674 (discussed at [22.140]); and
- the potential effect the sale of the shares will have on the control of the company and the consequences of that effect.

Section 50AA defines when a person controls a body. The s 50AA definition is similar to the definition of “control” in the accounting standards. Under s 50AA, an entity controls a second entity if the first entity has the capacity to determine the outcome of decisions about the second entity’s financial and operating policies.

Section 707(5), which is designed to prevent avoidance of s 707(2), requires disclosure to investors where a sale offer of securities of a body amounts to an indirect sale by the person who controlled the body. Section 707(5) applies to both a sale offer of unquoted securities and off-market sale offers within 12 months after their sale by a controller. Such offers require disclosure to investors if the controller sold the securities without disclosure to investors and either the controller sold them with the purpose of the buyer on-selling the securities (s 707(5)(c)(i)); or the buyer acquired the securities with the purpose of on-selling the securities: s 707(5)(c)(ii).

A controller is taken to have sold the securities and a buyer is taken to have acquired the securities, for the s 707(5)(c)(i) and (ii) purposes, if any of the securities are subsequently sold, or offered for sale, within 12 months after their sale by the controller unless it is proved that the circumstances of the initial sale and the subsequent sale are not such as

to give rise to reasonable grounds for concluding that the securities were sold with that purpose: s 707(6).

The exception for small-scale offers in s 708(1) does not apply to sales amounting to indirect off-market sales by the controller under s 707(5).

## Sales amounting to indirect issue

**[7.165]** Section 707(3) is an anti-avoidance provision. It aims to ensure that a body issuing securities cannot avoid disclosure to investors by issuing securities to an investor under one of the s 708 exemptions in circumstances where either the issuer or the investor had the purpose of on-selling the securities to others. In such circumstances the issue needs disclosure to investors.

Under s 707(4), securities are taken to have been issued or acquired with the purpose of on-sale if any of the securities are subsequently sold, or offered for sale, within 12 months after their issue unless it is proved that the circumstances of the issue and the subsequent sale are not such as to give rise to reasonable grounds for concluding that the securities were issued or acquired with that purpose.

Section 708A exempts the issuer from the requirement to make disclosure to investors under s 707(3) if investors already have access to prospectus-type information. The information can be available because:

- a prospectus for a retail issue has already been issued at about the same time as the private placement (s 708A(11) and (12)); or
- the issuer by a notice to the market verifies that it has complied with all its continuous disclosure and reporting obligations (s 708A(5) and (6)). The notice must also set out information that is excluded from the continuous disclosure to ensure that investors receive prospectus-like disclosure: s 708A(7).

## Hawking of financial products

**[7.170]** There is a general prohibition against “hawking” financial products, including securities such as shares and debentures. The hawking prohibition means a person must not offer securities to a consumer or invite the consumer to ask or apply for the securities: s 992A(1). The Financial Services (Hayne) Royal Commission found that unsolicited sales of financial products and hawking methods often contributed to consumers purchasing financial products that did not meet their needs.

A “consumer” is a retail client as discussed at [26.80]. Hawking arises where the offer, request or invitation to the consumer is made as a result of an unsolicited contact with the consumer. Unsolicited contact arises where the contact is wholly or partly by telephone, face-to-face meeting or other real-time interaction and the consumer did not consent to the contact: s 992A(4). To avoid the hawking prohibition, the consent to the contact must be given before the contact commences and within six weeks before the contact occurs or a longer period up to 12 weeks, if the consumer agrees: s 992A(5). The consumer may vary or withdraw consent to be contacted at any time: s 992A(6).

Breach of the prohibition in s 992A(1) is a strict liability offence: s 992A(9). The consumer has a right of return and refund: s 992AA(1). Where the financial product is returned, the legal relationship between the consumer and issuer and any contract for the acquisition of the product by the consumer are terminated from the time of return and without penalty to the consumer: s 992AA(2).

ASIC Regulatory Guide RG 38 *The hawking prohibition* assists the financial services industry to comply with the prohibition in s 992A. This regulatory guide is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## Advertising restrictions

**[7.175]** The primary aim of the fundraising provisions is investor protection through compulsory disclosure of relevant information. The aim of the fundraising provisions would be easily thwarted if a company could freely advertise or publicise its intention to issue securities. For this reason, the *Corporations Act* regulates advertising issues of securities.

The *Corporations Act* regulates advertising issues of securities.

Where an offer or intended offer requires a disclosure document, there is a prohibition on advertising the offer or intended offer or publishing a statement that refers to it or is reasonably likely to induce people to apply for the securities: s 734(2). This prohibition on advertising or publishing a statement also applies in the case of an offer of securities which would have needed a disclosure document but for the operation of s 708(1) which excludes personal small-scale offerings of fewer than 20 offers in 12 months.

In *ASIC v Maxwell* [2006] NSWSC 1052 the court held that a company contravened s 734(2) when it placed advertisements in various Sydney newspapers soliciting funds from the public in the form of loans for various building development projects. The newspaper advertisements referred to an offer of securities that were likely to induce people to apply for the loan agreements. The offers needed disclosure to investors. Even though the company provided interested investors with an information memorandum that described the terms of the investor loans to the company, it was not regarded as a disclosure document as required by the *Corporations Act*.

Different advertising restrictions apply for listed and unlisted securities. In the case of securities of a class already listed on the ASX, s 734(5)(a) permits advertising before lodgment of a disclosure document if the advertising includes a statement containing information on the following prescribed matters:

- the identity of the issuer of the securities;
- that a disclosure document will be made available;
- that a person should consider the disclosure document in deciding whether to acquire the securities; and
- that anyone who wants to acquire the securities must do so using the application form in the disclosure document.

Advertising unlisted securities prior to lodgment of a disclosure document is limited by s 734(5)(b) to the following:

- a statement identifying the offer or the securities;
- a statement that a disclosure document will be made available when the securities are offered;
- a statement that investors will have to complete an application form in or attached to a disclosure document; or
- optionally, a statement of how to receive a copy of the disclosure document.

After a disclosure document has been lodged with ASIC, s 734(6) requires advertisements to include a statement that:

- the offers of securities will be made in, or accompanied by, a copy of the disclosure document; and
- anyone wishing to acquire the securities will need to complete the application form that will be in or will accompany the disclosure document.

Section 734(7) specifically permits certain advertisements and publications. These include advertising or publicity that is a news report or is genuine comment in the media relating to the lodgment of a disclosure document or the information in such a document. News reports and genuine media comment are not permitted if anyone gives consideration or another benefit for publishing the report.

Section 1041H, which is based on s 18 of the *Australian Consumer Law*, has potential application to advertising in relation to securities. That section prohibits a person from engaging in misleading or deceptive conduct in connection with a notice published in relation to a financial product: *Corporations Act*, s 1041H(2)(b)(ii). A security is a type of a financial product: s 764A(1). Contravention of s 1041H is not a criminal offence: s 1041H(3). Section 1041H is discussed at [26.217].

In addition, ASIC or any person whose interests are affected may apply for an injunction under s 1324 to halt misleading or deceptive advertising or other notices in relation to securities.

## **ASIC's power to exempt and modify**

[7.180] The *Corporations Act* recognises that in some situations strict compliance with the fundraising provisions may be either too onerous or inappropriate. Section 741(1) gives ASIC the power to modify or vary any of the fundraising provisions and exempt a person from a particular provision of the fundraising provisions.

## **Misstatements and omissions**

### **Stop orders**

[7.185] Section 728 prohibits a person from offering securities under a disclosure document if it contains a misleading or deceptive statement or omits information required by the fundraising provisions. Where ASIC is satisfied that a lodged disclosure document would



contravene s 728, ASIC has the power under s 739(1) to make a stop order that prevents any further offers, issues, sales or transfer of the securities from being made.

ASIC can also issue a stop order if it is satisfied that the information in a disclosure document is not worded and presented in a clear, concise and effective manner as required by s 715A.

Before issuing a stop order, ASIC must hold a hearing at which any interested person is given an opportunity to make representations about whether a stop order should be made: s 739(2). ASIC may make an interim stop order pending the holding of a hearing if it considers that any delay in making the order would be prejudicial to the public interest: s 739(3). An interim stop order has effect for 21 days.

ASIC can make a stop order in respect of an offer of securities even after the closing date of offers: *Thompson v ASIC* [2002] FCA 512.

## Supplementary and replacement documents

**[7.190]** Section 728 makes it an offence to continue making offers after a person has become aware that a disclosure document contains misleading or deceptive statements, has omitted required information or new circumstances have arisen since lodgment that are materially adverse from the point of view of an investor. In such cases, s 719 requires the lodgment of either a supplementary or replacement document to correct the deficiency in the original disclosure document. A supplementary or replacement disclosure document may also be lodged if the person making the offer becomes aware that the information in the disclosure document is not worded and presented in a clear, concise and effective manner: s 719(1A).

Once a supplementary or replacement document has been lodged with ASIC, both the original disclosure document and the supplementary or replacement document must accompany subsequent offers of securities: s 719(4) and (5).

The s 719 requirement to lodge a supplementary or replacement document aims to ensure that a disclosure document contains accurate, adequate and up-to-date information prior to the expiration of the disclosure document.

## Liability for misstatements or omissions

**[7.195]** Section 728(1) is the key provision that prohibits a person from offering securities under a disclosure document if there is a misleading or deceptive statement in, or an omission from, a disclosure document.

A person must not offer securities under a disclosure document that is misleading or deceptive or that has material omissions.

Conduct is misleading or deceptive if it tends to induce error: *Australian Competition and Consumer Commission v TPG Internet Pty Ltd* [2013] HCA 54. It is the effect of the statement on the intended audience that is relevant, not the state of mind of the person making the statement: *Forrest v ASIC* [2012] HCA 39. The meaning of “misleading and deceptive conduct” is discussed in the context of s 1041H at [26.165]–[26.218].

A person is taken to have made a misleading statement about a future matter if they did not have reasonable grounds for making the statement: s 728(2).

*ASIC v Sydney Investment House Equities Pty Ltd* [2008] NSWSC 1224

[7.197] Sydney Investment House Capital Ltd issued a prospectus seeking to raise about \$8 million in preference shares from a large number of investors. The prospectus contained a number of forward-looking statements such as the company would return investors' capital through a selective buy-back by the company 36 months after allotment and that investors would be paid a 9 per cent return on their shares. The prospectus also stated that the money raised from the share issues would be invested in various property developments and that those investments would occur only after a recommendation to that effect was received from the company's "investment team". The company also promised not to invest in projects in which its directors had an interest unless the investment was made on arm's length terms and the interested directors would not participate in their self-interested investment decisions. The court held that these forward-looking statements were misleading because as the company was insolvent when the prospectus was issued, it could not have had reasonable grounds for making the statements about the proposed share buy-back and return on the shares. Shortly after the issue of the prospectus, the company failed to keep its promises. The court held that in the circumstances it could infer that the company did not have reasonable grounds for making the forward-looking statements in the prospectus about the use of investors' funds.

*Reiffel v ACN 075 839 226 Ltd* [2003] FCA 194

[7.200] Pannel Kerr Forster Consulting Australia (PKFCA), an independent expert, reviewed profit and other financial forecasts contained in a prospectus. The review report, which was also in the prospectus, contained PKFCA's negative assurance that nothing had come to their attention which caused them to believe the forecasts were not reasonable. PKFCA's review report also stated that it had reviewed the sensitivity analysis and that the underlying assumptions on which the forecasts were based were reasonable. After a number of investors acquired the securities issued pursuant to the prospectus, it was discovered that the actual profitability of the business was substantially below the forecasts. The investors commenced a class action against the promoter as well as PKFCA. In the case of PKFCA it was alleged that the negative assurance was misleading and deceptive for purposes of the predecessor of s 728.

The court held that in giving a negative assurance, PKFCA was in effect saying that based upon what it knew, the directors' assumptions provided a reasonable basis for the forecasts in the prospectus. It was implicit that PKFCA would exercise an appropriate degree of care, skill and judgment in informing itself and expressing the opinion. In the circumstances it was misleading and deceptive for PKFCA to express the opinions in its review report without qualification.

**[7.201]** Contravention of s 728(1) is a criminal offence if the misleading or deceptive statement or omission is materially adverse from the point of view of an investor: s 728(3).

Compensation for loss or damage resulting from misleading or deceptive statement.

Section 729 deals with the right to recover compensation for loss or damage resulting from a contravention of s 728(1). Under s 729(1), the right to compensation requires proof of causation in that the loss or damage suffered was because of the misleading or deceptive statement in, or omission from, a disclosure document. The usual way in which causation is established is by showing reliance on the document containing the misleading and deceptive statement or that the investor would have acted differently if the material omission had been disclosed: *Gardiner v Agricultural and Rural Finance Pty Ltd* [2007] NSWCA 235. The right to recover compensation under s 729 may be exercised where the shareholder has not rescinded the contract to acquire the shares: *Cadence Asset Management Pty Ltd v Concept Sports Ltd* [2005] FCAFC 265.

**[7.205]** Section 729 sets out those who may be liable for compensation and the extent of their liability. These include the offeror, the directors and proposed directors of the company making the offer, underwriters to the issue named in the disclosure document and persons such as experts who make a statement that is included in the disclosure document. People liable on the disclosure document are generally responsible for the disclosure document as a whole, except for those such as experts who provide a statement who are liable only for their own statements in the disclosure document.

Under s 730, a person referred to in s 729 must notify the person making the offer as soon as practicable if they become aware that:

- a material statement in the disclosure document is misleading or deceptive;
- there is a material omission from the disclosure document of required material; or
- a material new circumstance has arisen since lodgment of the disclosure document that would have been required to be included if it had arisen before the disclosure document was lodged.

Sections 731–733 set out the defences in relation to both criminal actions and compensation claims. Section 731 furnishes a due diligence defence in relation to a prospectus. Under s 731, there is a defence if the person made all reasonable inquiries and believed on reasonable grounds that the statement was not misleading or deceptive or that there was no omission.

Section 732, which applies to misleading or deceptive statements and omissions in an OIS and a profile statement, provides a defence if the person proves they did not know the statement was misleading or deceptive or that there was an omission.

Section 733(1) establishes a general reliance defence applicable to all disclosure documents under which there is no liability if the person proves they reasonably relied on information given by someone else. For the reliance defence to succeed, the person relied upon must be someone other than a director, employee or agent: s 733(1). A person is not regarded as an agent for purposes of the reasonable reliance defence in s 733(1) merely because they perform a particular professional or advisory function: s 733(2).

Under s 733(3), there is a defence in relation to misleading or deceptive statements and omissions for proposed directors, underwriters or makers of statements in disclosure documents if they publicly withdrew their consent to being named in a disclosure document.

## Crowd-sourced equity funding

**[7.210]** CSF enables small- and medium-sized businesses to access capital from many investors who make relatively small investments. Part 6D3.A of the *Corporations Act* separately regulates equity-based CSF under which eligible unlisted public companies and proprietary companies can offer their ordinary shares, via a licensed intermediary's internet site or other social media platform, using an offer document. The CSF regime in Pt 6D3.A establishes a disclosure regime that can be used for certain offers of securities for issue in small unlisted companies, instead of requiring compliance with the more detailed requirements applicable to disclosure documents generally: s 738A.

Part 6D.3A, among other things, replaces the provisions dealing with prospectuses and other disclosure documents in relation to CSF offers, sets out eligibility requirements for a company that wants to make an offer under the CSF regime, and provides for the regulation of CSF offers and intermediaries, including rules dealing with defective disclosure documents and advertising restrictions that specifically apply to CSF offers.

### Eligible offers

**[7.211]** An offer is eligible to be made under the CSF regime where the company offering its securities is an “eligible CSF company” at the time of the offer: s 738G(1)(b). An eligible CSF company must be an unlisted public company limited by shares or a proprietary company with its principal place of business and majority of directors in Australia. The company and all of its related parties must have gross assets and consolidated revenue of less than \$25 million. An eligible CSF company must not have a substantial purpose of investing in other entities. To encourage start-ups and other small-scale enterprises to utilise the CSF regime, the legislation creates exemptions from certain public company corporate governance and reporting requirements such as an exemption from holding an annual general meeting (s 250N(5) and (6)), an option to provide financial reports to shareholders online (s 314(1AF)) and not being required to appoint an auditor until more than \$1 million has been raised from CSF offers (s 301(5)).

The CSF offer must comply with the “issuer cap”, being the maximum amount of funds sought to be raised by an issuer company under the CSF regime: s 738G(1)(d) and s 738G(2). The cap is set at \$5 million in any 12-month period. Certain offers are excluded from the issuer cap including offers to sophisticated or professional investors. This exclusion reflects the policy that an issuer company should continue to have access to funding from wholesale investors such as venture capital funds.

The company or a related party of the company must not intend to use the funds sought under the offer to any extent to invest in securities or interests in other entities or managed investment schemes: s 738G(1)(e).

Where an offer does not satisfy these eligibility criteria, it will be deemed to be an offer of securities requiring disclosure under the general fundraising provisions contained in Pt 6D.2. Where a person makes an offer of securities requiring disclosure but does not lodge a prospectus or other required document, the person contravenes s 727(1) which is discussed at [7.25].

## CSF intermediaries

**[7.212]** The CSF legislation regulates the activities of intermediaries who play a key role in the CSF regime, as all CSF offers must be made through the platform of an intermediary. An intermediary must hold an Australian Financial Services Licence (AFSL) that expressly authorises the provision of a crowd-funding service: ss 738C and 766A(1)(ea). AFSLs are discussed at [26.75].

CSF is a type of financial service. A CSF offer can only be made by publishing a CSF offer document that complies with s 738J on a platform of a CSF intermediary: s 738L. A person is taken to provide a crowd-funding service if the person operates a platform on which a CSF offer document is published and applications may be made to the person for the issue, by the company, of securities under a CSF offer: s 766F(1). The crowd-funding service is provided to both an investor seeking to apply for the CSF securities and the company making the CSF offer. If the applicant for CSF securities is a “retail” investor, there are additional protections and obligations that apply. “Retail” client is defined in s 761G.

|                                    |
|------------------------------------|
| Obligations of CSF intermediaries. |
|------------------------------------|

An intermediary has a number of obligations under the CSF regime including:

- “gatekeeper” obligations set out in s 738Q which require, among other things, an intermediary to conduct prescribed checks to a reasonable standard (s 738Q(1));
- to provide a communication facility that can be used by investors for posts relating to the offer and to ask questions of the company making the offer or the intermediary (s 738ZA(5));
- to ensure retail clients receive the benefits of various investor protections such as cooling-off rights (s 738ZD), the investor cap (s 738ZC), acknowledgement of risk (s 738ZA(1)) and adherence to the financial assistance prohibition (s 738ZE); and
- to close or suspend the offer as required and appropriately deal with application monies (s 738ZB(1)).

## CSF offer document

**[7.213]** The CSF provisions set out a disclosure regime for making a CSF offer which involves an eligible CSF company publishing a CSF offer document on the platform of a single CSF intermediary: s 738L(1). A CSF offer document must be prepared for each CSF offer: s 738J(1). The requirement that the CSF offer be made via the platform of a single CSF intermediary is an important element of the CSF regime as the intermediary plays a central role in the administration and regulation of the CSF regime being under a

number of obligations set out in s 738ZA and supports compliance with rules such as the issuer and investor caps. All applications in response to the CSF offer must be made via the intermediary's offer platform under the terms of the agreement between the issuer company and intermediary: s 738L(2). This requirement imposes a number of investor protections, especially in relation to retail clients. These include cooling-off rights, risk warning and in relation to the communication facility. It also ensures that application money is handled appropriately by a CSF intermediary and will be subject to client money provisions and the CSF rules for when money can be paid to the issuer company and refunded to applicants. A CSF offer can be open for up to three months: s 738N(4)(a).

A CSF offer document must contain all the information specified in the regulations (s 738J(2)) and it usually contains the CSF offer. The specified information contained in the regulations includes information about the company and its business, the securities on offer and how the proceeds from the offer will be used. The CSF offer document does not need to be lodged with ASIC; however, where the CSF offer document does not comply with the legislative requirements, ASIC has the power to make a stop order under s 739(1)(e) to prevent issues of the securities while the order is in effect. This corresponds to the power ASIC has in relation to other Ch 6D disclosure documents which are discussed at [7.185].

An offeror company must obtain certain consents in writing from persons named as directors or proposed directors or persons making a statement in the offer document before a CSF offer document is able to be published: s 738M(1) and (2).

## Defective CSF offer document

**[7.214]** The CSF regime prohibits the offer of CSF securities under a defective offer document (s 738Y(1)) and prohibits an intermediary from publishing or continuing to publish a CSF offer document if the intermediary knows the document is defective: s 738Y(3). An intermediary is deemed to have knowledge that an offer document is defective if they would have had such knowledge had they conducted prescribed checks to a reasonable standard: s 738Q(4). An offer document is defective if it contains a misleading or deceptive statement, there is an omission of required information or since the document was published, a new circumstance has arisen that would have been required to have been included in the document had it arisen prior to the document's publication: s 738U(1). A misleading statement includes a statement about a future matter where the person making the statement did not have reasonable grounds for making it: s 738U(2).

The offeror company, the intermediary and any other persons who may become liable on the offer document are under an obligation to provide written notification to the company and intermediary as soon as practicable if they become aware the offer document is defective while it is still open: s 738V. Failure to make notification of a defective offer document is a strict liability offence: s 738V(4). Notification that an offer document is defective has significant consequences as it triggers the intermediary's obligation to remove the offer document from the platform and closes or suspends the offer thereby preventing further applications from being received in respect of the defective offer document. It also enables existing applicants to be provided with a

supplementary or replacement offer document that corrects the defect and enables them to recover application money previously paid, either by withdrawing their acceptance within one month or the offer will close but not “complete” under s 738N(7): ss 738W(1) and 738X.

Persons associated with a defective offer may be criminally liable or exposed to action by an investor for recovery of loss or damage where the offer document is defective and the statement, omission or new circumstance that caused the document to be defective is materially adverse from the point of view of an investor: s 738Y(4).

There are a number of defences available to a person who may otherwise be criminally liable in relation to a defective offer document. These defences are similar to those available in relation to other disclosure documents and include where a person did not know the offer document was defective (“lack of knowledge” defence): s 738Z(1), where the person placed reasonable reliance on information provided by another person apart from an agent, employee or director in the case of company (the “reasonable reliance” defence): s 738Z(3) or where a person named in an offer document publicly withdrew their consent to being named in the document: s 738Z(6).

## Investor protection provisions

**[7.215]** There are several investor protection provisions applicable to all investors with some additional protections that apply to “retail clients”. A retail client is subject to an investor cap that limits investments to a maximum of \$10,000 in relation to CSF offers by a particular issuer, within a 12-month period and via the same intermediary: s 738ZC(1). Retail clients who have made an application have cooling-off rights that allow them to withdraw their application within five business days of it being made: s 738ZD(1). The intermediary must then refund the application money as soon as practicable: s 738ZB(4) (a). There is also a prohibition on the provision of financial assistance: s 738ZE(2). Financial assistance is discussed at [8.325]–[8.375].

There are additional protections that apply to all investors. These include a general prohibition on advertising CSF offers: s 738ZG(1); however, issuers and intermediaries can advertise CSF offers as long as the advertisement refers to the CSF offer document and risk warning.

## Tutorial questions

1. Go to “Upcoming floats and listings” on the ASX website. Refer to a prospectus of a company seeking to float on the ASX in the near future.
  - (a) What are the purposes of raising the capital?
  - (b) Describe the company’s history, business(es) and business environment.
  - (c) What are the stated strategies and future directions the company intends to pursue?
  - (d) Does the prospectus refer to growth prospects?



- (e) Does the company propose to acquire a business? If so, from whom?
  - (f) What is the minimum subscription (if any)?
  - (g) What type of information is contained in the independent accountant's report?
  - (h) Outline the main risk factors prospective investors should consider.
  - (i) Describe any material or significant contracts entered into by the company.
2. How has ASIC sought to protect investors who participate in online fundraising?
3. Michelle and Phillip owned a successful tofu nut plantation. Not long ago they decided to form a company, Nutgro Ltd, to acquire and manage the existing plantation and to establish similar plantations in northern Victoria. As consideration for the sale of the business to the company, they receive a substantial block of shares.

At a recent board meeting the directors of Nutgro Ltd (Michelle, Phillip and Abe) were discussing raising \$50 million by issuing shares in order to fund further expansion of the business. Several fundraising options were considered:

- offering additional shares to existing shareholders;
  - offering shares to past and present employees of Nutgro Ltd; and
  - offering \$50 million worth of shares to Eastern Insurance Ltd.
- (a) Does Nutgro Ltd have to prepare a disclosure document in respect of the above offers? If so, what type of disclosure document must be prepared?
  - (b) Does the disclosure document have to disclose
    - details of the sale of Michelle and Phillip's tofu nut plantation to Nutgro?
    - profit and dividend forecast?
  - (c) Can Nutgro Ltd make CSF offers to its past and present employees?

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.
- For further corporations law links and material please refer to the Understanding Company Law website at <http://www.uclaw.com.au>.



## Chapter 8

# Share capital

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## Key points

- A share is a “chose in action”, being an item of intangible property, the rights attached to which are recognised and protected by the law. Ownership of a share gives the investor proprietary rights and imposes obligations as defined by the company’s constitution and the law. These rights include the right to vote and receive dividends. A shareholder does not own a direct interest in the company’s property.
- A company issues shares to investors to raise funds for operating its business activities. The issue price of a share is determined by contractual agreement between the company and the investor. Usually, the issue price is paid in the form of cash, although non-cash consideration may also be provided.
- An investor who pays the full issue price for their shares has no further liability to contribute capital to the company. Shares may also be issued partly paid. A shareholder who owns partly paid shares is liable to pay calls up to the amount of the issue price.
- A company may issue different classes of shares with differing rights attached. The most frequently issued classes of shares are ordinary and preference shares. Preference shares are a class of shares whose holders are usually given a right to be paid dividends at a fixed rate in priority or preference to ordinary shareholders.

- Holders of minority classes of shares are protected from variations of their class rights made without their approval. Such rights may only be varied in accordance with the constitution or a procedure set out in the *Corporations Act 2001* (Cth) (*Corporations Act*) which requires approval of at least 75 per cent of the votes of the affected class as well as a special resolution of the company.
- The *Corporations Act* regulates various types of share capital transactions such as share capital reductions, share buy-backs, indirect self-acquisitions and financial assistance to enable investors to directly or indirectly acquire shares in the company while ensuring that the transactions do not materially prejudice the interests of the company, its shareholders or the ability of the company to pay its creditors.

## Introduction

**[8.05]** Issuing shares to investors is one of the main sources of funds for a company limited by shares. Share capital (sometimes also referred to as “equity capital”) is the total amount of money or other property that investors provide to the company in consideration for the shares issued to them.

Directors usually have the power to issue shares and raise equity capital for a company. In exercising this power, directors owe a fiduciary duty to issue shares for a proper purpose. This is discussed in [15.150]–[15.190]. Share issues are regulated partly by the company’s constitution or applicable replaceable rules and partly by the *Corporations Act*. ASX Listing Rules also regulate share issues by listed companies.

Shares come within the definition of securities: s 92. The fundraising provisions of the *Corporations Act* require companies that offer shares and other types of securities to disclose relevant and accurate information to potential investors so that they can make an informed decision whether or not to take up the shares. The fundraising disclosure provisions are discussed in Chapter 7.

When shares are issued, they are allotted to the holders who become members after their names are entered in the register of members. The rules regarding the issue of shares are discussed at [8.50]–[8.105] in this chapter, and the process for becoming a member is discussed at [9.10]–[9.105].

A company may wish to issue shares that carry rights and obligations that differ from those of other shares with respect to matters such as voting rights, amount of dividend payments and priorities on payment of dividends. In such a case, the company may issue different classes of shares.

Historically, the issued share capital of a company was not able to be returned to shareholders as its creditors were entitled to rely on the issued capital as the source of payment of their debts ahead of payments to shareholders. Hence, there was an obligation imposed on companies to maintain their share capital. This was known as the rule in *Trevor v Whitworth* (1887) 12 App Cas 409, which has been modified by the *Corporations Act* so that share capital can be reduced and capital returned to shareholders, subject to certain requirements being met.

## Nature of shares

**[8.10]** A share is a “chose in action”, being an item of intangible property, the rights to which are recognised and protected by the law. A share is a right to a specified proportion of the company’s share capital but does not constitute a debt.

Ownership of a share gives the shareholder economic and proprietary rights as defined by the company’s constitution and the law. These rights include the right to payment of a dividend and to vote at a general meeting. Share ownership may also impose obligations such as an obligation to pay calls on partly paid shares. A shareholder does not have any proprietary interest in the company’s assets. Shares may be bought and sold, bequeathed under a will on the death of a shareholder and given as security for loans.

A share represents a proportionate interest held by a shareholder in the net worth of a company. A share's value is the proportion of the total net worth of the company's enterprise. The net asset backing of shares is based upon the balance sheet value of net assets divided by the number of issued shares. The market value of listed company shares takes into account various considerations such as market perceptions of the value of net assets, present and estimated future earnings, the quality of management and prospects of the industry in which the company operates.

The law recognises that ownership of a share is capable of being divided into legal and equitable interests: s 1070A(3). Generally, the same person holds both the legal and equitable interests in a share. However, in some cases, they may be held by different persons. For example, when shares are held on trust, the trustee has the legal interest and the beneficiary holds the equitable interest. This also occurs when shares are sold. When the contract of sale is made, the purchaser acquires an equitable interest and the vendor retains the legal interest in the shares. The purchaser obtains the legal interest when the company registers the transfer of shares. This is discussed at [9.155]–[9.170].

## Share options

**[8.15]** Share options may be granted by the company or by another person. A company grants an option when it agrees to issue shares to a person (the “option-holder”) at a future date. If the option-holder agrees to take up the shares, they are said to exercise the option and can require the company to allot the shares. As with any other contract, an option requires the option-holder to provide consideration for being granted the share option.

A company grants an option when it agrees to issue shares to a person at a future date.

Another form of option arises when a person, other than the company, grants someone else an option in relation to shares. An option may be to either buy or sell the underlying shares at a particular price called the “strike price”. An option to buy shares, called a “call” gives the option-holder the right, but not the obligation, to buy the shares. An option to sell shares is called a “put”. The ASX conducts an options market for the shares of certain listed companies.

An option-holder is not a member of the company until the option is exercised.

A convertible debenture or convertible note has similarities to a share option because it entitles the holder to convert a loan to the company into shares at a future date. The issue of convertible debentures or convertible notes involves a company borrowing money on terms whereby the loan may be redeemed by a later issue of shares. The debenture-holder, or note-holder in effect has an option to take up shares in the company at a future date. Convertible debentures and convertible notes are discussed at [11.30].

*ASX Listing Rule 7.1* regulates the issue of options by listed companies to take up its shares in the future. Among other things, this rule requires a listed company to obtain shareholder approval when granting options, which if exercised, would result in an issue

of shares exceeding 15 per cent of the company's capital. The ASX Listing Rules may be viewed on the ASX website which is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

To ensure disclosure of future capital commitments, s 170 requires companies to maintain a register of option-holders and copies of option documents containing the required particulars.

Companies often grant share options to their directors and executives as part of their remuneration.

Companies often grant share options to their directors and executives where they satisfy defined performance conditions. Options with appropriate performance conditions forming part of executive remuneration are a feature of good corporate governance because they can help ensure the interests of shareholders are aligned with the personal interests of the company's management. Remuneration is discussed at [12.290]–[12.325] and [14.80].

The *Corporations Act* ensures that shareholders receive information about options the company grants to its directors and senior officers. Particulars regarding options granted to listed company directors as part of their remuneration must be disclosed in the company's annual directors' report under ss 300 and 300A. Similar disclosure is required of options granted to the five most highly remunerated officers other than directors: s 300(1). There are greater disclosure requirements regarding share options that a listed company grants to its directors and other key management personnel as part of their remuneration: s 300A(1). The disclosure includes the value of options granted to those people as part of their remuneration as well as the value of options that they exercised during the financial year: s 300A(1)(e)(ii) and (iii). Directors' reports are discussed at [22.105]–[22.115].

## Stock

**[8.20]** Stock is a collection of shares expressed in units of money. Stock has the characteristic that, unlike a share, a holder can freely divide stock into amounts of any value. Each unit of stock can then be sold individually. Companies are prohibited from issuing stock or converting shares into stock: s 254F.

## Bearer shares

**[8.25]** Section 254F prohibits a company issuing bearer shares. Bearer shares or share warrants are documents sealed by a company that state the bearer is entitled to specified shares.

The term “share warrant” is now also used in a different sense. It is similar to an option over shares in a company. However, a share warrant is granted by a third person and not the company. Such share warrants are not included within the s 254F prohibition and are actively traded on the ASX.



## Stapled securities

**[8.30]** Stapled securities are a type of ASX listed security.

A stapled security involves two or more different types of securities that are contractually linked and cannot be traded separately. They often comprise a trust unit and a share in a related management company. The trust owns the assets of the business and the related company manages the trust's asset portfolio.

Stapled securities are two or more securities that are linked and cannot be traded separately.

Stapled securities are commonly issued by entities that act as property trusts or are engaged in the construction of motorways and other infrastructure. For example, the Transurban Group has an ownership interest in toll roads in Australia and the USA. Investors in the Transurban Group own a stapled security that consists of a share in Transurban Holdings Ltd, a share in Transurban International Ltd and a trust unit in the Transurban Holdings Trust. The various components of the Transurban stapled security cannot be traded separately. Each of the securities in the staple controls other entities. The Transurban Group stapled securities are listed on the ASX, and the group is currently a member of the S&P/ASX 20 index (that is, in the top 20 ASX entities by market capitalisation).

## Issued capital

### Authorised share capital abolished

**[8.35]** Prior to 1998 a company limited by shares was required to state in its constitution the amount of authorised or nominal capital with which it was registered and the division of this capital into shares of a fixed amount. This fixed amount was called the “par” or “nominal” value of the shares. A company's authorised capital was the maximum amount of share capital that the company was permitted to issue. An allotment of shares in excess of the authorised capital was void: *Bank of Hindustan China & Japan Ltd v Alison* (1871) LR 6 CP 222.

Companies are no longer required to state the amount of their authorised capital.

The pre-1998 requirement that a company had to state its authorised capital has been abolished because it served little purpose. Issued capital is of far greater significance than the maximum permitted share capital because it represents the amount received by, or owed to, the company from the issue of its shares. Creditors of companies limited by shares have a general right to expect that issued capital will not be returned to shareholders before creditors' claims are met in full. The principle that requires companies to maintain their share capital is discussed at [8.200] and following.

A company may provide in its constitution that directors cannot issue shares in excess of a stated limit. Such a restriction may be desirable where shareholders wish to prevent

their holdings being diluted or new members acquiring shares without the consent of existing shareholders.

## Abolition of par value

**[8.40]** A company may issue shares for any amount that it chooses without being restricted to a predetermined par or nominal value as specified in its constitution. The concept of “par value shares” was abolished in 1998 even if the shares had already been issued: s 254C.

The concept of par value has been abolished.

The abolition of the concept of par value recognised that it no longer served a useful commercial purpose and its continued existence added unnecessary complexity to the law dealing with share capital. Par value was an arbitrary amount stated in the constitution that often did not reflect the real value of the company's shares and could mislead some investors.

The removal of the concept of par value has resulted in significant simplification of various aspects of the share capital provisions.

## Fully and partly paid shares

**[8.45]** A company may issue shares either fully paid or partly paid: s 254A(1)(c). The amount unpaid on partly paid shares is called “reserve capital” or “uncalled capital”. The issued share capital of a company comprises both its paid up capital and reserve capital. A shareholder who holds fully paid shares has paid the entire issue price of the shares and has no further obligation to contribute money to the company.

A shareholder who owns partly paid shares is liable to pay calls on the shares.

A shareholder holding partly paid shares is liable to pay calls on the shares unless the company is a no liability company: s 254M. No liability companies are discussed at [3.30].

On a winding up, a member is liable to contribute to the company's property to an amount sufficient to pay the company's debts and the costs of the winding up: s 515. A shareholder need not contribute more than the amount (if any) unpaid on the shares: s 516. A liquidator has the power to make a call: s 477(2)(ca). A liquidator can make calls whether or not calls are permitted by the company's constitution: *Wright v Mansell* [2001] FCA 1519.

The issue of partly paid shares presupposes an obligation to pay a call because to reduce or extinguish the liability of a shareholder in respect of unpaid capital, amounts to a reduction of capital. The requirements for permitted capital reductions are discussed at [8.230].

A company may give security over its uncalled capital: s 124(1)(e). A company's shareholders may pass a special resolution that has the effect of restricting the

company's right to make calls to situations where the company becomes insolvent and goes into a form of external administration such as voluntary administration or liquidation: s 254N. The amount unpaid on shares, if any, must be stated in the register of members: s 169(3)(f).

The *ASX Operating Rule 3801* requires market participants such as brokers to alert retail clients of the need to inform themselves of their rights and obligations in relation to partly paid securities other than those of no liability companies. The features and risks associated with partly paid shares are set out in a prospectus or product disclosure statement. "Retail client" is defined in s 761G and is discussed at [26.80] and product disclosure statements are discussed at [26.98]. Market participants are also required to enter into a Client Agreement with retail clients who are purchasing partly paid securities for the first time. These requirements are aimed at increasing investor awareness of the risks of acquiring partly paid shares.

## Issue of shares

### Contractual rules

#### *Offer and acceptance*

**[8.50]** The rules of contract law apply to share issues. Usually, an investor makes an offer for shares by sending the company an application form and paying the issue price. This offer is accepted when the company, through its directors, decides to allot the shares and sends the notice of allotment. Where these communications are by post, acceptance by post is deemed effective when posted: *Byrne v Van Tienhoven* (1880) 5 CPD 344. For example, in *Household Fire & Carriage Accident Insurance Co v Grant* (1879) 4 Ex D 216, a notice of allotment sent by the company was lost in the mail. The applicant was held to be a member and therefore liable on a call even though he did not receive communication of acceptance. The requirement of communication of acceptance was impliedly dispensed with by the offeror in using the post.

The rules of contract law apply to share issues.

Under the law of contract, an offer lapses if not accepted within a reasonable time. In *Ramsgate Victoria Hotel Co v Montefiore* (1866) LR 1 Exch 109, it was held that an investor's offer to take up a share issue lapsed after a period of five months after being sent to the company. Therefore, the application for shares was no longer capable of acceptance by the company when it purported to allot the shares.

#### *Rights issues*

**[8.55]** A rights issue is made when a company offers to issue shares to existing shareholders in proportion to shares held. A contract is formed when the shareholder accepts the company's offer. Usually, the company specifies a closing date after which its offer lapses. The shareholder is entitled to take up shares under a rights issue from the date of the offer until the closing date.

A distinction is made between a renounceable rights issue and a non-renounceable rights issue. A renounceable rights issue is one that gives the shareholder the power to sell their rights prior to the closing date. The company agrees to issue shares to any person who owns the rights and accepts the offer. Renounceable rights are often listed on the ASX and are marketable in the same way as listed shares.

### *Issue of fewer shares than applied for*

**[8.60]** Application forms for share issues usually provide that the applicant agrees to take the number of shares applied for, or any lesser number that is allotted. This prevents problems arising where the number of shares applied for, exceeds the number the company proposes to issue. An allotment of a lesser number than that applied for would constitute a counter-offer under contract law because the terms of the offer and acceptance are not identical. The effect of a counter-offer is to destroy the original offer. By requiring an applicant to make an offer for a certain number of shares or a lesser number at the discretion of the company, this inconvenient result is avoided, and the contract is complete when the shares are issued.

### *Allotment and issue of shares*

**[8.65]** The expressions, “allotment of shares” and “issue of shares” are sometimes used interchangeably, although there is a distinction. An allotment is one step in the broader process of an issue of shares which also includes entry in the share register and delivery of share certificates. The various ways in which a person can become a member of a company and the process by which a person becomes a member are considered in Chapter 9.

## **Restrictions on allotment**

**[8.70]** There are several provisions in the *Corporations Act* that prohibit or make it an offence to issue securities in certain circumstances where conditions set out in a disclosure document are not met. This aims to protect shareholders. Disclosure documents and the fundraising provisions of the *Corporations Act* are discussed in Chapter 7.

### *Minimum subscription*

**[8.75]** If a disclosure document states that the securities will not be issued unless applications for a minimum number of securities are received or a minimum amount is raised, the person making the offer must not issue any of the shares until that minimum subscription condition is satisfied: s 723(2). Application money received from investors must be held in trust until the minimum subscription condition is fulfilled and the securities are issued: s 722.

The purpose of s 723 is to protect early subscribers where the company is unable to raise the minimum amount it needs to be a viable concern. Otherwise, the preliminary expenses of a failed company would be met by a relatively small number of investors without any real future prospects. Minimum subscriptions stated in a disclosure document are further discussed at [7.140].

## Stock exchange listing

**[8.80]** A disclosure document for an offer of securities may state or imply that the securities are to be quoted on a financial market, such as the ASX, whether in Australia or elsewhere. In such a case, unless an application for listing is made within seven days after the date of the disclosure document and the securities are listed within three months of that date, any issue or transfer of the securities in response to an application under the disclosure document is void. The offeror must return money received from applicants as soon as practicable: s 723(3). The offeror must also act in accordance with s 724(2). This is discussed at [8.75].

Applicants have the right to have their application money repaid on the giving of notice under s 737.

## Expiration of disclosure document

**[8.85]** A disclosure document must state that no securities will be issued on the basis of the document after the specified expiry date. This date must be no later than 13 months after the date of the disclosure document: ss 711(6), 714(2) and 715(3).

If an application for securities is received by the company after the expiry date, under s 725(3) the company must either:

- return application money received; or
- give the applicants one month to withdraw their application or return the securities that have been issued.

## Validation of improper issue of shares

**[8.90]** The court has wide powers to validate or confirm a purported issue of shares which is invalid for any reason or in which the terms of the issue are inconsistent with or unauthorised by any law or the company's constitution: s 254E.

The court has wide powers to validate or confirm otherwise invalid share issues.

The company, a shareholder or creditor of the company or any other person whose interests are affected by the share issue may make an application for validation. This section prevents a shareholder or creditor being adversely affected if the company has made an improper share issue that would otherwise be void.

*Re Swan Brewery Co Ltd (No 2)* (1976) 3 ACLR 168

**[8.95]** A company issued substantial numbers of shares to several other companies. The holders of these shares had, for several years after they were entered on the register of members, been paid dividends, allotted bonus shares and generally treated as members. It was eventually discovered that these companies were at all

material times subsidiaries of the Swan Brewery Co Ltd. The allotments to them were consequently void under a provision corresponding to s 259C, which prohibited a subsidiary holding shares in its holding company. The companies sought to have the allotments validated by the court under a predecessor to s 254E. Gillard J held that in the exceptional circumstances of the case it was “just and equitable” to validate the allotments so as to assist a large number of innocent people who would otherwise be adversely affected by invalid allotments.

*Kokotovich Constructions Pty Ltd v Wallington* (1995) 13 ACLC 1113

**[8.100]** An allotment of shares was validated because the parties had proceeded for 20 years on the basis that shares had been properly issued and an order validating the issue was just and equitable. The court rejected the argument that its discretion under the predecessor of s 254E should only be exercised where the validation was non-contentious.

The court also has a wide discretion under s 1322(4)(a) to validate certain irregularities arising from a contravention of the *Corporations Act* or the company's constitution. An order can only be made under this section if the irregularity was essentially of a procedural nature, the person who was party to the contravention acted honestly or it is just and equitable that the order be made and no substantial injustice is likely to be caused: s 1322(6). This power of the court is discussed at [21.220].

In *QBiotics Ltd* [2016] FCA 873 orders were made under s 1322(4)(a) that validated certain share issues and transfers over a six-year period that were inadvertently in contravention of a pre-emptive rights provision in the company's constitution. This case is further discussed at [9.167].

## Consideration for share issue

**[8.105]** A shareholder who has been allotted shares must pay the company the issue price of the shares which is the consideration for the share issue. In most cases, the consideration is cash. However, companies may issue shares for a non-cash consideration: *Re Wragg Ltd* [1897] 1 Ch 796. The payment of a non-cash consideration for a share issue often occurs when a partnership or sole tradership sells its business to a newly formed proprietary company. This occurred in *Salomon v A Salomon & Co Ltd* [1897] AC 22 discussed at [2.50].

Non-cash consideration must be consideration recognised by the law of contract.

A company cannot issue shares gratuitously. Any non-cash consideration must be consideration recognised by the law of contract. Hence the issue of shares in consideration of past services is past consideration and is not permitted. The company may require the allottee in such circumstances to later pay the full value of the shares in cash.

In *Re White Star Line Ltd* [1938] 1 All ER 607, it was held that the value of the consideration for an allotment of shares must be more than “sufficient” consideration required under the law of contract. It must represent money’s worth for the allotment.

The application for registration of a company limited by shares must, among other things, set out the amount (if any) each member agrees in writing to pay for each share: s 117(2)(k)(ii). Further, the application for registration of a public company that is limited by shares must set out the prescribed particulars about the share issue if shares will be issued for a non-cash consideration: s 117(2)(l). This is not required if the shares will be issued under a written contract and a copy of the contract is lodged with the application. Section 254X requires a company to lodge a notice of share issue with ASIC. This includes a copy or particulars of any contract whereby shares are issued by a public company for non-cash consideration. In addition, under s 254X(2) the company must also lodge with ASIC a certificate stating that payable stamp duty has been paid.

It is common for a company to issue shares for non-cash consideration to its promoters or directors. This is open to abuse if the company acquires overvalued assets. Promoters or directors are usually able to control the management of the company and so there may be no opportunity for an independent assessment of the value of the acquired asset. Promoters and directors in such cases may breach their fiduciary duties. This is discussed in Chapters 6 and 16 respectively.

Where a company acquires overvalued assets, this may be detrimental to shareholders and creditors. Section 711(2) requires a prospectus to set out details of interests held by directors, promoters and others connected with the prospectus or the offer that relate to the promotion of the company and property acquired by it. A lesser degree of disclosure is required in other types of disclosure documents: ss 714(1)(c) and 715(1)(e).

## Classes of shares

**[8.110]** A company may wish to issue different classes of shares for various reasons:

- It may wish to raise share capital on terms similar to borrowing from external creditors. This can be done by issuing shares that carry a specified rate of dividend which has priority over dividend payments to other classes of shares but with limited voting rights and no rights to participation in distribution of surplus assets on winding up.
- Small family companies may wish to concentrate control in the hands of the holders of a particular class of shares. Such shares often have weighted voting rights or exclusive rights to appoint directors.
- Some taxation minimisation schemes involve the issue of different classes of shares.
- A home unit company may own a building and issue different classes of shares, each of which entitles the shareholder to occupation rights in respect of a particular unit in the building to the exclusion of the holders of other classes of shares.

The most common ways in which classes of shares differ among each other are:

- entitlement to dividend;
- right to priority in payment of dividend;

- voting rights;
- right to priority of repayment of capital on winding up; and
- right to participate in a distribution of surplus assets on winding up.

The creation of different classes of shares is regarded as a matter for the company to determine because it does not affect outsiders such as creditors. If a company wishes to differentiate between the rights of different classes of shares, these rights should be clearly set out in the constitution or the share issue contract.

The application for registration of a company must include the class of shares that the persons who consent to be members agree in writing to take up: s 117(2)(k). A company must lodge a notice with ASIC setting out particulars of any division of shares into classes if the shares were not previously so divided or the shares were converted into shares in another class: s 246F(1). A public company must lodge (within 14 days) with ASIC a copy of each document or resolution that attaches rights or varies or cancels rights attaching to issued or unissued shares: s 246F(3).

## Preference shares

**[8.115]** The most common classes of shares are described as ordinary and preference shares. Preference shares are not defined in the *Corporations Act* but they are understood to possess some preference or priority over other or ordinary shares such as a priority to payment of dividend or repayment of capital in a winding up. The existence of preference shares therefore presupposes the existence of another class of shares which are not preference shares and over which, in some respect, the preference shares have a priority. Shares may still be characterised as preference shares, even though ordinary shares had not been issued at the time of issue of the preference shares: *Beck v Weinstock* [2013] HCA 15.

The rights of preference shareholders are determined with reference to the company's constitution and other relevant documents such as shareholder agreements and terms of share issue. As the name suggests, holders of preference shares have preferential rights ahead of ordinary shareholders on matters such as the right to receive dividends or returns of capital. As discussed at [8.140], these preferential rights must be set out in the company's constitution or approved by special resolution of the company: s 254A(2).

Preference shareholders usually have the right to receive dividends at a fixed percentage of the issue price of their shares. As a general rule, the dividend entitlements of ordinary shareholders are not expressed in terms of a fixed percentage of the issue price of their shares but are determined by the directors from year to year. Ordinary shareholders usually receive dividends if the company has surplus profits after payment of preference shareholders' dividends. Generally, preference shareholders also have preferential rights ahead of ordinary shareholders to be repaid their capital if the company is wound up.

If a company has a profitable year, the ordinary shareholders may receive a larger dividend than preference shareholders. On the other hand, if the company does not operate profitably, the ordinary shareholders may receive a smaller or even no dividend while the preference shareholders usually still receive their fixed rate of dividend subject to the dividend payment rules discussed in [10.30]. Therefore, the returns on investment



to ordinary shareholders are usually more closely tied to the fortunes of the company. Preference shares normally only carry restricted voting rights. These characteristics of preference shares reflect that preference shareholders are commercially seen as having some similarities to external creditors.

### *Participating preference shares*

**[8.120]** Preference shares may be participating or non-participating. They are referred to as “participating preference shares” if the preference shareholders have a further right to receive additional dividends as well as their preferential dividend entitlements. If the company is wound up, participating preference shareholders are presumed at common law to be entitled to receive surplus capital after the repayment of their capital contribution: *Re Plashett Pastoral Co Pty Ltd* (1969) 90 WN (Pt 1) (NSW) 295. Preference shares are presumed to be non-participating where this entitlement is not expressly stated in the company’s constitution: *Will v United Lankat Plantations Co Ltd* [1914] AC 11. This reflects the commercial attitude that preference shareholders are similar to creditors who lend at a fixed rate of return.

### *Cumulative preference shares*

**[8.125]** Preference shares may be cumulative or non-cumulative. If a company does not pay dividends in a particular year, cumulative preference shareholders have the right to be paid arrears of dividends in subsequent years ahead of ordinary shareholders. Preference shares are presumed to be cumulative if the company constitution is silent on the matter: *Webb v Earle* (1875) 20 Eq 556.

### *Deferred shares*

**[8.130]** Shares may also be described as deferred or founder’s shares. The holders of these shares only have rights to dividends if a prescribed amount has been paid to ordinary shareholders. Accordingly, the relationship between deferred and ordinary shares is similar to that between ordinary and preference shares.

### *Voting rights*

**[8.135]** Preference shareholders usually have limited voting rights. Examples of limited voting rights are rights to vote only:

- during a period when dividends are in arrears;
- on a proposal to vary class rights;
- on a proposal for reduction of capital; or
- on a proposal to wind up the company.

### *Setting out preference shareholder rights*

**[8.140]** The main rights attaching to preference shares must be set out in the company’s constitution or in a special resolution passed by the company.

Sections 254A(2) and 254G(2) require a company that issues preference shares or converts ordinary shares into preference shares to set out in its constitution, or otherwise

approve by special resolution, the rights of preference shareholders with respect to the following:

- repayment of capital;
- participation in surplus assets and profits;
- cumulative or non-cumulative dividends;
- voting; and
- priority of payment of capital and dividends in relation to other shares or other classes of preference shares.

These requirements enable prospective and existing preference shareholders to ascertain the rights attaching to their shares. It also seeks to ensure that the rights attaching to preference shares are more entrenched than they would be if contained in an ordinary resolution of the company or board of directors. It is still open for a company to provide in its constitution that the directors retain a discretion to determine the amount of dividends or the rate of redemption of redeemable preference shares. The exercise of such a power would not contravene ss 254A(2) and 254G(2).

### *Consequences of failure to set out preference shareholders' rights*

**[8.145]** Sections 254A(2) and 254G(2) require a company to set out in its constitution the rights of preference shareholders in relation to certain important matters. Prior to the introduction of these requirements, at common law certain presumptions were made regarding the rights of preference shareholders where the constitution was silent on the matter. See [8.120] and [8.125]. It is unclear what effect a contravention of ss 254A(2) and 254G(2) has on those common law presumptions. It is also uncertain whether there are any civil consequences where the provisions are contravened. There are several possibilities.

It may be that contravention of these provisions only constitutes an offence by the company and officers in default and does not otherwise alter preference shareholders' presumed common law rights. Another possibility is that a contravention may mean that the issue to preference shareholders is invalid because the issue is prohibited by the *Corporations Act*. In such a case, preference shareholders may apply to the court under s 254E or 1322(4)(a) for an order validating the improper issue. This is discussed at [8.90]–[8.100].

Sections 254A(2) and 254G(2) prohibit the issue of or conversion into preference shares only if the rights are not set out in the constitution or otherwise approved by special resolution. There is nothing to prohibit the deletion of such rights after the shares are issued. In *Simon v HPM Industries Pty Ltd* (1989) 7 ACLC 770, Hodgson J refrained from implying such a prohibition in a predecessor of s 254A(2). In such a case, the holders of a class of shares are left with statutory rights preventing variation of their class rights, as discussed at [8.155].

## **Redeemable preference shares**

**[8.150]** A company may issue redeemable preference shares: s 254A(1)(b). The main feature of redeemable preference shares is that the company can pay back the issue price of the

preference shares to the shareholder. This is referred to as the company “redeeming” its shares. Redeemable preference shares may be redeemed at a fixed time or at the option of the company or shareholder: s 254A(3). Redeemable preference shares may be redeemed only on the terms on which they were issued: s 254J(1). The ability of a company to issue redeemable preference shares enables it to redeem those shares without the need to meet the requirements necessary for reductions of capital and share buy-backs. These requirements are discussed at [8.230]–[8.310].

Shares may be redeemable preference shares even though there were no ordinary shares at the time the redeemable preference shares were issued. In such a case, the right to preferential payment of a dividend was a potential right that lacked practical content in the absence of ordinary shares: *Weinstock v Beck* [2013] HCA 15. In this case, the company was able to redeem the shares in accordance with its constitution for an issue price of \$8. Had the shares not been redeemable, their value may have been more than \$7 million.

Redeemable preference shares similar to borrowing.

There is a similarity between an issue of redeemable preference shares and borrowing money such as by an issue of debentures. In both cases, the company pays a set rate of return and the issue price, in the case of redeemable preference shares, and the amount borrowed, in the case of a loan, is repaid at an agreed future time. Because of this similarity, s 254J(1) allows companies to issue redeemable preference shares. However, despite some similarities, a redeemable preference shareholder is not a creditor: *Heesh v Baker* [2008] NSWSC 711.

The issue of redeemable preference shares has certain advantages over borrowing from the company’s point of view. The company is under no legal obligation to declare dividends; however, there is a contractual obligation to meet interest payments on borrowings. Consequently, the rights of lenders in the case of default are far stronger than the rights of shareholders. There are some disadvantages. For example, if the company borrows money, interest paid is deductible for taxation purposes, as are expenses incurred in procuring the loan. Dividends, however, are paid after the taxable income of a company is ascertained.

The *Corporations Act* imposes restrictions on the redemption of redeemable preference shares to ensure that the rights of the company’s creditors are not adversely affected. Under s 254K a company may only redeem redeemable preference shares:

- if they are fully paid (s 254K(a)); and
- out of profits or the proceeds of a new share issue made for the purpose of the redemption (s 254K(b)).

If a company does not redeem redeemable preference shares out of profits, the redemption involves a reduction of capital and the requirements of ss 256B and 256C must be complied with. These are discussed at [8.230] onwards. In addition, the company’s directors may contravene the insolvent trading provision in s 588G and be personally liable under s 588M if the company becomes insolvent when it redeems any redeemable preference shares. Insolvent trading is discussed at [18.100] onwards.

# Variation of class rights

## Statutory provisions

[8.155] The class rights provisions in ss 246B–246G are designed to strengthen the rights of holders of particular classes of shares where the directors or controlling shareholders seek to vary or cancel those rights. Section 246B is the key provision. It aims to ensure that holders of a class of shares approve any proposal to vary the rights attaching to their class of shares.

Section 246B deals with varying and cancelling class rights.

Table 8.1: Varying and cancelling class rights – s 246B

|                                                                                                                                      |   |                                                                                                                                                                                                                                                                                                                                                        |
|--------------------------------------------------------------------------------------------------------------------------------------|---|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| If constitution sets out the procedure for varying and cancelling class rights                                                       | ➔ | Rights may be varied or cancelled only where the procedure in the constitution is followed: s 246B(1)                                                                                                                                                                                                                                                  |
| If a company does not have a constitution or the constitution does not set out the procedure for varying and cancelling class rights | ➔ | Rights may be varied or cancelled only: <ul style="list-style-type: none"><li>• by special resolution of the company; and</li><li>• by special resolution passed at a meeting of the holders of the affected class; or</li><li>• with the written consent of members with at least 75 per cent of the votes of the affected class: s 246B(2)</li></ul> |

Shareholders are assisted in determining what rights are attached to their shares. As discussed at [8.140], ss 254A(2) and 254G(2) require a company that issues preference shares or converts ordinary shares into preference shares to set out in its constitution, or otherwise approve by special resolution, certain specified rights of preference shareholders. Further, the company must lodge, within 14 days, a notice with ASIC setting out particulars of any division of shares into classes or conversion of shares from one class to another: s 246F(1). A public company must also lodge, within 14 days, a copy of a document or resolution that affects rights attaching to issued or unissued shares or binds a class of members: s 246F(3). A shareholder may request a copy of the document or resolution from the company: s 246G(1).

## Application to set aside variation

[8.160] In addition to the requirements that a variation or cancellation of class rights must be approved by special resolutions of the company and the holders of the affected class of shares, s 246D(1) gives members of the affected class the right to apply to the court to set aside a variation or cancellation of their rights or a modification of the constitution to allow their rights to be varied or cancelled.

The application must be made by members holding at least 10 per cent of the votes of the class concerned and, under s 246D(2), must be made within one month after the variation, cancellation or modification is made. The members of the class who want to

have the variation, cancellation or modification set aside may appoint one or more of themselves to make the application on their behalf: s 246D(4). To alert members that their class rights have been varied or cancelled, the company must give written notice of the variation or cancellation to members of the affected class within seven days after the variation is made: s 246B(3).

A variation, cancellation or modification takes effect one month after it is made. However, if an application is made to set it aside, it takes effect when the application is withdrawn or determined: s 246D(3). If all the members in a class agree to a variation, cancellation or modification, it takes effect on the date of the resolution or consent or on a later specified date: s 246E.

## Remedies

**[8.165]** After hearing a s 246D(1) application, the court may set aside the variation, cancellation or modification if it is satisfied that it would unfairly prejudice the applicants: s 246D(5).

The court may set aside a variation or cancellation of class rights.

While s 246D(1) only allows members holding at least 10 per cent of the votes in the class of shares concerned to apply to set aside a variation, cancellation or modification, the *Corporations Act* provides a number of other remedies that can be pursued by members, even where they hold fewer than 10 per cent of the votes. If the company does not comply with the procedures in its constitution for varying or cancelling class rights, this constitutes a breach of the s 140(1)(a) contract between the company and its members. As discussed in [4.80], affected members of the class can apply for an order to force the company to comply with its constitution.

If a company attempts to vary or cancel class rights in contravention of either s 246B(1) or (2), affected members of the class can apply for an injunction under s 1324 to prevent the contravention. A single member of a class may also apply for a remedy under s 232 if the variation, cancellation or modification is oppressive or unfair. Sections 232 and 1324 are discussed in Chapter 24.

A special resolution to vary or cancel a class right contained in a company's constitution may be invalid if the alteration is beyond any purpose contemplated by the constitution or is oppressive: *Gambotto v WCP Ltd* (1995) 182 CLR 432. This is discussed at [4.220].

## What is a variation of class rights?

**[8.170]** While ss 246B and 246D give a degree of protection to the holders of classes of shares against variation of their rights without their consent, it must first be shown that there has been a variation or cancellation of rights.

Statutory variations of class rights.

Both s 246C and the common law regard certain actions as varying class rights. Section 246C(6) deems new issues of equally ranking preference shares as varying the class rights of existing preference shareholders. This provision refers only to new issues of equally ranking preference shares and not to the issue of higher ranking preference shares. It appears anomalous to protect holders of existing preference shares from later issues that rank equally while withholding protection where the later issue ranks ahead of existing preference shares. However, if a new issue of preference shares ranking ahead of existing preference shareholders involves a division of the preference shares into further classes, s 246C(1) takes this to be a variation of rights of the class existing before the division.

Common law meaning of variation of class rights.

The common law meaning of a variation of class rights has been narrowly interpreted. At common law, a variation of class rights is a variation that affects the strict legal rights of the member of the class. Variations that merely affect the value of the shares of a class member, or indirectly reduce voting rights, are not regarded as variations of class rights and consequently the provisions of ss 246B–246G do not apply. Examples of the strict legal rights of a class include the right to a specified rate of dividend and the right to appoint directors to represent a particular class of shareholders.

*Greenhalgh v Arderne Cinemas Ltd* [1946] 1 All ER 512

**[8.175]** A company issued 21,000 preference shares of 10 shillings each and 31,000 ordinary shares of 10 shillings each. Under the articles, each share carried one vote. The company also had the power under its constitution to subdivide its existing shares. When the company fell into financial difficulties it entered into an agreement with Greenhalgh by which he lent it £11,000 secured by a debenture. He was also issued with 10-shilling ordinary shares subdivided into 2-shilling shares. Each 2-shilling share was to have the same voting rights as the issued ordinary 10-shilling shares. After differences arose between the parties, the company resolved at a general meeting to subdivide all existing 10-shilling shares into 2-shilling shares ranking equally with the subdivided shares held by Greenhalgh. The effect of this was to dilute the proportion of votes that Greenhalgh previously had and meant that he no longer held sufficient shares to block the passing of special resolutions. Greenhalgh argued that the voting rights attached to his shares were varied without his consent as required by the constitution. It was held that the voting rights attached to Greenhalgh's shares were not varied even though they were diluted in a practical sense.

**[8.180]** The narrow interpretation given to the expression “variation of class rights” in *Greenhalgh's* case was also applied in *White v Bristol Aeroplane Co* [1953] Ch 65. In that case, a bonus issue to holders of ordinary shares only was held not to “affect, modify, vary, deal with or abrogate” the rights of existing preference shareholders. While the bonus issue had the effect of increasing the votes cast by ordinary shareholders and thereby diluting the percentage of votes of preference shareholders at shareholders’

meetings, this did not affect preference shareholders' strict legal rights which remained the same. They continued to have the right to one vote per preference share.

A return of capital to preference shareholders is a satisfaction of their rights and does not constitute a variation of class rights: *House of Fraser Plc v ACGE Investments Ltd* [1987] 2 WLR 1083.

### *What is a class of shares?*

**[8.185]** Whether the share capital of a company is comprised of different classes of shares depends on whether there is a commonality of interest between shareholders of a particular class. Shares may be divided into different classes despite the fact that the constitution does not refer to the groups of shares as classes. Classes of shares arise because one group of shareholders have different rights to another group: *Crompton v Morrish Hall Pty Ltd* [1965] NSW 240.

**[8.195]** There may be classes of shares for the purpose of the variation of class right rules even though all shares may appear to be classified as ordinary shares. Where the rights of each ordinary shareholder differ in that they each allow for exclusive possession of a particular residential unit, the share capital is divided into sub-classes of shares: *Re White Horses Pty Ltd (No 2)* [2016] QSC 282. A company's share capital may be divided into classes of shares even though there is only one holder of a particular class of shares. In such a case, a class meeting would be comprised of a single shareholder: *Buckland v Johnstone* (1991) 9 ACLC 1193.

## Share capital transactions

**[8.200]** It was noted at [8.105] that companies must receive cash or its equivalent when they issue shares. The funds raised in this way constitute the company's issued capital. A company's creditors can only look to the issued capital, and the way in which it has been applied, for payment in the event of a winding up. Creditors are generally unable to seek payment of company debts from shareholders because shareholders are protected by limited liability. Limited liability is discussed at [2.20]–[2.35]. Similarly, the company's shareholders are entitled to expect that the issued capital will be employed by the company for the objects (if any) set out in the company's constitution and that all shareholders will be treated fairly.

### Reductions of capital.

To protect creditors and shareholders, a general rule was developed that limited liability companies must maintain their issued share capital. This rule was known as "the rule in *Trevor v Whitworth*" and it prohibits a company from reducing its issued share capital. A clear way in which a company may reduce its capital is to purchase its shares from a shareholder. Where a company buys back its own shares, the assets of the company are reduced to fund the purchase, so the funds available to meet the claims of creditors are diminished to the extent of the buy-back. This is contrary to the principle that the claims of creditors of a limited liability company rank ahead of the claims of its shareholders.



One effect of the maintenance of share capital rule is that shareholders are “locked in” and the company is not permitted to return the issue price on their shares except in rare situations. According to Blair, “Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century” (2003) 51 *UCLA Law Review* 387, this feature of the law was an important reason why companies became popular from the 19th century onwards. Locking in shareholders’ capital was especially important for the growth of companies that established long-term highly specific investments such as railways and mines. Such enterprises need large amounts of capital to establish infrastructure and take a long time to generate revenue and profits. Locking in shareholders’ capital allowed companies to enter into long-term relationships with capital providers and managers to develop complex organisational structures and intellectual capital. This article may be viewed on the Social Science Research Network website which is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

The *Corporations Act* provides detailed procedures and requirements that must be complied with where a company engages in various transactions that could have the effect of reducing its capital. These provisions stem from the rule in *Trevor v Whitworth*. Various share capital transactions are now permitted as long as creditors’ and shareholders’ interests are protected.

The *Corporations Act* deals with the following transactions:

- share capital reductions;
- share buy-backs;
- self-acquisition and control of shares; and
- financial assistance.

## The rule in *Trevor v Whitworth*

**[8.205]** The rule in *Trevor v Whitworth* establishes the general principle that a company is prohibited from reducing its issued share capital because a reduction in capital could prejudice the rights of creditors as the reduction would, in effect, diminish the pool of funds available to the company to pay its creditors.

A company is generally prohibited from reducing its issued share capital because this may prejudice the rights of creditors.

*Trevor v Whitworth* (1887) 12 App Cas 409

**[8.210]** The executors of Whitworth, a deceased shareholder in James Schofield & Son Ltd, sold Whitworth’s shares in the company back to the company. Payment was to be by two instalments. Prior to the payment of the second instalment the company went into liquidation. The executors claimed this sum from the company’s liquidator, Trevor. The House of Lords held that a company had no power to purchase its own shares, even if permitted by its constitution. As the purchase was void, the claim of Whitworth’s executors for the balance of the buy-back proceeds failed.



This decision was based on the principle that the capital of a limited liability company should remain available to creditors. While creditors take the risk that the company's capital may be diminished in the course of the company's business, they are entitled to expect that the company's assets will not be returned to shareholders ahead of creditors.

**[8.215]** The cancellation of shares which have been forfeited under the terms on which they were issued is permitted under s 258D by resolution passed at a general meeting. Forfeiture of shares where there has been neither payment of money to shareholders nor a reduction of liability on partly paid shares is not detrimental to the interests of creditors because the pool of funds available to meet creditors' claims remains intact: *Bundaberg Sugar Ltd v Isis Central Sugar Mill Co Ltd* [2006] QSC 358. Forfeiture of shares is discussed at [9.265].

A reduction of capital that involves a return of capital to holders of only one class of share is not a variation of the class rights of other classes of shareholders: *Re Fowlers Vacola Manufacturing Co Ltd* [1966] VR 97. This means that the protective provisions applicable to variation of class rights discussed at [8.155] do not apply to reductions of capital which differentiate between the classes of shares.

Subject to certain exceptions the rule in *Trevor v Whitworth* has been incorporated into the *Corporations Act*.

## Self-acquisition prohibition: s 259A

**[8.220]** The rule in *Trevor v Whitworth* has been incorporated into the *Corporations Act*. Under s 259A, a company must not acquire shares in itself except in any one of the following circumstances:

- in buying back shares under s 257A. Permitted share buy-backs are discussed at [8.280];
- in acquiring an interest in its fully paid shares if no consideration is given by the company or an entity it controls;
- under a court order; and
- in circumstances covered by s 259B(2) and (3). These provisions deal with the situation where a company takes security over its shares under an approved employee share scheme or the security is taken in the ordinary course of business of a lender.

In *Re Wollongong Coal Ltd* [2017] NSWSC 201, it was held that the power of the court to make an order in relation to a share buy-back was limited to buy-backs specifically allowed under another part of the *Corporations Act* such as an order under oppression proceedings. The court, however, did not have the power to make an order under s 259A(c) which would have the effect of exempting a company from compliance with the procedural requirements and safeguards that apply in relation to share buy-backs as this would allow the court to circumvent the detailed legislation which among other things requires shareholder approval of a proposed transaction. The court drew support for its approach from the absence of criteria by which an application should be evaluated.

A company that contravenes the s 259A self-acquisition prohibition is not guilty of a criminal offence: s 259F(1). In addition, a contravention does not affect the validity of the acquisition. However, any person who is involved in a company's contravention of s 259A is in breach of s 259F(2) and subject to the civil penalty provisions. A person

commits an offence if they are involved in a contravention of s 259A and the involvement is dishonest: s 259F(3).

### *Taking security over own shares*

**[8.225]** The self-acquisition prohibition has been extended to prevent a company from taking security over its shares or the shares of a company that controls it: s 259B(1). This prohibition recognises that where a company takes security over its own shares, the enforcement of the security would result in the company acquiring shares in itself with the same effect as a breach of the prohibition in s 259A. Exceptions to this prohibition arise where the security is under an approved employee share scheme or is taken by a financial institution in the ordinary course of its business: s 259B(2) and (3).

Contravention of s 259B is treated in the same way as a contravention of the s 259A self-acquisition prohibition.

## Share capital reduction requirements

**[8.230]** Share capital reductions and share buy-backs are covered by ss 256A–258F. According to s 256A, the purpose of these provisions is to protect the interests of shareholders and creditors by:

- addressing the risk that the transactions may lead to the company's insolvency;
- seeking to ensure fairness between the company's shareholders; and
- requiring the company to disclose all material information.

A company must not reduce its capital unless it complies with the statutory requirements.

A company must not reduce its capital unless it complies with the requirements set out in s 256B(1): s 256D(1). Under s 256B(1), a company may reduce its share capital if the reduction:

- is fair and reasonable to the shareholders as a whole (s 256B(1)(a)); and
- does not materially prejudice the company's ability to pay its creditors (s 256B(1)(b)); and
- is approved by shareholders under s 256C (s 256B(1)(c)).

There are several reasons why a company may wish to reduce its share capital. For example, a company may have more capital than it needs after selling part of its business. Returning surplus capital to shareholders in such circumstances may give them tax advantages. A selective reduction of capital that involves returning capital to some shareholders and cancelling their shares may enable a majority shareholder to attain full ownership of the company by eliminating a minority shareholder with company funds.

Types of share capital reductions.

Share capital reductions may take a number of forms. A company reduces its share capital if it enters into a transaction with its shareholders that involves a payment for the return

of the shares to the company which then cancels some or all of the shares. Such capital reductions are a form of share buy-backs.

A reduction of capital occurs when a company cancels any paid up share capital that is lost or is not represented by available assets. This is referred to as “a loss reduction” and is specifically permitted by s 258F, provided it does not involve a cancellation of shares.

Section 256B(1) specifically treats a cancellation of a share for no consideration as a reduction of share capital. This type of transaction may differentiate between shareholders and may not be fair and reasonable to some of them. However, since no money is leaving the company, such a reduction does not materially prejudice the company’s ability to pay its creditors, and consequently the s 256B(1)(b) requirement does not apply.

A share capital reduction may also involve cancelling or reducing the amount unpaid on partly paid shares. Such a cancellation may materially prejudice the company’s ability to pay its creditors because in a liquidation, creditors look to the company’s reserve or uncalled capital as a source of funds to meet their claims. Both the company and the affected shareholders provide consideration in such a case. The company gives up its right to make a call on the shares, and the shareholder obtains the benefit of not having to pay the call. Section 256B(1A) clarifies that a cancellation of partly paid shares involves the giving of consideration so that the creditor protection requirement in s 256B(1)(b) must still be met.

A company’s power to reduce its share capital is vested in the directors and cannot be decided or proposed by shareholders. Shareholders only have the statutory right under s 256B to approve a capital reduction put forward by directors: *Re Molopo Energy Ltd* [2014] NSWSC 1864.

The payment of dividends when there is not a sufficient excess of assets over liabilities may amount to a reduction of capital. The circumstances in which dividends may be paid are discussed at [10.30].

### *Fair and reasonable to shareholders as a whole*

**[8.235]** A permitted reduction of capital must be fair and reasonable to the company’s shareholders as a whole: s 256B(1)(a). In *Elkington v Costa Exchange Ltd* [2011] VSC 501 it was held that the term “fair and reasonable” comprises one merged concept, the assessment of which requires a wide range of factors to be considered with value being just one of those factors.

Reference to the “shareholders as a whole” requires the courts to take a holistic view of the capital reduction so that the interests of all shareholders and not just the minority should be considered and the interests of one group of shareholders should not dominate those of another group of shareholders.

The following factors may be relevant in determining whether a capital reduction was fair and reasonable to shareholders as a whole:

- the adequacy of the consideration paid to shareholders;
- the company’s gearing;
- the company’s inability to maintain and grow its business;
- the inability of minority shareholders to otherwise sell their shares;

- whether some shareholders are deprived of their rights, for example, by stripping the company of funds that would otherwise be available for distribution to preference shareholders; and
- whether the reduction was being used to avoid the takeover or scheme of arrangement provisions.

A capital reduction may be fair and reasonable to shareholders “as a whole”, even though a reduction may not be fair and reasonable for every individual shareholder.

*Winpar Holdings Ltd v Goldfields Kalgoorlie Ltd* [2001] NSWCA 427

[8.240] Goldfields Kalgoorlie Ltd (GKL) called a shareholders’ meeting to approve a selective reduction of capital that involved the cancellation of the shares held by GKL’s minority shareholders in consideration of a payment to them of 55 cents per share. This was in excess of the amount determined by an independent expert as a fair and reasonable price per share. The effect of the capital reduction was to give GKL’s majority shareholder 100 per cent ownership of the company. Winpar, one of the minority shareholders, argued that the capital reduction was not fair and reasonable because it gave the majority shareholder a “special benefit” consisting of both a reduction in the level of head office costs as well as other synergy benefits from future rationalisation of operations. The New South Wales Court of Appeal held that the capital reduction was fair and reasonable because it gave benefits to both the majority and minority shareholders that they would not otherwise have received. The majority shareholder obtained a benefit arising from 100 per cent ownership, while the minority shareholders obtained an enhanced price for their shares.

*Re Fowlers Vacola Manufacturing Co Ltd* [1966] VR 97

[8.245] In this case, decided under previous share capital reduction provisions, it was held that a reduction of capital that involved a payment only to the company’s ordinary shareholders was not fair to the company’s preference shareholders. Fairness required at least equal treatment between the ordinary and preference shareholders in the reduction of capital because the company’s constitution gave the preference shareholders a priority to a return of capital in the case of a winding up.

## *No material prejudice in ability to pay creditors*

[8.250] A reduction of capital is permitted if it does not materially prejudice the company’s ability to pay its creditors: s 256B(1)(b). Creditor protection is a key rationale underlying the share capital reduction rules. Determining whether “material prejudice” arises is a question of assessing and comparing the positions before and after the transactions to see whether the company or its creditors are in a worse position.

Section 1324(1A) expressly gives creditors standing to apply for an injunction to prevent a reduction of capital if the company's insolvency is an element of a contravention of s 256B(1)(b). At the hearing of the s 1324 injunction, the company has the onus of proving that the reduction does not prejudice its ability to pay creditors: s 1324(1B). Section 256C(5) requires a company to lodge details relating to a proposed capital reduction with ASIC to assist creditors in discovering the details of a proposed capital reduction. This information, available to creditors and others through ASIC's Company Alert service, may assist creditors in deciding whether they should apply for the s 1324 injunction to stop the capital reduction.

A reduction of capital that involves a cancellation of shares for no consideration does not require consideration of creditors' interests as the company's financial position remains unaltered.

### *Shareholder approval*

**[8.255]** Section 256B(1)(c) permits a capital reduction if it is approved by shareholders under s 256C. The shareholder approval requirements depend upon whether the reduction is an equal or selective reduction. Shareholder approvals for selective reductions require a special resolution because of their greater potential for unfair discrimination against shareholders.

An equal reduction relates only to ordinary shares and is required to have the same terms for each ordinary shareholder and applies to each shareholder in proportion to the number of ordinary shares held. In all other cases, it is a selective reduction: s 256B(2). An equal reduction of capital must be approved by ordinary resolution passed at a general meeting of the company: s 256B(1). Certain differences in the terms of the reduction may be ignored for the purposes of determining whether the reduction is an equal reduction. Under s 256B(3), these include differences that are attributable to the shares having different dividend entitlements or unpaid amounts. These differences would not result in any inequity in the treatment of shareholders and so are disregarded for the purposes of determining the type of shareholder approval.

Equal capital reductions require approval by ordinary resolution. Selective reductions require approval by special resolution.

Selective reductions require approval by special resolution: s 256C(2). No votes in favour of the reduction may be cast by any person or their associates who would receive payment or other consideration as part of the reduction or whose liability to pay unpaid amounts on their shares is to be reduced. Alternatively, all ordinary shareholders may agree to the selective reduction by resolution at a general meeting.

Section 256C(2) gives additional protection to minority shareholders where a selective reduction involves a cancellation of shares. This recognises the rights of shareholders to prevent their shares from being expropriated against their wishes. A selective reduction that involves a cancellation of shares must also be approved by special resolution passed at a class meeting of the shareholders whose shares are to be cancelled, as well as the special resolution passed at the general meeting: s 256C(2). The class approval should be

passed at a separate class meeting, distinct from the general meeting at which the special resolution was passed: *Winpar Holdings Ltd v Goldfields Kalgoorlie Ltd* [2001] NSWCA 427.

The shareholders' meeting that considers a proposed reduction of capital must comply with the usual notice requirements. The notice requirements of general meetings are discussed at [21.70] onwards. In addition, the company must provide a statement with the notice of the shareholders' meeting, setting out all known information that is material to the decision on how to vote on the resolution to approve the capital reduction: s 256C(4).

Information that is material to the decision of shareholders in considering how to vote on the resolution may include:

- the effect of the reduction on particular shareholders and other shareholders;
- the interests of directors in the reduction; and
- correction of any misapprehensions that shareholders may have arising from accompanying reports or statements.

The company must lodge with ASIC the notice of the meeting and any accompanying documents before the notice is sent to shareholders: s 256C(5). Any resolution approving the reduction must be lodged within 14 days after it is passed and the company cannot make the reduction until 14 days after lodgment: s 256C(3).

If the reduction involves a share cancellation, a prescribed notice must be lodged with ASIC setting out the number of shares cancelled, the class of share and the consideration paid by the company on the cancellation: s 254Y.

These notice requirements are aimed at giving creditors and members advance notice of proposed reductions so that they may exercise their rights to oppose the reduction.

### *Failure to comply with reduction requirements*

**[8.260]** A capital reduction must comply with the requirements set out in s 256B(1): s 256D(1). If these requirements are not complied with, the contravention does not affect the validity of the reduction or any connected transaction: s 256D(2). The company is not guilty of any offence as the legislation is concerned with protecting shareholders and creditors, and this would not be achieved if the company were made liable for an offence.

Anyone involved in a contravention by a company contravenes a civil penalty provision by virtue of s 1317E (s 256D(3)), and the court may impose any one or more of the three civil penalty orders. Civil penalties are discussed at [19.120]–[19.150]. A person commits a criminal offence if they are involved in a company's contravention of s 256B and the involvement is dishonest: s 256D(4).

Section 1324 is specifically applicable to reductions of capital made in contravention of s 256B: s 256E. Under s 1324, the court may grant an injunction to prevent a person from contravening the *Corporations Act*. A person affected by the contravention may bring the application, and this includes a member or creditor of the company if the insolvency of the company is an element of the contravention: s 1324(1A)(b).

Where an application is brought under s 1324 in relation to a contravention involving a reduction of capital, the onus of proof is on the company or any other

person who allegedly acted in contravention of s 256B(1) to prove that there was no contravention: s 1324(1B).

The application brought under s 1324 may also seek damages: s 1324(10). Statutory injunctions are discussed at [24.305]–[24.325].

While a person may apply for a s 1324 injunction to stop a capital reduction that contravenes the s 256B(1) requirements, the effect of s 256D(2) is that the reduction is regarded as valid and cannot be reversed once it is made: *Winpar Holdings Ltd v Goldfields Kalgoorlie Ltd* [2001] NSWCA 427.

The insolvent trading section contained in s 588G deems a reduction of share capital as the incurring of a debt by the company when the reduction takes effect: s 588G(1A).

A reduction of capital is deemed to be an incurring of a debt for purposes of insolvent trading.

Therefore, if the reduction of capital of a company takes effect when the company is insolvent or it becomes insolvent because of the reduction, the directors may be liable under s 588M. An action under s 588M may be brought against the directors by the liquidator of the company or proceedings may be brought under the civil penalty provisions that apply to a contravention of s 588G: s 1317E. Insolvent trading and the civil penalty provisions are discussed at [18.220] onwards.

Section 256E lists various provisions that may also be relevant to share capital reductions. These include:

- Ch 6CA which requires disclosure of information by a disclosing entity about its securities which is material and not generally available. A listed company must disclose information regarding a reduction so as to keep the market informed. This is discussed in [22.135];
- Ch 2E dealing with financial benefits to directors and related parties may require approval of the general meeting. A reduction may confer a financial benefit on directors. This is discussed at [16.40] onwards;
- s 125 allows a company's constitution to restrict the exercise of the company's powers and this may include the power to reduce share capital. This is discussed in [4.60]; and
- ss 246B–246G protect holders of classes of shares from a variation of their class rights. This is discussed at [8.155]–[8.195].

### *Permitted share capital reductions*

**[8.265]** Certain types of share capital reductions are specifically permitted and therefore are not subject to the s 256B(1) requirements discussed at [8.230]–[8.255]. These include:

- where a company has the right to grant a lease or right of occupancy under a company title home unit scheme. This enables a person to gain occupancy rights over an apartment by means of acquiring particular shares in the company that owns the building. Should the building be converted into strata title, the shares are surrendered in return for the transfer of strata title over the apartment. This surrender is a capital reduction authorised by s 258B;



- cancellations of shares forfeited under the terms on which they were issued. The cancellation must be by resolution of the general meeting (s 258D);
- redemptions of redeemable preference shares out of the proceeds of a new issue of shares made for this purpose: s 258E(1)(a). This is governed by ss 254J–254K and is discussed at [8.150];
- share buy-backs under ss 257A–257J where the shares are paid for out of share capital: s 258E(1)(b); and
- cancellation of paid up share capital that is lost or not represented by available assets: s 258F. Such reductions are referred to as “lost reductions”. A lost reduction can only occur where the requirements of the Australian Accounting Standards are met.

## Share buy-backs

**[8.270]** The most direct way in which a company may reduce its share capital is by buying back its own shares from a shareholder. Prior to 1989, the rule in *Trevor v Whitworth* and legislative adoptions of this rule prohibited share buy-backs. It became increasingly apparent that the prohibition against share buy-backs was largely ineffective in its primary aim of protecting creditors and in many circumstances could be beneficial to companies and their shareholders.

Section 257A now permits a company to buy back its own shares if:

- the buy-back does not materially prejudice the company’s ability to pay its creditors; and
- the company follows the procedures set out in ss 257A–257J.

Share buy-backs permitted if statutory safeguards are met.

The purposes of the share buy-back rules as stated in s 256A are the same as for reductions of share capital. They are to protect the interests of shareholders and creditors by:

- addressing the risk of these transactions leading to the company’s insolvency;
- seeking to ensure fairness between the company’s shareholders; and
- requiring the company to disclose all material information.

## Reasons for permitting share buy-backs

**[8.275]** Share buy-backs are now relatively common, particularly share buy-backs by listed companies. Share buy-backs may provide valuable benefits to both the shareholders who sell their shares as well as to those who choose not to. In some situations share buy-backs also benefit the company.

Shareholders who sell into a buy-back may benefit because of the favourable tax treatment of share buy-backs compared to dividends. For example, shareholders who make a capital gain on selling their shares need only include 50 per cent of the gain in their assessable incomes.



Many share buy-backs by listed companies involve the company buying back its shares at less than market value while shareholders receive favourable tax benefits. Selling for less than market value may trigger a capital loss for tax purposes for some vendor shareholders that can be offset against their other capital gains. In addition, shareholders at low marginal tax rates (such as superannuation funds) may be financially compensated for the capital loss on the sale of their shares because they also receive a special fully franked dividend. The effect of the imputation system for taxation of dividends (discussed at [10.55]) on low marginal tax rate taxpayers is that not only do such vendor shareholders not pay tax on the special fully franked dividend, they may also offset excess franking credits attaching to that dividend against the tax due on their other taxable income.

Other possible reasons why companies undertake share buy-backs include adjusting financial leverage, making the company more difficult to take over and increasing the company's share price.

## Permitted share buy-backs

**[8.280]** The *Corporations Act* recognises the following five types of buy-backs:

- equal access schemes;
- selective buy-backs;
- on-market buy-backs;
- employee share scheme buy-backs; and
- minimum holding buy-backs.

**Table 8.2: Procedures applicable to buy-backs (required steps) – s 257B**

| Procedures [and sections applied]      | minimum holding | employee share scheme |                  | on-market          |                  | equal access scheme |                  | selective buy-back |
|----------------------------------------|-----------------|-----------------------|------------------|--------------------|------------------|---------------------|------------------|--------------------|
|                                        |                 | within 10/12 limit    | over 10/12 limit | within 10/12 limit | over 10/12 limit | within 10/12 limit  | over 10/12 limit |                    |
| ordinary resolution [257C]             | —               | —                     | yes              | —                  | yes              | —                   | yes              | —                  |
| special/unanimous resolution [257D]    | —               | —                     | —                | —                  | —                | —                   | —                | yes                |
| lodge offer documents with ASIC [257E] | —               | —                     | —                | —                  | —                | yes                 | yes              | yes                |

|                                                      |     |     |     |     |     |     |     |     |
|------------------------------------------------------|-----|-----|-----|-----|-----|-----|-----|-----|
| 14 days notice [257F]                                | —   | yes | yes | yes | yes | yes | yes | yes |
| disclose relevant information when offer made [257G] | —   | —   | —   | —   | —   | yes | yes | yes |
| cancel shares [257H]                                 | yes | yes | yes | yes | yes | yes | yes | yes |
| notify cancellation to ASIC [254Y]                   | yes | yes | yes | yes | yes | yes | yes | yes |

Section 257B contains a table that indicates the procedural requirements for each type of buy-back: see Table 8.2. It is important to note that shareholders are not forced to sell their shares in a buy-back but may choose to do so.

As a general rule, companies are able to buy back up to 10 per cent of their shares within a 12-month period (the 10/12 limit) without shareholder approval and with minimum procedural requirements. This general rule does not apply to selective buy-backs.

The 10/12 limit refers to 10 per cent of the smallest number of votes attaching to voting shares during the last 12 months: s 257B(4).

|                  |
|------------------|
| The 10/12 limit. |
|------------------|

In determining whether this limit has been exceeded, previous buy-backs that occurred in the last 12 months and the voting shares that are subject to the proposed buy-back are taken into account: s 257B(5). The reference to the smallest number of votes attaching to voting shares on issue in s 257B(4) is aimed at preventing companies from issuing shares so as to increase the permitted share buy-back limit.

Once a buy-back agreement has been entered into, all rights attaching to the shares bought back are suspended. This means that the shares no longer carry voting rights and the company cannot deal in the shares. Upon registration of the transfer to the company, the shares must be cancelled: s 257H.

Within one month after the shares are cancelled, the company must lodge a notice with ASIC stating the number and class of shares transferred and the consideration paid: s 254Y.

### *Equal access scheme*

**[8.285]** An equal access scheme is defined in s 257B(2) and (3) and requires offers to be made only to ordinary shareholders to buy back the same percentage of shares from each and every shareholder. All offers must have the same terms, and all ordinary shareholders must have a reasonable opportunity to accept the offers made to them. The buy-back agreements are not entered into until a specified time for acceptances has closed.

Certain differences in the terms of the offers are permissible in cases such as where the shares have different accrued dividend entitlements and the shares are paid up to different amounts: s 257B(3).

Where the 10/12 limit is exceeded, an ordinary resolution of the general meeting must approve the terms of the buy-back agreement before it is entered into or the agreement must be conditional on such an approval: s 257C(1). The notice of meeting must include all material information known to the company and not previously disclosed, to enable the shareholders to decide whether to vote in favour of the resolution: ss 257C(2) and 257G. Notice of an intended buy-back setting out the terms of the offer and any accompanying documents must be lodged with ASIC irrespective of whether the 10/12 limit is exceeded: s 257F.

### *Selective share buy-backs*

**[8.290]** These are defined in s 9 to mean a buy-back not included in the other four types. Selective buy-backs are buy-back offers made to particular shareholders to the exclusion of others or offers made to holders of shares other than ordinary shares.

Selective buy-backs result in differential treatment of shareholders and so require shareholder approval by special resolution.

Because selective buy-backs involve differential treatment, the *Corporations Act* imposes the requirement that shareholders must approve a selective buy-back either unanimously or by special resolution. If a special resolution is passed approving a selective buy-back and the financial information provided to shareholders turned out to be inaccurate or misleading and deceptive, the shareholder approval which relied on the financial statements is invalid: *BPE SAM IV M Ltd v DRA Global Ltd* [2020] FCA 738.

Selling shareholders or their associates cannot vote in favour of this resolution: s 257D(1). Material information must accompany the notice of meeting in the same way as in the case of an equal access scheme: ss 257D(2) and 257G. The documents must also be lodged with ASIC: s 257D(3). ASIC has the power to exempt a company from the operation of s 257D: s 257D(4). ASIC must be notified at prescribed times both before and after the buy-back: ss 257E, 257F and 254Y.

### *On-market buy-backs*

**[8.295]** A buy-back is an on-market buy-back if it results from an offer made by a listed corporation on the ASX or other prescribed financial market in the ordinary course of trading on that market: s 257B(6). Shareholder approval by ordinary resolution is necessary only where the buy-back exceeds the 10/12 limit. Notice must be lodged with ASIC before the buy-back is entered into (s 257F) and after cancellation of the shares: s 254Y. *ASX Listing Rules 7.29 and 7.33* regulate on-market buy-backs. ASX Listing Rule 7.33 provides that a company may only buy back shares under an on-market buy-back at a price which is not more than 5 per cent above the average of the market price for shares in that class.

## *Employee share scheme buy-backs*

**[8.300]** “Employee share scheme buy-back” is defined in s 9 and has as its purpose the acquisition of shares in a company by or on behalf of employees or directors who hold salaried employment in the company or a related body corporate. The required procedure is identical to that of on-market buy-backs.

## *Minimum holding buy-backs*

**[8.305]** This type of buy-back is defined in s 9 as a buy-back of all of a holder’s shares in a listed corporation if the shares are less than a marketable parcel. Under ASX Operating Rules, a marketable parcel is not less than \$500 based on the trading price of the shares.

## *Other relevant provisions*

**[8.310]** Section 257J sets out signposts to other provisions that are relevant to buy-backs. These include the insolvent trading section contained in s 588G and the statutory injunction provision in s 1324. Other provisions relevant to share capital reductions listed in s 256E are also applicable to share buy-backs. These are set out at [8.260].

A company that buys back its shares is deemed to have incurred a debt at the time the buy-back agreement is entered into: s 588G(1A). This may result in a director being made personally liable for insolvent trading, discussed at [18.100] onwards.

Where a buy-back causes a company to become insolvent, the liquidator of the company may seek a court order to recover the consideration paid to vendor shareholders for the buy-back as a voidable transaction: s 588FF. This is discussed at [32.475] onwards.

Where the company goes into liquidation, and at the time it has not paid the selling shareholders in full, the shareholders may claim as creditors for the debt but rank after other creditors: ss 553AA and 563AA.

Where a share buy-back constitutes a contravention of the *Corporations Act*, it is deemed to affect the interests of creditors and shareholders if the insolvency of the company is an element of the contravention: s 1324(1A). This enables a creditor or member to apply to the court for an injunction or damages under s 1324(1) and (10). This is discussed at [24.305]–[24.325].

## **Indirect self-acquisitions**

**[8.315]** A company may indirectly acquire control of its own shares by gaining control of an entity that holds those shares. Such cross-shareholding arrangements amount to indirect self-acquisitions and could enable de facto share buy-backs to occur outside the regulation of the share buy-back and capital reduction provisions. This would defeat the policy behind the rule in *Trevor v Whitworth* and the related statutory prohibitions in ss 256B and 257A. Indirect self-acquisitions are regulated by ss 259C and 259D.

The issue or transfer of shares of a company to an entity it controls is void: s 259C(1). The controlled entity may be a partnership, trust or other company.

### Meaning of “control”.

A company is regarded as being in control of an entity that holds shares in the company if the company has the capacity to determine the outcome of decisions about the entity's financial and operating policies: s 259E(1). This definition of control is similar to the definition of “control” in Accounting Standard AASB 10 *Consolidated Financial Statements*, [5]–[9]. In determining whether a company has this capacity, the practical influence the company can exert is considered rather than the legal rights it can enforce. It is also relevant to consider existing practice or patterns of behaviour affecting the entity's financial or operating policies: s 259E(2).

A company is not taken to control an entity merely because the company and an unrelated entity jointly have the capacity to determine the outcome of decisions about another entity's financial and operating policies: s 259E(3). This may arise under a joint venture agreement. Control of an entity also does not arise merely because of a capacity that a company is under a legal obligation to exercise for the benefit of someone other than its shareholders: s 259E(4). Such a situation may arise if a company holds shares as a trustee.

### Exceptions to prohibition.

This prohibition is subject to several exceptions. These include where:

- the issue or transfer is to the entity as trustee and neither the company nor the entity has a beneficial interest in the trust (s 259C(1)(b));
- the issue is made as a result of an offer to all holders of the class of shares being issued and does not discriminate unfairly in favour of the entity (s 259C(1)(c)); and
- the transfer to the entity is by a wholly owned subsidiary of a body corporate and the entity is also a wholly owned subsidiary of that body corporate (s 259C(1)(d)).

### Validation of prohibited transfer by the court.

The court has power under s 1322(4) to validate issues or transfers of shares that would otherwise be void under s 259C. Such an order can only be made if the court is satisfied that the matter is of a procedural nature, the parties to the contravention acted honestly or it is just and equitable that the order be made. In any case, an order can only be made if no substantial injustice is caused to any person: s 1322(6).

### ASIC exemption.

ASIC may exempt a company from the operation of the s 259C prohibition: s 259C(2). Issues or transfers in the situations covered by s 259C(1)(c) and (d) must be disposed of within 12 months of acquisition or the company must cease to control the entity: s 259D(1). ASIC may extend the 12-month period.

### Gaining or increasing control over shareholder.

A company may also gain indirect control over its shares by gaining or increasing control over an entity that already holds shares in the company. In such cases, s 259D(1) applies so that the entity must cease holding the shares or the company must cease to control the entity within 12 months after the company gains control of the entity. During the period when the company controls the entity, voting rights attaching to the shares cannot be exercised: s 259D(3).

If voting rights are exercised in contravention of s 259D(3), the resolution on which the voting rights were exercised will be invalidated by the court only if it is of the opinion that a substantial injustice has been caused that cannot be otherwise remedied: s 1322(3B). If the company still controls the entity at the end of the 12-month period and the entity continues to hold the company's shares, the company commits an offence for each day during which the situation continues: s 259D(4). However, a contravention of s 259D does not affect the validity of any transaction: s 259D(6). Under s 259D(5) the requirements under s 259D(1) do not apply where the entity holds the shares as a personal representative or trustee where neither the entity nor the company has a beneficial interest in the trust.

## Financial assistance

**[8.325]** A company may indirectly reduce its capital if it financially assists a person to acquire shares in the company. In some cases, such financial assistance is regarded as offending the spirit of the rule in *Trevor v Whitworth*.

The financial assistance provisions in ss 260A–260D seek to maintain shareholder and creditor protection where appropriate, without imposing unnecessary restrictions on companies that enter into what appear to be ordinary commercial transactions which cause no detriment to creditors or shareholders. The requirements for giving financial assistance broadly correspond to the requirements for capital reductions.

Under s 260A a company may financially assist a person to acquire shares in the company or its holding company only if certain conditions are satisfied.

Conditions to be satisfied before a company may financially assist a person to acquire shares in the company.

These are that:

- giving the assistance does not materially prejudice the interests of the company, its shareholders or the company's ability to pay its creditors (s 260A(1)(a)); or
- the assistance is approved by shareholders under s 260B; or
- the assistance is exempted under s 260C.

For financial assistance to be given, there must be a sufficient link between the financial assistance and the acquisition of shares. The acquisition need not actually take place. The provision may be contravened and an injunction under s 1324 can be ordered before any acquisition actually takes place. Section 260A includes conduct that is in connection with the process of the acquisition of shares and is not limited to conduct for the purpose of the acquisition. The acquisition does not require transfer and registration and for the purposes of s 260A, an acquisition may occur where the giving of financial assistance has

been prevented by legal action and if that legal action had not been brought, financial assistance would have been given.

Whether the financial assistance materially prejudices the company's ability to pay its creditors, involves a comparison of the company's positions before and after the giving of the financial assistance to assess if its ability to pay its creditors has worsened. Prejudice extends to the company's ability to pay its creditors as and when their claims fell due: *Connective Services Pty Ltd v Sleat Pty Ltd* [2019] HCA 33. The onus is on the company to show that the financial assistance does not materially prejudice the company, its shareholders or creditors: s 1324(1B).

### *What is financial assistance?*

[8.330] "Financial assistance" is not defined in the *Corporations Act*. The courts have given the term its ordinary commercial meaning which involves examining the commercial realities of the transaction. Because a contravention of the s 260A prohibition is a breach of a civil penalty provision and an offence committed by a person involved in the company's contravention, the term should not be unnecessarily expanded to cover ordinary commercial transactions that do not involve material prejudice. In *Connective Services Pty Ltd v Sleat Pty Ltd* [2019] HCA 33, the court considered that financial assistance need not involve a money payment by the company to the person acquiring the shares. "Any action by the company can be financial assistance if it eases the financial burden that would be involved in the process of acquisition or if it improves the person's 'net balance of financial advantage' in relation to the acquisition". The court gave a number of examples of giving financial assistance such as the company paying a non-cash dividend, issuing a debenture, granting security or paying consultancy fees. This case is discussed at [8.362].

A previous version of the financial assistance provisions gave several examples of financial assistance. These included:

- the company lending a person money to be used to acquire shares in the company;
- the company guaranteeing a person's loan where the proceeds of the loan are used to acquire shares in the company; and
- the company providing its own assets as security for a person's loan where the proceeds of the loan are used to acquire shares in the company.

Under s 260A(2) financial assistance may be given before or after the acquisition of shares and it may take the form of paying a dividend.

#### Examples of giving financial assistance.

[8.335] The financial assistance prohibition is very broad and, as the examples at [8.340]–[8.362] indicate, it encompasses otherwise legitimate commercial transactions in a wide range of circumstances. The following cases provide examples of financial assistance.

#### *ASIC v Adler* [2002] NSWSC 171

[8.340] A subsidiary of a listed holding company gave an unsecured loan to an entity controlled by a director and substantial shareholder of the listed company. A large

part of this loan was used to acquire shares in the holding company on market. It was held that the substance of the transaction was that the subsidiary gave financial assistance to acquire shares in its holding company. Both the holding company and its subsidiary suffered material prejudice as a result of the financial assistance. The subsidiary was materially prejudiced by the fact that it initially exchanged cash for either an unsecured loan or the equitable rights it obtained which were of less value than the cash handed over. It was also held that the loan transaction involved multiple breaches of directors' duties. These are discussed at [15.240].

*Hunters Products Group Ltd v Kindley Products Pty Ltd* (1996) 14 ACLC 826

**[8.345]** A shareholder of Hunters Products Group Ltd (Hunters) agreed to buy the shares owned by Hunters' other shareholder. Part of the purchase price came from Hunters' bank account. The Supreme Court of Victoria held that this amounted to Hunters providing financial assistance for the purchase of its shares and was prohibited under a predecessor of s 260A.

*Independent Steels Pty Ltd v Ryan* [1990] VR 247

**[8.350]** The shareholders of Marlon Australia Pty Ltd (Marlon) agreed to sell their shares to another company. Under the sale agreement the vendor shareholders were to be paid part of the purchase price from the gross turnover of Independent Steels Pty Ltd, a wholly owned subsidiary of Marlon. The Supreme Court of Victoria held that this payment resulted in a subsidiary providing prohibited financial assistance for the purchase of shares in its holding company.

*ZBB (Aust) Ltd v Allen* (1991) 9 ACLC 687

**[8.360]** A company seeking to issue shares to the public entered into an underwriting agreement under which the underwriter would take up any shortfall in the public issue. The underwriter fell into financial difficulties and it was agreed that an associated company would pay the underwriter's contractual obligation to the issuer company.

It was held that the issuer company in reality was making a loan to the underwriter and so gave indirect financial assistance to the underwriter to acquire its shares in contravention of the *Companies Code* equivalent of s 260A.

*Connective Services Pty Ltd v Sleat Pty Ltd* [2019] HCA 33

**[8.362]** The constitution of a company contained a pre-emption clause that required selling shareholders to first offer their shares to existing shareholders in proportion



to the number of shares they held. One of the three shareholders entered into agreements to transfer shares, in breach of the pre-emption clause, to a person who was not a shareholder. The company brought a legal action under s 1324 seeking an injunction to prevent the agreements proceeding. The High Court held that the legal action brought by the company to enforce the pre-emptive rights constituted giving financial assistance to existing shareholders as the action was at the company's expense but was for the benefit of only some shareholders. The financial assistance could not be given as it contravened s 260A(1) unless it was approved by shareholders or if the company could show that bringing the proceedings did not materially prejudice the interests of the company, its shareholders or its ability to pay its creditors.

### *Shareholder approval*

**[8.365]** According to s 260A(1)(b), a company may financially assist a person to acquire shares in the company or its holding company if the assistance is approved by shareholders under s 260B. Shareholder approval for financial assistance must be given by special resolution passed at the general meeting or by resolution agreed to by all ordinary shareholders. The person acquiring the shares or an associate may not cast votes in favour of the resolution: s 260B(1).

If the company that gives the financial assistance becomes a subsidiary of an Australian holding company immediately after the person acquires its shares, the financial assistance must also be approved by a special resolution passed at a general meeting of that holding company: s 260B(2) and (3).

Where meetings are convened for the purpose of passing a special resolution under s 260B, a statement must accompany the notice of meeting that sets out all known information material to the decision on how to vote on the resolution. If it would be unreasonable to do so, the company does not have to disclose information that has been disclosed previously: s 260B(4).

The notice of meeting and accompanying documents must be lodged with ASIC before being sent to members: s 260B(5). A special resolution approving the financial assistance must also be lodged with ASIC within 14 days of being passed: s 260B(7).

Financial assistance may be given under s 260A(1)(b) even though the assistance need only be approved by shareholders under s 260B(1). This does not address a situation where the financial assistance may materially affect the company's ability to pay its creditors. This can be contrasted with the share capital reduction and share buy-back provisions that expressly prohibit share capital reductions or share buy-backs if they would materially affect the company's ability to pay its creditors, whether or not there has been shareholder approval.

The financial assistance provisions have been criticised because they prohibit commercial transactions that are innocently entered into and do not adversely affect shareholders or creditors. At the same time they do not offer protection in other cases where assets may be transferred out of companies to the detriment of creditors. As a result, the equivalent UK legislation, as it applied to private companies, was repealed in 2008.

## *Exempted financial assistance*

**[8.370]** Under s 260A(1)(c) of the *Corporations Act*, a company may also financially assist a person to acquire shares in the company or its holding company if the assistance is exempted under s 260C. The various exemptions under s 260C concern situations where financial assistance is given in the ordinary course of commercial dealings such as payments to the company for shares by instalments, financial assistance is given by a financial institution to enable customers to purchase the financial institution's shares, the assistance is part of an employee share scheme approved by general meeting of the company and it is under a permitted reduction of capital or share buy-back.

## *Consequences of failing to comply with s 260A*

**[8.375]** As is the case with contraventions of the reduction of capital provisions, s 260D provides that a contravention of s 260A does not affect the validity of the transactions concerned, and the company is not guilty of an offence. Section 260A is a designated civil penalty provision, and therefore any person who is involved in a company's contravention of s 260A is subject to the civil penalty provisions by virtue of s 1317E. The civil penalty provisions are discussed at [19.120]–[19.150].

The insolvent trading section contained in s 588G deems that where a company financially assists a person to acquire shares in the company as the incurring of a debt by the company when the agreement to provide assistance is entered into or provided: s 588G(1A).

Therefore, if a company gives financial assistance at a time when the company is insolvent or it becomes insolvent because of giving the assistance, the directors may be liable under s 588M. An action under s 588M may be brought against the directors by the liquidator of the company or proceedings may be brought under the civil penalty provisions that apply to a contravention of s 588G: s 1317E. Insolvent trading and the civil penalty provisions are discussed at [18.220] onwards.

A contravention of s 260A also enables a remedy to be sought under s 1324 where the court may grant an injunction to prevent a breach of the *Corporations Act*. This is discussed in the context of reductions of capital in [8.260].

## **Tutorial questions**

1. Dante Ltd has an issued capital of \$1 million consisting of 700,000 ordinary shares and 300,000 preference shares. The Dante family who comprise the majority of the company's directors owns the majority of the ordinary shares. Lee, a director of Dante Ltd, owns all the preference shares. Under the constitution, each share carries one vote irrespective of its class of shares. In addition, the constitution provides that any preference shareholder owning at least 25 per cent of the company's issued capital is entitled to be appointed as a director. At a recent board meeting, a majority of the directors decided:

- that the company should issue a further 1 million preference shares with a \$1 issue price paid to 1 cent to the ordinary shareholders. These preference shares will rank equally with Lee's preference shares; and
- to make a bonus issue of ordinary shares to the existing ordinary shareholders.

Lee believes the share issues will adversely affect the value of her shares.

Explain what rights, if any, she has under ss 246B–246E of the *Corporations Act* to prevent the company from carrying out the directors' decisions.

2. Ardvaark Ltd's directors would like to return as much capital as possible to its shareholders. Its share capital consists of class A shares with a \$10 issue price per share paid up to \$6 and class B shares which are fully paid.

Advise the directors of the legal requirements regarding the following proposals:

- (a) that the company cancels the \$4 unpaid on each class A share; and
- (b) that the company buys back 15 per cent of the class B shares.

Would your advice be different if Ardvaark Ltd had financial difficulties? Explain.

3. Gregory was recently appointed a director of Quick Fit Ltd. As part of his remuneration, the company agreed to an arrangement whereby Gregory will borrow \$3 million from Southward Bank and Quick Fit Ltd will guarantee this loan. This money will then be paid to Quick Fit Ltd in consideration for an issue of shares to Gregory at a 10 per cent discount to the current market price of the shares.

Advise whether this arrangement is permissible and if not, the consequences of these transactions proceeding and any steps the parties should take.

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.

## Chapter 9

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# Membership

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## Key points

- There are various ways in which a person may become a member of a company. Generally, a person must agree to become a member and have their details entered on the company's register of members.
- The register of members is proof of the matters shown in it in the absence of evidence to the contrary. A person may apply to the court to have the register corrected.
- An unlisted company must generally issue a share certificate when shares are issued or a transfer of shares has been lodged. A share certificate is evidence of the title of a member to the shares specified.
- A share certificate may be relied upon, and if it contains incorrect information, the company is liable for any loss arising from the error.
- A transfer of shares occurs on a sale or gift and passes ownership from one shareholder to another. Shares are presumed to be freely transferable although proprietary companies usually restrict the transfer of shares by a provision in the constitution that allows directors to refuse to register a transfer.
- The procedure for transfers of shares requires delivery to the company of an instrument of transfer signed by the transferor and transferee and the share certificate held by the transferor.
- The constitutions of companies often give directors the right to refuse to register a transfer of shares and they need not give reasons for a refusal unless required to do so. Directors must exercise their discretion in accordance with their fiduciary duties. The court may intervene where a refusal to register a transfer is without just cause or is oppressive.
- Clearing House Electronic Subregister System is the electronic settlement system used in Australian Securities Exchange trading and has replaced the traditional procedure of paper transfers for share market transactions.
- Shares may pass from a shareholder to another by operation of law. This occurs upon the death or bankruptcy of a member and involves a transmission of shares to an executor or other personal representative or the trustee in bankruptcy, respectively.

## Introduction

**[9.05]** The members of a company with a share capital are its shareholders. To become a shareholder, it is first necessary to become a member. The members of a company limited by guarantee are not shareholders because the company does not have a share capital.

A company need only have one member: *Corporations Act 2001* (Cth) (*Corporations Act*), s 114. Section 113 sets 50 as the maximum number of non-employee shareholders a proprietary company can have. Crowd-sourced funding (CSF) shareholders of a proprietary company are not counted towards the 50 shareholder maximum: s 113(2)(c). CSF is discussed at [7.210]–[7.215]. There is no upper limit on the number of members of a public company.

Various rights and obligations are incidental to membership. The determination of whether a person is a member of a company is significant for several reasons:

- only members or their proxies are entitled to vote at general meetings. This is discussed at [21.145];
- only members are entitled to receive dividends. This is discussed in Chapter 10;
- members with partly paid shares are liable to pay calls made by a company other than a no liability company (s 254M(1));
- if the company is in the process of being wound up, the members may be liable to contribute towards the payments of its debts (ss 514–529); and
- members, as contributories, are generally entitled to share in the company's surplus assets on a winding up. This is discussed at [32.710].

A company may be a shareholder in another company, however generally it cannot own shares in itself or, if it is a subsidiary, it cannot own shares in its holding company. These prohibitions are applications of the principle that a company must maintain its share capital, discussed at [8.200] onwards.

## Becoming a member

**[9.10]** As discussed at [8.50], the relationship between a company and its members is based on contract law.

A person becomes a member by agreeing to do so and having their name entered in the register of members.

This means that there must be an agreement between the company and the member. Members must agree to become members and have their names and other prescribed details entered on the register of members: s 231(b). A person may become a member in several ways:

- being a member on the registration of the company (s 231(a));
- arising from conversion of a company from one limited by guarantee to one limited by shares (s 231(c));

- applying for and receiving an issue of shares. This is discussed at [8.50] onwards;
- accepting a transfer of shares from a present member;
- receiving shares by transmission on the death or bankruptcy of a member;
- exercising an option over shares and requiring the company to issue the shares;
- buying shares at the strike price under a call warrant. Warrants are discussed at [8.25]; and
- holders of convertible notes may exercise their right to convert them into shares in the company. Convertible notes are discussed at [11.30].

## Consenting to membership in application for registration

**[9.15]** The application for registration of a company must state the names, addresses and other prescribed information of each person who consents to become a member: s 117(2)(c). In the case of a company limited by shares, the application must also include the number and class of shares the member proposes to take up. Those persons become members on registration of the company, being issued with the specified number of shares: s 120. The persons' names and addresses must be entered in the register of members: s 169.

## Register of members

**[9.20]** All companies must set up and maintain a register of members (also called a "share register") containing prescribed information about the shareholders and the shares they own: ss 168(1)(a) and 169. Other than cases where a person agrees to become a member in the application for registration of a company, a person must agree to become a member and to have their name entered in the register of members before the person becomes a member: s 231(b). A mere entitlement to be recorded as a member is not enough. The beneficial ownership of shares, without registration, is insufficient to make a person a member: *Federal Commissioner of Taxation v Patcorp Investments Ltd* [1976] HCA 67. Exceptions occur when a member dies, becomes bankrupt or is otherwise incapable of administering their own affairs. The member's personal representative may then become a member of the company.

## Required information

**[9.25]** The information required to be contained in the register of members includes:

- names and addresses of the members;
- the date at which the name of the member was entered;
- if the company has more than 50 members, an up-to-date index of members' names. The index must be convenient to use; however, a separate index is not required if the register itself is kept in alphabetical order;
- the dates on which allotments took place, the number of shares in each allotment, the shares held by each member, the class of shares, the share or certificate numbers (if any) and the amounts paid on the shares;



- indications of any shares in non-listed companies that a member does not hold beneficially; and
- the name and details of each person who stopped being a member of the company within the last seven years and the date of ceasing to be a member. This information must be kept separately from the rest of the register.

### *Location*

**[9.30]** The register of members must be kept at the registered office, the principal place of business, the place where the work involved in maintaining the register is done or a place approved by Australian Securities and Investments Commission (ASIC). The place must be in Australia: s 172(1). The address at which the register is kept must be notified to ASIC within seven days after it is established or moved from its registered office or principal place of business: s 172(2).

### *Right of inspection*

**[9.35]** A company must allow anyone to inspect its share register whether it is kept on a computer or hard copy register: s 173(1). Shareholders may inspect the register without charge. The company may require non-shareholders who wish to inspect the register to pay a fee up to a prescribed amount: s 173(2). A company must also give a person a copy of its register. A company need not provide copies of its registers unless satisfied that the person accessing a copy is doing so for a proper purpose. Improper use of register information is discussed at [9.40].

Under s 173(3), a company must give a person a copy of the register within seven days if the person makes an application to the company in accordance with the requirements of s 173(3A) and pays any fee required by the company up to the prescribed amount. The information contained in the register that a company must provide to an applicant includes email addresses nominated by members if they elected to receive communications from the company by email: *Lawrence v Melbourne Football Club Ltd* [2022] VSC 658. An application must state each purpose for which the person is accessing the copy, and none of the purposes can be a prescribed purpose under the *Corporations Regulations 2001* (Cth) (*Corporations Regulations*), reg 2C.1.03.

If a company fails within the prescribed time to provide the requested copy of the register containing the required information, the applicant has standing to seek an injunction under s 1324(2): *AXA Asia Pacific Holdings Ltd v Direct Share Purchasing Corporation Pty Ltd* [2009] FCAFC 15. Section 1324 injunctions are discussed at [24.305]–[24.325].

### *Prohibited use of register information*

**[9.40]** The *Corporations Act* attempts to balance two competing interests. On the one hand, the public has a right to know the identity of a company's shareholders. On the other hand, shareholders are entitled to have their privacy protected. The public's right to know is achieved by s 173(1): see [9.35]. The competing privacy policy consideration is achieved by s 177.

Under s 177(1), a person must not use or disclose information obtained from a register to contact shareholders or send material to shareholders.

Certain uses of the information in a register are prohibited.

A note to s 177(1) says that putting a shareholder's name and address (obtained from the register) on a mailing list for advertising material is an example of using information obtained from a register to contact or send material to a person and is not permitted. A person is also prohibited from using or disclosing information obtained from a register for the improper purposes set out in *Corporations Regulations*, reg 2C.1.03: *Corporations Act*, s 177(1AA). Under that regulation, improper purposes for getting a copy of the registers and improper use of register information include soliciting donations from shareholders and gathering information about the personal wealth of shareholders.

Contravention of s 177(1) or (1AA) is an offence of strict liability: s 177(1B). A person who contravenes s 177(1) or (1AA) is also liable to compensate anyone who suffers loss or damage as a result of the contravention: s 177(2). In addition, the company can claim any profits made by a person as a result of a contravention: s 177(3) and (4).

Section 177(1A) creates two exceptions to the prohibition in s 177(1). A person can use information obtained from a register to contact or send material to shareholders if the use or disclosure of the information is:

- relevant to the holding of the shares recorded in the register or the exercise of the rights attaching to them; or
- approved by the company.

Relevant uses of register information include contacting shareholders in relation to the performance of the company and the board, bringing an oppression remedy action or influencing company management with respect to the operation of the company. The following case provides an example of an improper use of information obtained from a register.

*IMF (Aust) Ltd v Sons of Gwalia Ltd* [2005] FCAFC 75

**[9.45]** The court held that the use of the share register information to invite shareholders to join a class action against the company and its directors was not permitted by s 177(1A). The proposed use of the information in the register by a litigation funder was in effect an attempt to market its services. The invitation to join the proposed litigation was not connected with the “holding of the shares recorded in the register or the exercise of the rights attaching to them” as required by s 177(1A). Rather, the proposed litigation was connected with the circumstances in which investors became members of Sons of Gwalia by purchasing shares.

## Significance of the register

**[9.50]** In the absence of evidence to the contrary, the register is proof of the matters shown in it: s 176.

*Re Clifton Springs Hotel Ltd* [1939] VLR 27

**[9.55]** Pask made an application for shares and forwarded payment to the company. His name was entered in the register of members, but no notice of allotment or acceptance was sent to him. He denied receiving any communication from the company other than notice of an extraordinary meeting. The company subsequently went into liquidation and the liquidator included Pask on a list of contributories as a holder of partly paid shares, even though there were no minutes recording an allotment of shares to him. The court held that Pask was a member because his name was entered in the register.

**[9.60]** In *Maddocks v DJE Constructions Pty Ltd* (1982) 148 CLR 104, the High Court held that a person does not become a member until the person's name is entered in the share register. It was irrelevant that the company had not maintained a register.

However, where the register is altered in contravention of the constitution, the entry in the register is void and the transferor remains the legal owner of the shares.

*Sung Li Holdings Ltd v Medicom Finance Pty Ltd* (1995) 13 ACLC 952

**[9.65]** A company's constitution provided that a transfer of shares was only to be registered if authorised by the board. The board did not meet to approve the transfer, but the transferee's name was registered. It was held that the transferee could not be recognised as the owner of the shares until the board approved the transfer.

**[9.70]** A company need only deal with those persons named in the register and cannot have regard to the interests that those persons may create over their shares in favour of others. No notice of a trust is entered on the register: s 1072E(10).

Only a person registered as a member can gain rights under provisions of the *Corporations Act* applicable to members. In *BWN Industries Pty Ltd v Downey* (1993) 11 ACLC 1191, a mortgagee with security rights over shares was unable to requisition a meeting of members under the predecessor of s 249D through notice given by a receiver manager. An applicant seeking a remedy under s 232 must also generally be a registered member. This remedy is discussed at [24.20]–[24.35].

A contravention of the company registers provisions is an offence with the prescribed penalties under Sch 3 of the *Corporations Act*.

## Correction of a register

**[9.75]** Under s 175(1), a company or a person aggrieved may apply to the court to correct a register kept by the company. The most common situation occurs where an aggrieved member claims that the register of members is incorrect. This may arise in a wide range of circumstances. The jurisdiction of the court to correct the share register arises where the applicant can assert some legal or equitable right: *Price v Powers* [2005] WASC 154.

The court may order to correct the register.

The court may order the company to correct the register and to compensate the applicant for loss or damage suffered: s 175(2). Where a register is corrected by order of the court, the company must lodge notice of the correction with ASIC: s 175(3).

Although correction of the share register is of a procedural nature, the court may examine various underlying issues. For example, an application for correction of the share register may involve the resolution of a legal issue or a dispute between members or between an alleged member and the company or the invalidation of an agreement or action. Where there are complex legal issues involved, the court may first require resolution of these issues before ordering correction of the register.

Applications to the court to correct the share register have involved a wide range of issues.

*McLaughlin v Daily Telegraph Newspaper Co (No 2) (1904) 1 CLR 243*

**[9.80]** McLaughlin became incapable of managing his business affairs because of mental illness. He executed a power of attorney authorising his wife to deal with his property. Exercising this power, his wife sold shares in the company, standing in his name. She signed the transfer, which was then registered by the company. Neither the company nor the transferee had notice of McLaughlin's incapacity.

Sometime later McLaughlin recovered so as to be able to manage his affairs. In the meantime the value of the shares had substantially increased and the company had made a share issue to existing shareholders. Large dividends had also been declared. McLaughlin applied to the court for rectification of the register of the company, claiming that he did not know that he was executing a power of attorney and his wife was aware of this. The court found that this was so and therefore the power of attorney was void. As a result, the purported transfer executed by McLaughlin's wife was also void. The company was ordered to rectify its register to enter McLaughlin as the owner of the shares sold, together with the new shares subsequently issued by the company and to pay all dividends declared on those shares to him. McLaughlin, however, was ordered to pay over to the company the proceeds from the sale of shares received by his wife.

**[9.90]** Other examples where correction of the share register was sought by a member include where:

- the directors issued shares in breach of their fiduciary duties by exercising their powers for an improper purpose. A court order that the allotment was invalid because of the breach of duty would then require a supplementary order to correct the register. The duty of directors to exercise powers for a proper purpose is discussed at [15.145]–[15.175];
- a transfer of shares occurs in breach of the constitution or replaceable rules, for example where a pre-emption clause was not complied with: *Carew-Reid v Public Trustee* (1996) 14 ACLC 1106;

- the parties to a share buy-back agreement were mistaken as to the taxation implications upon which the agreement was based. The effect of the mistake was that because of the resultant substantial taxation liability, the subject matter of the buy-back agreement was “essentially and radically” different from what the parties had believed to exist. The parties successfully applied to the court to have the buy-back agreement declared void and the share register corrected to reflect this: *HWG Holdings Pty Ltd v Fairlie Court Pty Ltd* [2015] VSC 519; and
- transfers of shares to minors were voidable and the transferor was restored to the register. The order for correction of the register dated from the order and not the transfers: *Homestake Gold of Australia Ltd v Peninsula Gold Pty Ltd* (1996) 131 FLR 447.

## Minors as members

**[9.95]** Minors, that is persons under 18 years of age, may be shareholders of companies. However, a contract under which a minor acquires shares is a voidable contract.

A contract under which a minor acquires shares is a voidable contract.

This is because the minor acquires an interest in a subject of a permanent nature under which continuous or recurring obligations arise. Such contracts are voidable in that they are valid and binding on the minor unless and until the minor repudiates the contract before attaining 18 years of age or within a reasonable time thereafter. Thus minor shareholders are liable to pay calls, if the calls are made prior to repudiation, but they are not liable to pay calls made after they repudiate.

While a minor may avoid further obligations after repudiation of the contract, generally, money paid for the shares is irrecoverable. In order to recover money paid, the minor must show total failure of consideration.

*Steinberg v Scala (Leeds) Ltd* [1923] 2 Ch 452

**[9.100]** A minor applied for shares which she was duly allotted. She paid the amount due on allotment and the first call. She did not receive any dividends and did not exercise any rights attaching to the shares. While still a minor, she repudiated the contract and sought to recover the money she had paid. This claim was unsuccessful. There had not been total failure of consideration. She had paid for the shares and they had been duly allotted to her. She obtained what she had bargained for even though she had obtained no tangible benefit as a result of being a shareholder.

**[9.105]** In *Homestake Gold of Australia Ltd v Peninsula Gold Pty Ltd* (1996) 131 FLR 447, deeds that provided for the transfer of shares to minors and were signed by each minor's guardian were held to be ineffective. Under the *Minors (Property and Contracts) Act 1970* (NSW), the deeds would only be binding on the minors if they had participated in their execution and they were beneficial to them.

## List of members in extract of particulars

**[9.110]** As discussed at [1.85], ASIC maintains a publicly accessible national database of information on all Australian companies. Among other things, this information includes shareholders' names and addresses. ASIC obtains this information from the companies themselves. Section 346A requires ASIC to send a company, within two weeks of its review date, an annual extract of particulars that contains the information prescribed by reg 2N.2.01 of the *Corporations Regulations*. The prescribed information includes details, as at the company's review date, of the names and addresses of all members in the case of companies with no more than 20 members. For proprietary companies with more than 20 members, the information includes the names and addresses of the top 20 members in each class of shares. If the information in a company's extract of particulars is incorrect, s 346C of the *Corporations Act* requires the company to respond and give ASIC the correct information.

## Disclosure of interests in shares

**[9.115]** A person may hold shares as a trustee for a particular beneficiary. This is often the case when a shareholder dies or becomes bankrupt. On death, the deceased's executor or trustee becomes entitled to the legal interest in the deceased's shares. On bankruptcy, the bankrupt's shares vest in the trustee of bankruptcy on behalf of the bankrupt's creditors. Similarly, trustees of superannuation funds that own shares, hold those shares on behalf of members of the fund.

A trustee shareholder does not generally need to disclose the existence of the trust or the identity of the beneficiaries.

As a general rule, the *Corporations Act* does not require a person who holds shares as a trustee to disclose that fact to the company or to disclose the identity of the beneficiaries. As regards the register of members, s 1072E(10) provides, except as provided by that section, no notice of a trust must be entered on a register and the company does not recognise the existence of any trust. Section 1072E(10) is primarily for the convenience of public companies. A company may, however, consent to marking its register in such a way as to identify that the shares are held by a trustee: s 1072E(9). In the case of proprietary companies, a person who holds shares as a trustee for a body corporate must notify the proprietary company of that fact: s 1072E(11).

The substantial shareholding provisions and the tracing beneficial ownership provisions of the *Corporations Act* are exceptions to the general rule and may require a person who holds shares in a listed company as a trustee to disclose that fact to the company or to disclose the identity of the beneficiaries.

The substantial shareholding provisions, ss 671B–671C, aim to promote an informed market for shares of listed companies. The provisions oblige persons entitled to not less than 5 per cent of the voting shares of a listed company to disclose to the company full particulars of their entitlement in the shares. Disclosure of substantial shareholdings

enables both a company and the market to know who controls significant shareholdings. The filing of a substantial shareholder notice is often the first indication of an impending takeover bid.

Disclosure of identity of persons who have a relevant interest in shares in listed companies.

Sections 672A–672F complement the substantial shareholding provisions. They enable the company or ASIC to obtain information not only as to the identity of persons who control voting shares or a “relevant interest” in those shares, but also the nature and extent of their interest.

The disclosure of interests in shares are part of the disclosure requirements under the takeover provisions of the *Corporations Act* and are discussed at [25.30]–[25.40].

## Share certificates

### Statutory requirements

**[9.120]** A share certificate is prima facie evidence of the title of a shareholder to the number of shares specified: s 1070C(2). Where a share certificate has been duly issued but the shareholder’s name has not been entered in the register of members, the shareholder may be a member for the purposes of an application under s 232. This is despite the operation of s 176 which states that the register is prima facie evidence of the matters contained therein: *Re Independent Quarries Pty Ltd* (1994) 12 ACLC 159.

A share certificate is prima facie evidence of the title of a shareholder to the number of shares specified.

Share certificates also enable the company to identify its shareholders and as discussed at [9.165], a company will generally require production of the certificate before registering a transfer or transmission of shares.

Under s 1070C(1), a share certificate must state:

- the name of the company and its jurisdiction of registration;
- the class of shares; and
- the amount unpaid on the shares.

A company is required by s 1071H(1) and (2) to complete and have ready for delivery a share certificate within two months of an allotment of shares or within one month after a transfer of shares is lodged with the company. Non-compliance with these requirements is an offence. Application may be made to the court for an order compelling the company to issue a share certificate: s 1071H(6).

A company need not issue a share certificate where it is entitled not to do so. It will be so entitled if it refuses to register a transfer (s 1071H(3)), or where the conditions of allotment provide that a certificate need not be issued: s 1071H(1).

Under s 1071H(2), a company also need not issue a share certificate if the operating rules of Clearing House Electronic Subregister System (CHES) apply. This is designed to facilitate electronic stock exchange transactions and is discussed at [9.225]–[9.241].

## Liability of company for issue of incorrect share certificate

**[9.125]** A share certificate is not a contractual document but a certification by the company of the information contained in it. As discussed at [9.50]–[9.70], the legal rights and liabilities of members depend on their names being entered in the register of members. However, because a share certificate is *prima facie* evidence of the title of the member to the shares, the company is liable at common law for any loss arising from an error in the share certificate. The purpose of a share certificate is to enable people to rely on the information it contains.

A company is estopped from denying the truth of the information in a share certificate once someone changes their position in reliance on the information contained in it.

Once the company issues a share certificate and a person changes their position in reliance on it, the company is estopped or prevented from denying the truth of its contents.

### *Re Bahia and San Francisco Rail Co* (1868) LR 3 QB 584

**[9.130]** B relied on a share certificate that stated A was the owner of a certain number of shares and purchased those shares from him. After B became registered as the holder, it transpired that A was not the true owner. He had forged the signature of the true owner, C, on a transfer and had forwarded this forged transfer together with a stolen share certificate made out in C's name to the company. The company, without negligence or fraud, then issued the certificate to A.

The court held that C, as true owner, was entitled to have his name restored to the register. B could not acquire better title than the defective title of A. As a result, B's name was removed from the register. B obviously had rights against A based on A's fraud. The company was held liable to B for damages because it was estopped from denying to him that A was the true owner. The company could not deny to B that which it had earlier certified. While it could not register B as the holder of the shares because of its duty to C, the company could only compensate B by paying damages, being the value of the shares at the time the company refused to register B or when B's name was removed from the register.

**[9.135]** Estoppel may arise where a purported transfer of shares is later found to be invalid.

### *Daily Telegraph Co v Cohen* (1905) 5 SR (NSW) 520

**[9.140]** Shares were sold under a purported exercise of a power of attorney. The power of attorney and associated transfer of shares were later held to be void. The original owner's name was therefore restored to the register. In the meantime,



the transferee had in turn transferred the shares to Cohen. Cohen's name was removed from the register, but the company was held liable in damages to him because it was estopped from denying that his transferor was the true owner as it had previously certified.

**[9.145]** If a certificate states that a shareholder has fully paid shares when in fact they are partly paid, the company is also estopped from denying that they are fully paid. This means that the company is unable to make a call on the shares: *Burkinshaw v Nicholls* (1878) 3 App Cas 1004.

Estoppel operates against a company only if someone has changed position in reliance on the certificate. Estoppel cannot be used by anyone who has knowledge of the truth. It is rare for a person to whom a false certificate is first issued to be able to rely on estoppel. Generally, that person knows the true situation and has not changed their position in reliance on the certificate.

The position of an outsider who relies on a share certificate issued by a company is further strengthened by the statutory assumptions contained in s 129. In particular, the outsider may assume that an officer or agent of the company who has authority to issue a document or certified copy of a document on behalf of the company also has authority to warrant that the document or certified copy is genuine: s 129(7). The s 129 assumptions are discussed at [5.235]–[5.380].

A company is not liable to someone who has put forward a forged transfer. This is so, even if the person did not know of the forgery. In fact a person who presents a transfer to the company impliedly warrants that the transfer is genuine and will be held liable to the company even though acting innocently.

## Forged certificates

**[9.150]** While a company cannot deny the truth of information contained in its valid share certificates, it is generally not liable if the certificate is forged. However, if the forgery is the result of fraudulent acts of an officer, agent or employee of the company, the assumptions in s 129 permit an outsider to assume that the certificate is validly executed and is otherwise genuine: s 128(3). In such a case, the company is bound by the share certificate even though it has been forged. This overcomes the decision in *Ruben v Great Fingall Consolidated* [1906] AC 439, discussed at [5.380].

# Transfer of shares

## Transferability of shares

**[9.155]** A transfer of shares occurs when ownership of shares passes from one shareholder to another person. The transferee becomes a member of the company after the transferee's name and details are entered in the register of members. The transferor ceases to be a member if the entire shareholding is transferred. As a general rule, shares in a company are presumed to be transferable without restrictions. This is an important characteristic of listed companies and is necessary for stock exchange trading.

Shares are presumed to be transferable without restrictions. This is subject to the company's constitution which may impose restrictions.

Section 1070A(1) provides that shares are transferable as provided by the company's constitution. Proprietary companies were once required to restrict transfers of shares. The constitutions of many proprietary companies still contain restrictions on the transfer of shares because the shareholders have an expectation that approval will be required before a new person can become a shareholder. It is the nature of closely held companies that the identity of members is important and membership is restricted to known or approved persons. The proprietary company replaceable rule in s 1072G is an example of a common restriction on the transfer of shares. Section 1072G gives proprietary company directors a discretion to refuse to register a transfer for any reason.

Australian Securities Exchange (ASX) Listing Rule 8.10 prohibits listed companies from preventing, delaying or interfering with the registration of a transfer of shares. The existence of such restrictions on transfer would prevent the operation of a free market in the company's shares as a purchaser would be uncertain of gaining registration as a shareholder.

## Instrument of transfer

**[9.160]** A sale of shares is similar to a sale of land since, in addition to a contract of sale, registration is necessary to complete the transaction. A contract for the sale of shares is not complete until the shares are transferred and the name of the transferee is entered in the register of members.

Section 1071B(2) prohibits a company, notwithstanding anything in its constitution, from registering a transfer unless a "proper" instrument of transfer has been delivered to the company.

An instrument of transfer documents the transfer of ownership of shares from an existing shareholder to another person.

An instrument of transfer, signed by both the transferor and transferee, documents the transfer of ownership of shares from an existing shareholder to another person. The seller (transferor) delivers a signed transfer, together with the relevant share certificates, to the buyer (transferee). Some Australian States impose a stamp duty tax on transfers of shares in unlisted companies. Stamp duty is not payable on transfers of shares in listed companies.

The replaceable rule in s 1072F(2) provides that the directors are not required to register a transfer unless the transfer and any share certificate has been lodged at the company's registered office. The directors may also reasonably require any further information to establish whether the transferor has the right to transfer the shares. Lodgment is usually done by the transferee. The transferor remains the holder of the shares and a member until the transfer is registered and the name of the transferee is entered in the register of members: s 1072F(1). This is important where the shares are partly paid because the transferor remains liable for calls until the transfer is registered. For this reason, provision

is made by s 1071D(1) for the transferor to require the company to register the transfer in the same manner as if the application had been made by the transferee.

The CHESS system allows the shares of listed companies to be transferred electronically without the use of transfer documentation and share certificates. This system is discussed at [9.225].

## Procedure for transfer of shares

**[9.165]** The completion of a share transaction in an unlisted company requires a share transfer to be executed by the transferor and transferee and together with the share certificate, delivered to the registered office of the company: s 1072F(2). Any other requirement set out in the constitution, such as approval of directors, must also be met: *Poliwka v Heven Holdings Pty Ltd* (1992) 10 ACLC 1759.

The completion of a share transaction in an unlisted company requires a share transfer to be executed and together with the share certificate, delivered to the registered office of the company.

The procedure for transfer of shares is relatively straightforward where all the shares specified in the share certificate are sold to one buyer. A seller who sells only part of the shareholding will generally be reluctant to hand over the share certificate to the buyer. In other cases, the transferor can forward the share certificate to the company with the request that it certify the instrument of transfer. If this is done, the company notes on the instrument of transfer that it holds the transferor's share certificate.

Under s 1071G(4), an instrument of transfer is deemed to be certified if it bears the words "certificate lodged" or words to that effect. The certification constitutes a representation by the company to any person acting on the faith of it that such documents as on the face of them show prima facie title to the shares to the transferor named in the instrument of transfer, have been produced to it: s 1071G(1). The certification is not, however, a representation that the transferor has any title to the shares.

A valid transfer of shares requires compliance with the procedural requirements set out in the legislation and the company's constitution. In *Re Motasea Pty Ltd* [2014] NSWSC 69 a person claimed to be a shareholder of a company based upon being named as a shareholder in an annual return of the company lodged with ASIC. The court held the person was not a shareholder as there was no evidence that the necessary procedural requirements were satisfied with regards to a transfer of shares. There appeared to be no members' register, no executed or stamped transfer documents and no evidence of any minute of meeting relating to any such transfer. There was also no evidence that any capital gains tax or applicable stamp duty was paid on such a transfer.

## Validation of irregular share transfers

**[9.167]** The court has a discretion under s 1322(4)(a) to validate certain irregularities arising from a contravention of the *Corporations Act* or the company's constitution. As well as validating procedural irregularities, s 1322(4)(c) gives the court the power to relieve a

person from any civil liability in respect of a contravention of the legislation or failure to comply with the company's constitution. An order can only be made under s 1322(4)(a) if the irregularity was essentially of a procedural nature, the person who was party to the contravention acted honestly or it is just and equitable that the order be made and no substantial injustice is likely to be caused: s 1322(6). This power of the court is discussed at [21.220].

In *QBiotics Ltd* [2016] FCA 873, orders were made under s 1322(4)(a) validating certain share transfers over a six-year period that were in contravention of a pre-emptive rights provision in the company's constitution and accordingly corrected the register of members. The court accepted that the non-compliance with the constitution was inadvertent, as at the time the company was registered, it was unforeseeable that a capital raising would occur and the pre-emption clause was overlooked. The board did not attempt to dishonestly deprive shareholders of their rights. It was just and equitable to make the orders validating the share issues to fulfil the expectations of the parties to the share transfers and to provide certainty as to the accuracy of the share register. In balancing the prejudice that could arise if the share issues were validated, the court found that no complaints had been received from shareholders and the balance lay in favour of making the orders.

In *Re Poseidon Nickel Ltd* [2018] FCA 1063, a listed company issued shares to four categories of persons in contravention of the prospectus provisions in Pt 6D.2. Some recipients of the share issues subsequently on-sold those shares within 12 months without disclosure in contravention of s 707(3). In order to protect the shareholders who were not the initial recipients of the share issues as well as to maintain the integrity of future dealings in the company's shares, the court granted the company's application under s 1322(4) and validated the initial share issues. However, the court refused to relieve two of the categories of the initial recipients of the share issues from civil liability because their contraventions were not innocent. They ought to have known of the disclosure requirements under s 707(3).

## Unregistered transfers

**[9.170]** As discussed at [9.165], for a sale of shares to be complete, several steps must be taken. Usually there is a contract between the transferor and transferee. The transferor then hands over the duly executed transfer and share certificate to the transferee. The transferee lodges the completed transfer and certificate with the company. To complete the process, the company registers the name of the transferee in the register of members and issues a new share certificate in the transferee's name.

A problem arises where the transferor and transferee enter into a contract for sale of shares but for some reason the share transfer is not registered by the company. From the company's point of view, the transfer is incomplete or inchoate. As discussed at [9.115], under s 1072E(10) the company need only recognise legal interests in shares and is not affected by notice of any trusts. This is also often set out in the constitution. The effect of this is that the company recognises the transferor as holder of the shares until their name is removed from the register and replaced by the name of the transferee. This is important if, for example, the company makes a call before the transfer is registered. In such a case the transferor is still liable. Similarly, the company is entitled to send notice

of meetings to the transferor, and it is the transferor who is entitled to vote in respect of the shares: *Re Fernlake Pty Ltd* [1995] 1 Qd R 597.

With regard to the transferor and transferee, property in the shares passes at the time the transferor hands over the signed transfer and share certificate. The transferee becomes the beneficial owner as soon as the contract is made. From this time on, the seller holds the shares as trustee for the buyer. The buyer is said to have an equitable interest: *Niord Pty Ltd v Adelaide Petroleum NL* (1990) 54 SASR 87. Thus the seller must account to the buyer for any dividends the company may pay to the seller and the buyer must indemnify the seller for any obligations incurred after the contract date.

The unregistered buyer is entitled to direct the seller how to exercise voting rights. If the seller fails to obey the directions of the buyer, that vote is valid in terms of the company but the buyer can bring an action against the seller either for breach of contract or breach of trust: *Re Fernlake Pty Ltd* [1995] 1 Qd R 597.

Registration of transfers of shares is of great importance. If a shareholder dishonestly contracts to sell the same shares to two different buyers, the buyer who first obtains registration becomes the holder of the shares. Where the equities are equal, the first to register a valid transfer acquires priority. In this way the claim of the first buyer may be defeated by the second buyer if the second buyer obtains registration first, without notice of the previous contract. The first buyer only has an action against the seller: *Shropshire Union Railway v R* (1875) 7 HL 496. This situation is very unlikely if the first buyer obtains the share certificate. This would usually be effective in precluding the second buyer obtaining registration.

Where neither buyer obtains registration, the first to acquire an interest under the contract will prevail. This may occur where the directors properly exercise a power to refuse to register a transfer.

## Restrictions on transfer of shares

**[9.175]** There are two conflicting legal principles governing transfer of shares. The owner of property, including a shareholder, is presumed to have a general right to transfer personal property. Application of this principle prevents a shareholder being unwillingly locked into a company. The characteristic of unrestricted transferability of shares was an important feature in the historical development of companies. On the other hand, small proprietary companies generally retain the nature of partnerships and so find it appropriate to restrict the transfer of shares. Section 140(2) prevents modifications of the constitution to increase or impose restrictions on the right to transfer shares without a member's consent in writing.

A restriction on transfer of shares contained in the company's constitution must be clear and unambiguous.

As shareholders are presumed to have a prima facie right to transfer their shares, any restriction contained in the company's constitution must be clear and unambiguous: *Greenhalgh v Mallard* [1943] 2 All ER 234. A restriction will not be implied

in a particular case and where possible, the restriction will be construed narrowly rather than broadly.

The most usual form of restriction on transfer of shares in company constitutions gives directors a discretion to refuse to register a transfer. However, this discretion cannot be applied in certain cases. It was held in *Andco Nominees Pty Ltd v Lestato Pty Ltd* (1995) 126 FLR 404 that a restriction on the transfer of shares in the constitution did not apply:

- to a transmission of shares on the death or bankruptcy of a shareholder;
- to a compulsory transfer of shares by court order; or
- to a transfer of shares from a retiring trustee to a new trustee.

## Refusal to register transfer or transmission of shares

**[9.180]** The proprietary company replaceable rule in s 1072G provides that directors of a proprietary company have the power to refuse to register a transfer of shares for any reason. The replaceable rule in s 1072F(3) is applicable to all companies and allows directors to refuse to register a transfer of shares if the shares are not fully paid up or the company has a lien over the shares.

If a company refuses to register a transfer, it must send the transferee notice of the refusal within two months after the transfer was lodged with it: s 1071E. Breach of this requirement is an offence. It may also result in the company losing the right to deny registration to the transferee: *Re Swaledale Cleaners Ltd* [1968] 1 WLR 1710.

Where the company's constitution gives directors a discretion to refuse to register a transfer, they must exercise this power in good faith in the best interests of the company. This is one aspect of the fiduciary duty owed by directors to the company and is further discussed in Chapter 15.

### Reasons for refusal

**[9.185]** If the company's constitution does not require the directors to disclose grounds or reasons for a refusal to register a transfer, the directors do not need to disclose reasons or grounds for their refusal: *Berry and Stewart v Tottenham Hotspur Football Co* [1935] Ch 718. A person wishing to challenge the refusal had to show that the directors acted in bad faith or for improper purposes. This made it difficult to discharge the onus of proof resting on the transferee.

#### *Re Smith and Fawcett Ltd* [1942] Ch 304

**[9.190]** A shareholder held 4,001 shares in a company at the time of his death. His son, as executor of his father's estate, sought to be registered as the holder of those shares. The company's constitution provided that "the directors may at any time in their absolute and uncontrolled discretion refuse to register any transfer of shares". The directors refused to register the transfer unless 2,000 of the shares were sold to a certain director at a stated price, in which case they would register a transfer of the remaining shares. It was held that the directors had an unfettered discretion that

had only to be exercised bona fide in the interests of the company as seen by them and in the absence of bad faith, the directors were entitled to refuse to register the transfer.

**[9.195]** Where the directors are only permitted to refuse to register a transfer on certain specified grounds and it can be shown that the refusal was on other grounds, the courts may order that the transfer be registered. Where the constitution of a company empowers it to refuse to register a transfer of shares in some particular circumstances, the courts will strictly examine the provisions in the constitution in order to determine whether or not the refusal was authorised: *Equiticorp Industries Ltd v ACI International Ltd* [1987] VR 485.

**[9.205]** Where the constitution requires the directors to pass a resolution refusing to register a transfer, the transferee is entitled to registration unless the directors actually resolve as a board to reject registration: *Beck v Tuckey Pty Ltd* [2007] NSWSC 1065.

### *Without just cause*

**[9.210]** If the directors refuse to register a transfer of shares, the transferee may 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: s 1071F.

The court may order that a transfer be registered if a refusal by directors was without just cause.

Section 1071F gives effect to the general right of shareholders to transfer their shares. It strengthens the position of a transferee as it provides a simpler procedure to enable transferees to challenge directors' refusals to register transfers without just cause. Just because directors have the right under a company's constitution to refuse to register a transfer without being required to give reasons, a refusal may not in itself constitute just cause: *Trafalgar West Investments Pty Ltd v Superior Lawns Australia Pty Ltd* [2012] WASC 460. This provision provides the court with a wide discretion to balance the interests of the parties.

The onus of showing an absence of just cause rests with the party seeking registration. However, once it appears objectively that there was no just cause for the refusal to register a transfer, an evidentiary onus may shift to the directors to show they acted with just cause in their refusal. While failure to give their reasons does not of itself prove there is no just cause, at least where the constitution does not require reasons for refusal to be given, the failure to provide reasons may assist in the drawing of an inference that there is no just cause for refusal: *Beck v Tuckey Pty Ltd* [2007] NSWSC 1065.

The constitutions of some companies require a particular person, other than the board of directors, to approve the registration of a transfer of shares. Section 1071F also gives a transferee a remedy if that person refuses to register the transfer without just cause.



Section 1071F applies to a transmission of shares as well as a transfer of shares. Transmission of shares is discussed at [9.250].

Section 232 appears to enable members to apply for a remedy in cases where directors fail to register a transfer of shares, and the failure is contrary to the interests of the members as a whole or constitutes oppression or conduct which is unfairly prejudicial to, or unfairly discriminatory against the members. This section may enable a member to obtain a remedy in cases such as *Re Smith and Fawcett Ltd* [1942] Ch 304 discussed at [9.190]. The oppression remedy is discussed at [24.15]–[24.280].

*Re Winmardun Pty Ltd* (1991) 9 ACLC 238

**[9.215]** A shareholder of a family company entered into a deed of arrangement under Pt X of the *Bankruptcy Act 1966* (Cth) and Waters was appointed as the trustee of the deed. Under the deed, the shareholder's property vested in the trustee. Waters sought registration from the directors of a transmission of the shares to him. While the directors did not formally refuse to register the transmission, they indicated that they would not register the transmission to Waters on the grounds that he was not a family member. The directors argued that a transmission to Waters was not in the company's best interests. Waters applied under a predecessor of s 1071F for an order that the company acquire the shares.

The court held that the reasons given by the directors for the refusal to register the transmission did not provide a foundation for the formation of a bona fide opinion by them that it would not be in the company's best interests to register Waters as a shareholder. For this reason their failure to register the transmission was without just cause. The court, however, refused to order that the company purchase the shares and instead ordered that Waters be registered as a shareholder of the company.

## Unsolicited offers to purchase listed shares off-market

**[9.220]** Unsolicited offers to purchase shares and other financial products off-market are regulated by Div 5A of Pt 7.9: ss 1019C–1019K. Sellers who accepted unsolicited offers to purchase their shares off-market have the right to refuse to transfer their shares to the buyer if the offer documentation either did not comply with the Div 5A requirements or contained a misleading or deceptive statement: s 1019K.

Unsolicited offers to purchase listed company shares off-market are regulated.

The Div 5A provisions seek to prevent situations where access is gained to company registers containing the names and addresses of many unsophisticated shareholders for the purpose of sending them unsolicited offers to buy their shares for significantly less than the prevailing market price. The offer letters often do not mention the market price of the shares. The fine print in some offers may also state that the offeror would pay for



the shares in small instalments over a long period of time, often years. Occasionally, unsophisticated shareholders have accepted such unfavourable offers, unaware that they could have sold their shares on market for a higher price.

Under Div 5A, unsolicited offers to purchase shares and other financial products off-market may only be made by an offeror who sends an offer document in printed or electronic form addressed to a particular offeree: s 1019E(1). This requirement ensures that offers are addressed to specific people and not to a general class of persons such as all the shareholders of a particular company. The offer document must be dated and must remain open for at least one month after the date of the offer and cannot remain open for more than 12 months after this date: s 1019G(1). An offer may be withdrawn by the offeror but must remain open for at least one month after the date of the offer: s 1019G(2). An offer may only be withdrawn by sending a withdrawal document addressed to the offeree: s 1019G(3).

Offer documents must be clearly worded and contain the following information required by s 1019I:

- the identity of the offeror;
- the offer price;
- a fair estimate of the value of shares and the basis upon which this estimate was made;
- the period during which the offer remains open;
- a statement that the offer may be withdrawn by sending a withdrawal document to the offeree but may not be withdrawn within one month of the date of offer.

The terms of the offer generally cannot be varied except in specified circumstances such as an increase or decrease in value as provided for in s 1019J: s 1019H.

## Clearing House Electronic Sub-register System (CHES)

**[9.225]** The CHES is an electronic settlement and transfer system operated by ASX Settlement Pty Ltd (ASX Settlement), a subsidiary of the ASX. ASX Settlement authorises participants such as brokers and institutional investors to access CHES and settle trades made by themselves or on behalf of their clients. For ASX listed companies, CHES replaced the traditional paper-based share transfer procedure with an electronic format. Under CHES, shares and other securities are electronically transferred and registered. CHES also provides an electronic subregister that is automatically updated to reflect a change in ownership. CHES settles trades primarily in shares as well as in a number of other financial products approved for settlement such as warrants, stapled securities and options.

CHES is the electronic settlement and transfer system operated by the ASX.

The ASX has published an explanatory brochure on CHES which is available on its website and is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## Purpose of CHESS

[9.230] CHESS was introduced in 1994 to enable the ASX to compete effectively with overseas stock exchanges by offering an efficient electronic settlement system. The aims of CHESS include faster and more efficient settlement with reduced risk and cost savings for market participants.

These aims are achieved by enabling both transactions and settlement to take place electronically.

## Participant sponsorship

[9.235] Under CHESS, stockbrokers and institutional investors are referred to as clearing and settlement (CS) facility “participants” as they have direct access to the settlement process. These participants are able to sponsor their clients who enter into a sponsorship agreement with a broker. The client’s shareholdings are registered on the sponsor’s own electronic register. Brokers are deemed to have warranted that a transferor has good title, the information contained in the transfer document is accurate and the broker was authorised to effect the transfer: *Corporations Regulations*, reg 7.11.17.

Some companies offer “issuer sponsorship” which enables a shareholder to choose the company as sponsor rather than a broker. In such a case, the holding is registered on the company’s register. This register, together with the CS subregister, comprises a particular listed company’s register of members.

## Issuer sponsorship

[9.240] Shareholders who have not entered into a CHESS sponsorship agreement with a broker or other participant are registered on the issuer-sponsored subregister. Shareholders who wish to sell issuer-sponsored shares must notify their broker who converts the shares from issuer-sponsored subregister to the CHESS subregister in order to settle the trade.

## Proposed replacement of CHESS

[9.241] The ASX announced in 2017 that it intended to replace CHESS with a new blockchain-based system it was building using distributed ledger technology (DLT), to modernise and upgrade the existing system. This project proved to be too difficult to implement and after several delays was abandoned in 2022. The existing CHESS system will now remain in place with some upgrades until at least 2025. In the meantime, an industry consultation group has been established to advise the ASX on how to best implement a new CHESS update or replacement platform.

## Clear and Settlement Operating Rules

[9.245] The Clear Operating Rules and Settlement Operating Rules are binding on issuers, participants and the CS facility itself as if contracts under seal: s 822B. The rules may be enforced by the court: s 822C.

The operating rules override the constitution of a company in respect of CS transfers: s 1070A(1). The CS facility is entitled to assume that its operating rules have been complied with: *Corporations Regulations*, reg 7.11.34.

## Transmission of shares

**[9.250]** Transmission of shares occurs by operation of law if a shareholder dies, becomes incapable through mental or physical incapacity, or becomes a bankrupt. In such cases, the shares vest in the deceased shareholder's personal representative or the trustee in bankruptcy. The procedure for transfer of shares does not apply.

Transmission of shares occurs by operation of law when a shareholder dies or becomes bankrupt.

Where the shareholder dies leaving a will, the executor named in the will becomes the deceased's personal representative. If there is no will, the shares vest in the Public Trustee and on the granting of administration they vest in the administrator who is usually the deceased's next of kin. The personal representative becomes legal owner of the shares even though not registered as a member. Proof of the personal representative's status must be furnished to the company. Sufficient evidence of this is a document evidencing a grant of probate or letters of administration: s 1071B(13).

The replaceable rule in s 1072A deals with the transmission of shares on the death of a shareholder. If the shares were owned solely by the deceased shareholder, the company will only recognise the personal representative as being entitled to the deceased shareholder's interest in the shares: s 1072A(1). If the personal representative provides the information the directors reasonably require to establish the representative's entitlement to be registered as a shareholder, the personal representative may elect to be registered or may, by completing a share transfer, transfer the shares to another person. The personal representative has the same rights as the deceased shareholder, whether or not registered as the holder of shares: s 1072A(2)(b). If the personal representative chooses to be registered, the company must register the representative as a shareholder: s 1072A(3). If the personal representative elects to transfer the shares, the transfer is subject to the rules applicable to transfers generally: s 1072A(4).

Where a deceased shareholder owned shares jointly, the company will recognise only the survivor as being entitled to the deceased shareholder's interest in the shares. The estate of the deceased shareholder is not released from any liability in respect of the shares: s 1072A(5). This is applicable to calls made on partly paid shares.

Section 1072E(2) provides that a personal representative may choose to be registered in a representative capacity as the holder of the shares registered in the name of the deceased. The personal representative is then subject to the same liabilities as if the shares had remained registered in the name of the deceased. This provision is subject to provisions to the contrary in the company's constitution. For example, the directors could refuse to register the personal representative if empowered to do so.

The administrator of the estate of a shareholder who has become incapable through mental or physical infirmity stands in a similar position to a personal representative: s 1072E(4).

A personal representative may, however, choose not to become registered as a member and merely execute a transfer to another. Section 1071B(5) and (6) allows the personal representative to do this even though not registered. Again, this is subject to provisions to the contrary in the company's constitution.

For the purpose of seeking a remedy under s 232, 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 and may therefore bring an action, whether or not they are registered as a member, where the requisite oppression or unfairness can be shown. This is discussed in Chapter 24.

If a shareholder becomes bankrupt, the *Bankruptcy Act 1966* (Cth) (*Bankruptcy Act*) provides that their property vests in the trustee in bankruptcy. Under s 1072E(6) of the *Corporations Act*, the trustee in bankruptcy may be registered as the holder of the shares. However, usually registration is not sought because adequate powers are conferred by the *Bankruptcy Act* to carry out the trustee's functions without registration. The bankrupt usually remains a member.

Section 1072B provides for a replaceable rule dealing with transmission of shares on the bankruptcy of a shareholder. Similar to the situation of transmission on the death of a shareholder, the trustee may be required by the directors to establish entitlement to be registered. Upon doing so, the trustee may choose to be registered or to transfer the shares to another person: s 1072B(1). The company must then register the trustee as holder of the shares or transfer the shares in accordance with the rules applicable to transfers generally: s 1072B(2) and (3). This replaceable rule is subject to the *Bankruptcy Act*: s 1072B(4).

Where an insolvent person enters into a deed of arrangement under the *Bankruptcy Act*, the shares held by the insolvent person also pass to the trustee by operation of law and this is a transmission of shares: *Re Winmardun Pty Ltd* (1991) 9 ACLC 238.

## Liability of members

**[9.255]** As discussed at [3.10] onwards, the liability of members depends upon the type of company. The liability of members of a company limited by shares is limited to the amount, if any, unpaid on their shares: s 516. This is discussed at [3.15]. If a company has issued partly paid shares, members are liable to pay calls on the shares in accordance with the terms on which the shares are on issue: s 254M(1). Directors usually have the power to make calls. Where a call is not paid by a member holding partly paid shares, the shares may be forfeited as discussed at [9.265].

On the winding up of a company, s 515 provides that every present and past member is liable to contribute to the property of the company to an amount sufficient for payment of its debts, costs of winding up and adjustment of rights as between its contributories. This broad statement is then subject to several qualifications. A past member who has ceased to be a member for more than one year prior to commencement of winding up is not liable to contribute: s 521. This period is extended to three years

in the case of an unlimited company having converted to a limited company during that period: s 523. A past member is not liable to contribute in respect of any debts or liabilities incurred after they ceased to be a member (s 520), only being liable to contribute where it appears to the court that the existing members are unable to satisfy the company's debts: s 522.

The liability of a member of a company limited by guarantee is limited to the amount undertaken to be contributed by the member to the property of the company in the event of its being wound up: s 517. In the case of an unlimited company, members are liable to contribute to the full extent of the debts and liabilities of the company. The liability of past members is subject to the same qualifications as in the case of companies limited by shares.

The liability of contributories is of the nature of a debt under a deed at the time their liability commenced but payable from the time calls are made enforcing the liability: s 527.

A “contributory” is any person who is liable to contribute to the property of a company on winding up. Its meaning is extended by s 9 to include members holding fully paid shares even though they have no further liability and past members who are liable to contribute under s 516.

Contributories have the right to apply to the court for a compulsory winding up under s 462(2)(c).

Although members are contractually bound by the company's constitution and any replaceable rules under s 140(1), they are not bound by a modification of the constitution made after they became members where the modification requires them to take more shares or increases their liability to the company. This is subject to their agreement in writing: s 140(2).

## Cessation of membership

**[9.260]** Where shares are transferred and the transfer is duly registered, the transferor ceases to be a member. The death of a member also results in cessation of membership. The deceased's shares are transmitted to their personal representative.

A person may cease to be a member where that person's shares are compulsorily acquired. This may occur by way of a selective reduction of capital under ss 256B and 256C, as part of a scheme of arrangement (s 414) or under the compulsory acquisitions provisions in Ch 6A.

All persons cease to be members on the deregistration of the company.

## Forfeiture of shares

**[9.265]** As discussed at [8.45], shares may be issued partly paid. The unpaid amount may be called up in whole or in part by the company or by its liquidator. The power to make calls is usually exercised by the directors under the general powers conferred by the replaceable rule contained in s 198A.

Shares may be forfeited on non-payment of a call.

Where a company issues partly paid shares, the shareholder is liable to pay calls on the shares in accordance with the terms of the share issue: s 254M(1). The constitution of a company may also provide for the forfeiture and sale of the shares if a call is not paid.

A shareholder of a no liability company is not under a contractual obligation to pay calls or any contribution to the debts and liabilities of the company: s 254M(2). Section 254Q sets out a procedure that confers a power of forfeiture on a no liability company where a call is not paid. It provides for immediate forfeiture without the need for a resolution of the directors. In *Diversified Mineral Resources NL v Amusmet Investments Pty Ltd* (1991) 24 NSWLR 77, shares in a no liability company were automatically forfeited 14 days after the date of a call. This was despite the existence of litigation that involved a dispute over whether the shares were fully or partly paid at the time of the call. Forfeited shares of a no liability company must be offered for sale by public auction within six weeks after the call has become payable: s 254Q(2).

Shares may also be forfeited under the company's constitution for reasons other than non-payment of a call. For example, in *Bundaberg Sugar Ltd v Isis Central Sugar Mill Co Ltd* [2006] QSC 358 the constitution of a company which operated as a co-operative provided for the forfeiture of shares of shareholders who were not suppliers of sugar to the company so as to enable the company to retain its co-operative status which conferred significant taxation advantages. It was held that this power conferred on the directors to forfeit fully paid shares for no consideration did not amount to a reduction of capital as no payment was made by the company to the shareholder whose shares were forfeited. The company did not become the owner of its shares, as forfeited shares are in abeyance until they are reissued, sold or cancelled. A company may, by resolution of the general meeting, cancel shares forfeited under the terms on which they were issued: s 258D.

## Surrender of shares

**[9.270]** A shareholder cannot surrender partly paid shares because this would breach the principle that a company must maintain its share capital. It would constitute an indirect way for a company to hold shares in itself and would result in part of the issued capital being extinguished. It is even doubtful whether a company can accept a surrender of fully paid shares. A valid surrender of shares may only occur where they are liable to be validly forfeited: *Trevor v Whitworth* (1887) 12 App Cas 409.

## The company's power of lien

**[9.275]** Similar to the power of a company to forfeit and sell shares after non-payment of a call is a company's right of lien over partly paid shares for all money called or payable at a fixed time in respect of that share. This right is often set out in a company's constitution and usually extends to all dividends payable on the shares.

A lien is the right to hold property of another as security for payment of a debt. The company may then sell the shares over which it has a lien. In this way, the shareholder

ceases to be a member. Any surplus proceeds from the sale after the debt has been met are payable to the shareholder.

Where the constitution is expressed in broad terms to confer a lien over all shares and not just partly paid shares, the lien may secure any debts of the shareholder and is not restricted to debts relating to the shares: *Chase Corp (Aust) Pty Ltd v North Sydney Brick and Tile Co Ltd* (1994) 35 NSWLR 1.

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.





## Chapter 10

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# Dividends

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### Key points

- The rules governing the procedure for payment of dividends are contained either in the replaceable rules or in a company's constitution (if any).
- Under the replaceable rules, directors have the power to pay dividends. If a company's constitution provides for declaration of dividends, the directors usually have the power to recommend that a dividend be paid and the shareholders can only declare a dividend up to the recommended amount. Shareholders cannot override the powers of the directors not to pay a dividend even where the company's assets sufficiently exceed its liabilities.
- Dividends may be paid if the company's assets exceed its liabilities and the excess is sufficient for the payment of the dividend.
- Payment of a dividend must be fair and reasonable to shareholders as a whole and must not materially prejudice the company's ability to pay its creditors.
- A payment of dividends if assets do not exceed liabilities may result in civil penalty orders against the directors because of a breach of the reduction of capital or insolvent trading provisions. Directors may also breach their fiduciary duties, especially where creditors are adversely affected.

## Introduction

**[10.05]** Dividends are payments to shareholders and represent a return on the shareholder's investment in the company. Prior to 2010, a "profits test" applied that specified that dividends could only be paid out of company profits. The profits test has been replaced by a "net assets" solvency test discussed at [10.30].

## Procedure for payment of dividends

**[10.10]** The rules governing the procedure for payment of dividends are contained in either the replaceable rules (ss 254U and 254W(2)) or the dividend provisions in a company's constitution (if any). Dividends may be paid in a number of ways. While a cash payment is the most common form of dividend, a company may also pay dividends by an issue of shares. Such dividends are referred to as "bonus shares". Many listed companies have dividend reinvestment plans that give shareholders the option of forgoing a cash dividend in exchange for the issue of new shares. Other methods of paying dividends include the grant of share options and the transfer of assets. Dividends may also be applied to paying up any amount unpaid on partly paid shares.

## Who decides whether to pay dividends?

**[10.15]** The replaceable rule in s 254U(1) gives directors the power to pay a dividend without the need for a prior dividend declaration by shareholders.

Directors normally determine that a dividend is payable and fix the amount.

This rule enables directors to determine that a dividend is payable, fix the amount, determine the time for payment and the method of payment. Because s 254U is a replaceable rule, it can be displaced or modified by a provision in a company's constitution. An example of a constitutional rule that displaces or modifies the replaceable rule in s 254U is a clause in a company's constitution that a dividend may only be paid if it is declared by shareholders at a general meeting on the recommendation of the directors.

The company does not incur a debt to shareholders merely by fixing the amount or time for payment of a dividend. A debt to shareholders entitled to the dividend is not incurred until the time fixed for payment arrives and the decision to pay the dividend may be revoked at any time before then: s 254V(1). Shareholders may enforce payment of the dividend as any other contractual debt if the dividend is not paid on the date fixed for payment. However, if a company has a constitution that provides for the declaration of dividends, the company incurs a debt when the dividend is declared: s 254V(2). A company's constitution may provide for the declaration of a dividend within the meaning of s 254V(2) even though it describes the power of the directors as being to "determine" rather than "declare" a dividend as these words have the same meaning in this context: *Deputy Commissioner of Taxation v Bluebottle UK Ltd* [2006] NSWCA 360.

Shareholders cannot force directors to pay a dividend.

As a general rule, shareholders cannot force a company to pay dividends even if it has sufficient surplus assets to do so: *Burland v Earle* [1902] AC 83. However, in exceptional circumstances, a refusal by a profitable company to pay dividends may be part of a broader pattern of behaviour that amounts to oppressive or unfair conduct for purposes of a remedy under s 232: *Sanford v Sanford Courier Service Pty Ltd* (1986) 5 ACLC 394. This is discussed at [24.15]–[24.280]. Shareholders may be able to force the company to declare a dividend in circumstances where the company is lawfully able to do so, and the terms of the company's constitution indicate that it was the intention of the parties that a shareholder would be entitled to a fixed, mandatory dividend with no requirement for a separate decision by the directors to declare or pay the dividend and no right of the company to withhold payment: *Wambo Coal Pty Ltd v Sumiseki Materials Co Ltd* [2014] NSWCA 326.

## Interim dividends

**[10.20]** It is quite common for a company's constitution to draw a distinction between the payment of interim and the declaration of final dividends. A final dividend reflects the results of a completed year of trading while an interim dividend reflects what is anticipated to be the position at the end of the year. Accordingly, a decision to pay interim dividends can be revoked or amended before the dividend is paid and so does not create an enforceable right to payment until the time for payment arrives: *Brookton Co-operative Soc Ltd v FCT* (1981) 147 CLR 441.

## Dividend rights

**[10.25]** Dividends are payable to those entered on the company's share register as members at the time the dividend is payable or is declared. In many companies, the shares may be divided into different classes. In the case of public companies, s 254W(1) specifies that each share has the same dividend rights unless the company has a constitution that provides for the shares to have different dividend rights or different dividend rights are provided for by special resolution of the company. In the case of proprietary companies, s 254W(2) contains a replaceable rule that allows directors to pay dividends as they see fit. This is subject to the terms on which the shares were issued.

Section 254W(3) and (4) sets out special rules for no liability companies. A shareholder of a no liability company is not entitled to a dividend if a call has been made on the share that is due and unpaid. Further, subject to provisions to the contrary in a no liability company's constitution, dividends are payable in proportion to the number of shares held, irrespective of the amount paid up on them.

A company limited by guarantee is prohibited from paying a dividend to its members: s 254SA.

## Net assets solvency test

**[10.30]** A company must not pay a dividend unless three requirements are met under s 254T.

The company's assets must exceed its liabilities immediately before the dividend is declared, and the excess must be sufficient for the payment of the dividend: s 254T(1)(a).

The company's assets and liabilities are calculated in accordance with applicable accounting standards, in particular AASB 111: s 254T(2). In *Fitz Jersey Pty Ltd v Atlas Construction Group Pty Ltd* [2021] NSWSC 1692 and *Fitz Jersey Pty Ltd v Atlas Construction Group Pty Ltd* [2022] NSWSC 394, a company received a provisional over-payment under a construction contract that was not recognised as revenue by AASB 111 because there was a possibility that some part may have had to be paid back. The company paid a dividend and soon after went into liquidation. It was held that as at the date the company declared a dividend, its assets did not exceed its liabilities so the requirements under s 254T(1)(a) were not met.

The payment of a dividend must be fair and reasonable to the company's shareholders as a whole: s 254T(1)(b). A proposed payment of a dividend may be fair and reasonable to the shareholders as a whole if it is commercially justifiable and makes due allowance for risk, even though it involves the adoption of a higher risk strategy by the company's directors than was previously the case: *KGD Investments Pty Ltd v Placard Holdings Pty Ltd* [2015] VSC 712.

The payment of a dividend must not materially prejudice the company's ability to pay its creditors: s 254T(1)(c). According to a note to s 254T(1), 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. The reduced ability to pay creditors includes a material increase in the risk that the creditors will not get paid at all and a material delay in paying them when their debts are due: *DSHE Holdings Pty Ltd v Abboud* [2021] NSWSC 673.

The requirements in s 254T(1)(b) and (c) are similar to the corresponding requirements in s 256B(1)(a) and (b) in relation to permitted reductions of capital. This is because in both cases a payment is made to shareholders or their liabilities are reduced so there is a possibility that the interests of creditors may be prejudiced. Reductions of capital are discussed at [8.230].

Draft legislation released in 2014, proposed the removal of the net assets test and its replacement with a solvency test. Under these proposals, dividends could only be declared or paid where the directors reasonably believe that the company will be solvent immediately after the dividend is declared or paid. These proposed amendments are in line with the share capital transaction provisions and aim to expand the circumstances in which dividends could be paid to shareholders. Share capital transactions are discussed at [8.200] onwards. A solvency test has not been enacted.

## Remedies for improper dividend payments

### Unauthorised reduction of capital

**[10.35]** Where dividends are paid when there is not a sufficient excess of assets over liabilities, this may amount to a reduction of capital. According to s 256B(1), a company may reduce its capital if the reduction:

- is fair and reasonable to shareholders as a whole;
- does not materially prejudice the company's ability to pay its creditors; and
- is approved by shareholders under s 256C.

If the reduction does not satisfy the s 256B(1) requirements, the company contravenes s 256D. While the contravention does not invalidate the dividend payment, any director involved may be liable for a civil penalty order: s 256D(2) and (3). Reductions of capital are further discussed at [8.230].

## Insolvent trading

**[10.40]** As discussed at [18.100]–[18.240], directors contravene s 588G if they fail to prevent their company from incurring debts when there are reasonable grounds for suspecting that the company is insolvent. This is called “insolvent trading”.

Payment of a dividend by an insolvent company may be insolvent trading.

Under s 588G(1A), a company is regarded as having incurred a debt when a dividend is paid or, if the company has a constitution that provides for the declaration of dividends, when the dividend is declared.

When the company is wound up, directors who contravened s 588G may be personally liable to either the company’s liquidator or particular unsecured creditors for any loss or damage suffered because of the company’s insolvency: s 588M. Section 588G is also a civil penalty provision, and the court may make civil penalty orders against directors who contravene the section: ss 1317E and 1317G.

## Breach of directors’ duties

**[10.45]** Under s 254T(1)(c), a dividend payment must not materially prejudice the company’s ability to pay its creditors. Creditors are materially prejudiced if a dividend payment results in the company becoming insolvent.

Payment of a dividend by an insolvent company may constitute a breach of duty by the directors.

Directors who authorise a dividend payment in such circumstances breach their fiduciary duties and may be held personally liable to repay the amount of the dividend to the company: *Hilton International Ltd v Hilton* (1988) 4 NZCLC 96-265. Directors may also breach their duty of care if they arrange for their company to pay a dividend if they do not make appropriate inquiries as to whether the company has assets that sufficiently exceed liabilities immediately before the dividend is declared: *ASIC v Loiterton* [2004] NSWSC 172.

## Injunction to restrain dividend payment

**[10.50]** Contravention of s 254T may trigger an application for a s 1324 injunction to restrain the company from paying the dividend. ASIC or any other person whose interests are affected by the contravention may apply for a s 1324 injunction. Shareholders’ interests would be affected if a dividend was not fair and reasonable to them and

therefore they would have standing to apply for an injunction. Creditors would also have standing to apply for a s 1324 injunction where a dividend payment materially prejudices the company's ability to pay them. Section 1324 injunctions are further discussed at [24.305]–[24.325].

## Taxation of dividends

**[10.55]** The imputation system for the taxation of company dividends was introduced in 1987 to eliminate double taxation of company profits. Under the imputation system, the tax paid by a company is imputed to shareholders by means of imputation credits attached to the dividends they receive (called “franked dividends”). For the years 2021–2022, the company tax rate depends on whether or not a company is a “base rate entity” as defined in the taxation legislation. A company is a base rate entity if no more than 80 per cent of its assessable income is passive income, such as dividends, interest or rent, and its aggregated annual turnover is less than \$50 million. The tax rate of a base rate entity is 25 per cent of taxable income. Companies that do not meet both these conditions are taxed at 30 per cent of their taxable income.

Franked dividends plus an amount equal to the imputation credits attaching to them are included in a shareholder's assessable income. Australian resident shareholders, however, are entitled to a tax offset in the form of a rebate of the imputation credit applicable to those dividends. If the company is a base rate entity, the imputation credit is 25/75 of the dividend. The imputation credit of non-base rate entity companies is 30/70 of the dividend.

As a general rule a company must frank a dividend to the extent of the credit or surplus balance in its franking account at the time the dividend is paid. Credits to a franking account arise when a company pays a tax instalment. They also arise when a company receives a franked dividend from another company. Franked dividends paid by a company to its shareholders are debited from its franking account.

A company must provide a dividend statement in an approved form when it pays dividends to its shareholders. This tells shareholders the extent to which their dividends are franked and the amount of the imputation credit attaching to them.

To the extent that a dividend is unfranked there are no imputation credits attached. Such dividends are included in the assessable income of shareholders and are taxed at their marginal rates.

## Tutorial questions

1. The shareholders of ABC Ltd, a company formed to operate a large hotel, are concerned that although the company's assets exceed its liabilities, they have not yet been paid a dividend. The directors contend that surplus assets are required to build up working capital. Can the shareholders take legal action to force the directors to pay a dividend? If the company's assets exceed its liabilities and the directors intended paying all the surplus out as dividends, could the shareholders do anything to reduce or prevent the payment of these dividends?

2. A company's assets exceed its liabilities by \$100,000 in the current year and the directors wish to declare that entire amount as a dividend to shareholders. One of the company's creditors is concerned that the company will become insolvent if the \$100,000 dividend is paid. What (if anything) can the creditor do about this?

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.





## Chapter 11

# Debentures and personal property securities

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## Key points

- A company can raise capital by borrowing. This may be done by the company issuing debentures. A debenture involves an undertaking by the company to repay a debt. It often includes a security interest over the company's assets to secure the debt. Debentures may be issued to many investors or to a single creditor – such as a bank or other financier.
- An offer of debentures to investors attracts the operation of the fundraising provisions in Ch 6D of the *Corporations Act 2001* (Cth) in the same way as offers of shares. If the fundraising provisions apply to a debenture offer, a borrowing company must also enter into a trust deed with certain prescribed terms and appoint a trustee to safeguard the interests of debenture-holders.
- The *Personal Property Securities Act 2009* (Cth) and associated legislation reformed the law regarding borrowing money on security of personal property (property other than land). The reforms introduced a new term, “security interest”. A security interest is an interest in personal property that, in substance, secures the payment or performance of an obligation.
- Security interests include traditionally recognised forms of security such as charges, liens or pledges. A security interest also includes certain arrangements that were not previously recognised as security interests, such as retention of title arrangements, consignment sales, hire-purchase agreements and leases of goods.
- A security interest may take the form of either a circulating security interest or non-circulating security interest. A circulating security interest allows the grantor to sell or transfer the circulating assets in the ordinary course of its business, free of the security interest. The grantor of a non-circulating security interest is not permitted to sell or otherwise dispose of the collateral free of the security interest without the secured party's consent.
- A security interest must “attach” to personal property for it to be enforceable against the grantor.
- It is in the interests of the secured party to “perfect” their security interest once it attaches to personal property by registering their security interest in the property. Registering a security interest involves lodging a financing statement, containing prescribed details, on the searchable online Register of Personal Property Securities (PPS Register) maintained by the Registrar of Personal Property Securities.
- It is in the interests of secured parties to promptly register their security interest. A secured party may lose their ability to enforce their security interest if it was registered 20 or more days after the security agreement that created it came into force and the company then goes into liquidation, or voluntary administration or executes a deed of company arrangement. A secured party may also lose its security interest if the security interest was registered

within six months before the company goes into liquidation, voluntary administration or executes a deed of company arrangement.

- Priority rules apply where two or more security interests are attached to the same property. These rules determine the order in which the proceeds of sale of the property, as part of enforcement proceedings, are distributed among the various secured parties.
- A security interest may be invalidated in certain circumstances. For example, security interests granted to a company's officers may be invalid where the officer takes steps to enforce the security interest within six months after it is made without obtaining prior court leave.

## Distinction between share capital and loan capital

[11.05] As discussed at [8.05], a company may raise funds by the issue of share capital or by borrowing from lenders. A company may borrow from a bank or other finance provider, with or without security, in the same way as an individual. This is called loan capital or debt finance. It is part of the management function of the board of directors to determine the extent to which the financial needs of a company are better met by a raising share capital or loan capital.

The basic distinction between share capital and loan capital is that a shareholder is a member of the company whose rights are set out in the company's constitution or replaceable rules, whereas a lender is an external creditor whose rights are set out in the borrowing documents or other contracts. As discussed at [8.200] onwards, there are rules dealing with the raising and maintenance of share capital. These rules do not apply to loan capital. For example, interest on a loan must be paid regardless of the company's financial position while dividends can only be paid if the company's assets exceed its liabilities immediately before a dividend is declared and the excess is sufficient for the payment of the dividend.

While this distinction between the nature of shareholders and lenders is usually clear cut, from a commercial point of view, their respective rights may sometimes appear to be similar. For example, as discussed in Chapter 8 ([8.115]–[8.150] onwards) preference shares and, in particular, redeemable preference shares, often give shareholders rights that are similar to the rights of external creditors such as a fixed rate of return. From a commercial point of view, their role in the company is seen as similar to that of lenders. Nevertheless, in a legal sense, the holders of preference shares are members of the company and not external creditors. Their rights are contained in the company's constitution or replaceable rules. Lenders to the company generally have stronger contractual rights set out in the borrowing documents. If the company is wound up, its creditors have priority in repayment over all shareholders.

## Gearing

[11.10] The ratio of borrowed funds to issued share capital is described as the “gearing” of a company. If the company borrowed a large amount relative to its issued share capital, it is said to be “highly geared”. On the other hand, if it has borrowed relatively little compared to its issued share capital, the company is said to have a “low gearing” ratio.

## Taxation

[11.15] Income tax legislation confers certain advantages on the raising of loan finance compared with the issue of share capital. Interest on a loan and other associated expenses are allowable deductions that reduce the taxable income of companies. Interest that lenders receive is assessable income in their hands. Dividends paid by a company, together with expenses incurred in issuing share capital, are not deductible. Dividends are only paid after tax is paid by the company. As discussed at [10.55], under the imputation system, where a company pays dividends from profits that have been taxed (“franked

dividends”), Australian resident shareholders who receive these dividends, obtain a taxation credit (“imputation credit”) for the tax paid by the company.

## Borrowing powers of companies

**[11.20]** A company has the power to borrow in the same way as an individual. It also has specific powers to issue debentures and give security for loans by granting a security interest in uncalled capital and granting a circulating security interest over its property: s 124(1). This is despite any express restriction or prohibition contained in the company’s constitution, if it has one: s 125(1).

A matter of concern to lenders is whether the persons acting for the company have the requisite authority to borrow on behalf of the company. Directors usually have the power to borrow for the company. The replaceable rule in s 198A gives directors the power to manage the company’s business which includes the power to borrow. In rare cases, a company’s constitution may limit the directors’ powers to borrow, for example, by requiring approval of shareholders for loans exceeding a certain amount. Notwithstanding such limits in the constitution, lenders are protected by s 129(1) and may assume that the constitution has been complied with. This is discussed at [5.240].

## Debentures

### Definitions

**[11.25]** A method of borrowing by companies is the issue of debentures. The term “debenture” has several meanings. At common law, a debenture is a document that acknowledges a company’s indebtedness. The debt is often secured by a security interest over the property of the company but a debenture need not be secured.

A debenture includes an undertaking by a company to repay as a debt, money deposited with or lent to it.

Under the *Corporations Act*, “debenture” has a broader meaning than the common law meaning. Section 9 states that a debenture is a chose in action that includes an undertaking by a body to repay as a debt, money deposited with or lent to the body. The chose in action may (but need not) include a security interest over property of the body to secure repayment of the money.

The s 9 definition excludes certain undertakings to repay money deposited with or lent to a bank and payments by cheque.

While the s 9 definition of debenture specifically notes that a debenture may (but need not necessarily) be secured by a security interest over the body’s property, there is a widely held impression that the term “debenture” implies that the borrowing is secured. For this reason, the *Corporations Act* regulates how debentures can be described to investors. Under s 283BH a borrower may describe a debenture in one of

three ways depending on the security provided. These three descriptions are outlined in Table 11.1.

**Table 11.1: How debentures may be described**

| Description                              | When description may be used                                                                                                                                                                                                                                                          |
|------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Mortgage debenture                       | Only if the circumstances in s 283BH(2) are satisfied. These circumstances include where repayment of the borrowings is secured by a first mortgage given to the trustee for debenture-holders over land vested in the borrower or in any of the guarantors: s 283BH(2)(c)            |
| Debenture                                | Only if the circumstances in s 283BH(2) and (3) are satisfied. These circumstances include where repayment of the borrowings is secured by a security interest in favour of the trustee for debenture-holders over the tangible property of the borrower or guarantors: s 283BH(3)(a) |
| Unsecured note or unsecured deposit note | In any other case                                                                                                                                                                                                                                                                     |

The relationship between the borrowing company and a debenture-holder is governed by the law of contract and, if the debenture is secured, also by property law. The debenture provisions in Ch 2L (ss 283AA–283I) of the *Corporations Act* regulate the issue of debentures. The *Personal Property Securities Act 2009* (Cth) (*PPS Act*) also regulates debentures where the security interest is over personal property which is property other than land.

## Convertible debentures or notes

[11.30] A borrowing company may issue convertible debentures or convertible notes to lenders. These provide the holders with a right to convert the debentures or notes into shares. In this way, the holders obtain the advantages of being debenture-holder creditors with a secured, regular return, and after a period, they may exercise their right to be issued shares and thereby gain the benefit of any increase in the company's share price. From the company's point of view, if its future prospects are seen by investors as attractive, it may find its convertible debentures marketable at a relatively low interest rate. Holders may be prepared to accept a lower interest rate in exchange for the prospect of converting the debentures into shares with an increased market value. The company may also be able to avoid having to raise funds to redeem the debentures if the holders elect to convert them into shares.

## Application of fundraising provisions

[11.35] The s 92 definition of “securities” includes debentures as well as shares, so the fundraising provisions apply to offers of debentures to investors. Section 727 prohibits a person making offers of debentures or distributing application forms for debenture offers, unless a disclosure document for the offer has been lodged with Australian Securities and Investments Commission (ASIC). The fundraising provisions are discussed

in Chapter 7. In addition, the provisions of Ch 2L – Debentures – apply specifically to offers of debentures that require disclosure to investors under the fundraising provisions of Ch 6D: s 283AA(1)(a).

## Trust deed and trustee

**[11.40]** A borrowing company that proposes to offer its debentures in circumstances that require a disclosure document under Ch 6D is required to appoint a trustee for the debenture-holders and prepare a trust deed.

The provisions of Pt 2L.1 set out the requirements for a trust deed and trustee for debenture-holders.

Under s 283AA, a body must enter into a trust deed and appoint a trustee before the body makes an offer of debentures that needs disclosure to investors under Ch 6D. Section 283AB requires the trust deed to provide that the rights of debenture-holders are held in trust by the trustee for their benefit.

Section 283AC specifies who can act as a trustee for debenture-holders. Eligible trustees include trustee companies holding an Australian financial services licence, registered life insurance providers, banks and bodies approved by ASIC. In order to ensure the trustee is independent of the borrower, s 283AC(2) specifies that a person may only be appointed or act as trustee for debenture-holders if the appointment or acting will not result in a conflict of interest or duty.

## Borrower's and guarantor's duties

**[11.45]** The *Corporations Act* imposes a number of statutory duties on a borrower including a requirement to enter into a trust deed under s 283AA.

The term “borrower” in relation to a debenture means the body that is, or will be, liable to repay money under the debenture: s 9. Under s 283BB, the general duties of a borrower include the duty to:

- carry on and conduct its business in a proper and efficient manner; and
- make all its financial and other records available for inspection by the trustee and give the trustee any information, explanations or other assistance required about the matters relating to those records.

Sections 283BC–283BF impose a number of specific duties on borrowers including duties to:

- notify ASIC of the name of the trustee (s 283BC);
- replace the trustee if this becomes necessary (s 283BD);
- inform the trustee about any security interests the borrower creates (s 283BE); and
- give the trustee and ASIC quarterly reports about certain specific matters of relevance to debenture-holders (s 283BF).

ASIC is required to establish and maintain a publicly accessible register containing prescribed details relating to trustees for debenture-holders: s 283BCA.

A guarantor in relation to a debenture means a body that has guaranteed the repayment of any money deposited or lent to the borrower under the debenture: s 9. Under ss 283CB and 283CC, a guarantor is under a duty to carry on and conduct its business in a proper and efficient manner, to make its financial records available for inspection by the trustee and to notify the trustee about any security interests it creates.

A borrower and guarantor commit a criminal offence if they intentionally or recklessly contravene any of the statutory duties imposed upon them: ss 283BI and 283CE.

## Trustee's duties

**[11.50]** The trustee is subject to a range of duties listed in s 283DA. For example, a trustee must exercise reasonable diligence to ascertain whether the property of the borrower and of each guarantor will be sufficient to repay the amount deposited or lent when it becomes due: s 283DA(a). A trustee must also exercise reasonable diligence to ascertain whether the borrower or any guarantor has committed any breach of the terms of the debentures, the provisions of the trust deed or Ch 2L.

## Statutory rights of debenture-holders

**[11.55]** The *Corporations Act* gives debenture-holders or their trustee several rights. For example, under s 318, a borrower must give the trustee for debenture-holders a copy of its annual financial report, directors' report and auditor's report by the deadline for the financial year set by s 315. In addition, a borrower's auditor must give the trustee for debenture-holders a copy of the auditor's report within seven days after providing the original to the company or its members: s 313(1). The auditor must also provide a report on any matters prejudicial to debenture-holders' interests within seven days of the auditor becoming aware of the matter: s 313(2).

Section 283EA gives debenture-holders, who hold 10 per cent or more of the nominal value of the issued debentures, the power to direct the borrower to call a meeting of debenture-holders. The trustee may also call a meeting of debenture-holders if the borrower or guarantor has failed to remedy any breach of the terms of the debentures, provisions of the trust deed or Ch 2L: s 283EB(1). The purpose of such a meeting is to enable the trustee to inform the debenture-holders of the failure, submit proposals for protection of the debenture-holders' interests and to ask for directions in relation to the matter.

## Register of debenture-holders

**[11.60]** A company that issues debentures is required to set up and maintain a register of debenture-holders: s 168(1)(c). Under s 171, the register of debenture-holders must contain the following information about each holder of a debenture:

- the debenture-holder's name and address; and
- the amount of the debentures held.



# Personal property securities

## Overview

**[11.65]** The law regarding borrowing on security of personal property, meaning property other than land, underwent major reform with the enactment of the *PPS Act*, a single national law applicable to all security interests in personal property.

The *PPS Act* takes a “functional approach” to regulating personal property securities, so that all transactions under which a borrower grants a lender an interest in the borrower’s personal property, as security for a loan or other obligation, are regulated in the same way regardless of the legal form of the transaction. The *PPS Act* applies whether the borrower is an individual or a company and operates nationally.

The personal property securities regime also set up a single national online Register of Personal Property Securities (PPS Register) administered by a Commonwealth government authority, the Australian Financial Security Authority (AFSA). In the company law context, the AFSA-administered PPS Register replaced ASIC’s register of company charges.

## Personal property

**[11.70]** The *PPS Act* regulates security interests in “personal property”. Under s 10 of that Act, “personal property” is property other than land. Personal property includes both tangible property such as plant, equipment and inventory and intangible property such as shares and receivables. The *PPS Act* does not apply to goods (other than crops) affixed to land. Goods affixed to land are described as fixtures and are regarded as part of the land. The test of whether a good is affixed to land depends upon the objective intention with which the good was put in place, having regard to the degree and object of the annexation. Relevant factors in determining the degree and object of annexation include whether the parties intended the goods to be permanently affixed and the degree of difficulty and cost in removing the item: *Forge Group Power Pty Ltd v General Electric International Inc* [2016] NSWSC 52.

## Security interest

**[11.75]** The term “security interest” is defined in s 12(1) of the *PPS Act* under which a security interest is an interest in personal property provided for by a transaction that, in substance, secures the payment or performance of an obligation (without regard to the form of the transaction or the identity of the person who has title to the property). Under this definition, a security interest also includes arrangements that were not traditionally recognised as securities, such as conditional sale agreements (including agreements to sell subject to retention of title (RoT)), hire-purchase agreements and leases of goods.

Under s 12(3)(c) of the *PPS Act* a security interest includes the interest of a lessor of goods under a PPS lease. The term PPS lease includes a lease of goods for a term of more than one year: s 13(1)(a). However, a PPS lease does not include a lease by a lessor who is not regularly engaged in the business of leasing goods: s 13(2)(a).

In *Sandhurst Golf Estates Pty Ltd v Coppersmith Pty Ltd* [2014] VSC 217, it was held that there must be a consensual transaction that gives rise to the security interest. Claims over the personal property of the plaintiff based on the possibility of obtaining equitable relief from a court following a dispute between the parties did not amount to a security interest and could not be registered under the Act.

The functional approach of the *PPS Act* applies to the *Corporations Act* because s 51A(a) provides that a security interest means a “PPSA security interest”. A “PPSA security interest” is a security interest as defined in s 12(1) of the *PPS Act*: s 51. Under the *Corporations Act*, a security interest also includes traditionally recognised forms of security such as charges, liens or pledges: s 51A(b).

## Grantor and secured party

**[11.80]** A grantor is a person who owns or has the interest in the personal property to which a security interest is attached: *PPS Act*, s 10. Normally the grantor is the person or company whose borrowing is secured by the security interest.

A secured party is the person to whom a security interest has been granted. A secured party, therefore, includes a chargee, lienor or pledgee where the security interest consists of a charge, lien or pledge. Because the definition of “security interest” also includes a “PPSA security interest”, a “secured party” includes persons who were not traditionally regarded as secured parties. For example, a seller of personal property subject to RoT arrangements, an owner of personal property financed under hire-purchase arrangements and a lessor of personal property subject to lease financing arrangements are all regarded as secured parties: s 51B of the *Corporations Act*.

## Security agreement

**[11.85]** A security agreement is an agreement or other act by which a security interest is created: *PPS Act*, s 10. A security agreement includes a debenture trust deed as well as other loan agreements that create security interests.

## Attachment and collateral

**[11.90]** The *PPS Act* introduced the concept of attachment. A security interest must “attach” to personal property for it to be enforceable against the grantor. The personal property to which a security interest is attached is defined in s 10 as “collateral”.

Under s 19(2) of the *PPS Act*, a security interest attaches to personal property when the grantor has rights in the property or the power to transfer rights in the property to the secured party and the secured party either provides value or the grantor does an act by which the security interest arises, such as signing a security agreement in respect of the property. As soon as a security interest attaches to collateral, the secured party acquires enforceable rights against the collateral: *PPS Act*, s 19(1).

A security interest in respect of particular collateral is enforceable against third parties if it is attached to the property. As well as attachment, for a security interest to be enforceable against third parties, the secured party must have possession or control of the collateral or there must be a written security agreement between the parties signed by the grantor that covers the collateral.

## Perfection

**[11.95]** Under s 21 of the *PPS Act*, a secured party “perfects” their security interest by:

- registering an interest in the collateral. Registration is discussed at [11.180]; or
- taking possession of the collateral (other than as a result of seizure or repossession); or
- taking control of certain types of collateral (such as an account with a bank or other authorised deposit-taking institution, letters of credit, negotiable instruments, satellites and other space objects).

It is important for a secured party to perfect their security interest once it attaches to collateral for two main reasons. First, perfection of security interests is important to obtain priority over competing security interests in the same collateral. If a secured party does not perfect their security interest, another person’s security interest in the same collateral may take priority or another person may acquire an interest in the collateral free of the secured party’s security interest. The priority rules are discussed at [11.195]. Perfection is also important if the grantor goes into liquidation, or voluntary administration, becomes subject to a deed of company administration or is restructured. As discussed at [11.140], [11.150] and [11.205], in some situations an unperfected security interest may be unenforceable or void.

Sections 22 and 32–40 of the *PPS Act* have specific rules for attachment and perfection of security interests in particular types of collateral.

## Circulating and non-circulating security interests

**[11.100]** As noted above at [11.75], the definition of security interest includes charges. Prior to the *PPS Act* reforms, a charge could take the form of either a fixed charge or a floating charge. The *PPS Act* replaced the concepts of fixed and floating charges with new terminology. Security agreements may create security interests that have the features of fixed and floating charges but are now called “non-circulating security interests” or “circulating security interests”, respectively.

### *Circulating security interest*

**[11.105]** Under s 51C of the *Corporations Act* a “circulating security interest” is either a floating charge or a PPSA security interest (see [11.75]) if the security interest has attached to a “circulating asset” (as defined in s 340 of the *PPS Act*). Section 51C says that personal property is a circulating asset if the secured party has given the grantor authority for any transfer of the personal property to be made, in the ordinary course of the grantor’s business, free of the security interest.

Because a grantor is able to sell or otherwise dispose of circulating assets in the ordinary course of business without obtaining the secured party’s prior consent, a

circulating security interest provides a grantor with the means to use constantly changing circulating assets, such as inventory and book debts, as security for a loan. The grantor is also able to replace individual items of the collateral in the future and the replaced items would also be subject to the circulating security interest. Transactions to sell or otherwise dispose of circulating assets are within the ordinary course of business if they are made for the purpose of carrying on the business even where a particular transaction is exceptional in nature, provided its purpose is to maintain the borrowing company as a going concern: *Reynolds Bros (Motors) Pty Ltd v Esanda Ltd* (1983) 8 ACLR 422.

**[11.120]** A transaction is in the ordinary course of business where a borrower grants a later non-circulating security interest over specific collateral that has priority over a prior circulating security interest covering that collateral. Priorities are discussed at [11.195]–[11.200]. A disposal of a company's business in its entirety as a preliminary step in ceasing business would not be in the ordinary course of business.

Under the pre-PPS Act law, a floating charge was said to “float” over the category of property secured by the charge, and the borrower had the right to sell, or otherwise dispose, of any item in the category in the ordinary course of business. If the borrower defaulted under the floating charge loan agreement, the charge ceased to float and dropped down to attach itself to the particular property in the category secured by the charge then owned by the borrower, at the time of default. The floating charge was said to “crystallise” and became in effect a fixed charge over the property held at the time of crystallisation or acquired afterwards.

The PPS Act dispensed with the concept of crystallisation of floating charges. Under the current law, the terms of the security agreement specify the circumstances that constitute a default of a circulating security interest, such as not paying principal or interest on time. The security agreement also governs the respective rights of grantors and secured parties in the event of a default.

## *Non-circulating security interest*

**[11.125]** While the *Corporations Act* does not specifically define “non-circulating security interest”, under the PPS Act a fixed charge is a security interest in a non-circulating asset and hence is not a circulating security interest for purposes of the *Corporations Act*.

A non-circulating security interest attaches to specific personal property identified in the security agreement owned by the grantor. An important feature of a non-circulating security interest is that the grantor is not entitled to sell or otherwise dispose of the collateral free of the security interest without the secured party's consent.

## *Relevance of distinction between circulating and non-circulating security interests*

**[11.130]** It may be important to determine whether a security interest is a circulating or non-circulating security interest because if a grantor of a security interest that is a non-circulating security interest defaults under the security agreement, the secured party is entitled to take possession of the collateral, sell it and use the proceeds to repay the debt owed by the grantor. On the other hand, if the collateral is subject to a circulating security interest and the secured party appoints a receiver to enforce the security interest,

s 433 of the *Corporations Act* requires the receiver to use the proceeds of sale to pay debts to certain unsecured creditors such as employees in priority to claims of a secured party with a circulating security interest. Under s 561 similar priorities apply to circulating security interest creditors if the grantor goes into liquidation. This is discussed at [32.675]. The effect of ss 433 and 561 is that secured parties with non-circulating security interests have priority and so stand in a stronger position than secured parties with circulating security interests.

## Retention of title clauses

**[11.135]** An RoT clause is a term in a contract for a sale of goods under which the seller retains title or ownership of the goods until the goods are paid for. If the buyer does not pay the purchase price, the seller is entitled to repossess the goods. Under the pre-PPS *Act* law the seller remained the owner of the goods sold and the buyer was regarded as a bailee. Because a RoT arrangement was not legally a charge over the goods sold, it did not have to be registered under the pre-PPS *Act* registration rules. Some RoT clauses were drafted so that where the buyer on-sold the goods to third parties, the seller would be entitled to the proceeds of the on-sale: *Aluminium Industries Vaassen BV v Romalpa Aluminium Ltd* [1976] 2 All ER 552.

The PPS *Act* changed the pre-existing law in relation to RoT clauses. Applying a functional approach, RoT arrangements are now regarded as security interests, and by virtue of s 51F of the *Corporations Act*, the personal property sold subject to a RoT clause is called “PPSA retention of title property”. Personal property that is the subject of a hire-purchase agreement, a lease or a consignment agreement that secures the payment or performance of an obligation is also regarded as “PPSA retention of title property”.

Applying the PPS *Act* terminology to a RoT arrangement, the seller is the secured party and the buyer is the grantor of the security interest. As a RoT arrangement is a security interest, the PPS *Act* rules regarding perfection (see [11.95]), and registration (see [11.180]) apply. A RoT arrangement is also one type of “purchase money security interest” (PMSI) and in certain circumstances has a super priority over other security interests that are not PMSIs (see [11.200]).

## Invalidation of security interests

**[11.136]** There are several provisions in the *Corporations Act* that invalidate security interests in certain circumstances. These provisions come into operation where the grantor company goes into liquidation within specified times after the security interest is granted or it is insolvent at the time the security interest is granted. The circumstances which give rise to these invalidating provisions include where an unsecured creditor is favoured over other unsecured creditors by being elevated to a secured creditor, where company assets are unfairly put out of reach of creditors and where company officers are favoured over other creditors by being granted a security interest.

## *Voidable antecedent transactions*

**[11.140]** The liquidator of an insolvent company is able to avoid certain antecedent transactions specified in ss 588FA–588FJ. Antecedent transactions are discussed at [32.475]

onwards. These are transactions entered into by a company prior to the commencement of its winding up in insolvency. The antecedent transactions provisions include security interests that are:

- unfair preferences under s 588FA; or
- uncommercial transactions under s 588FB; or
- unfair loans under s 588FD.

Unfair preferences and uncommercial transactions are referred to as “insolvent transactions” if the company was insolvent when they were entered into: s 588FC. An unfair preference is voidable under s 588FE(2) if it was entered into during or after the six months ending on the date of the winding up application (described as the “relation back day”). An uncommercial transaction is voidable if it was entered into during or after two years ending on the relation-back day. Unfair loans to the company are voidable whenever made: s 588FE(6).

The company’s liquidator may apply to the court under s 588FF for a variety of orders in relation to voidable transactions. The orders include an order declaring the agreement constituting the transaction to be void: s 588FF(1)(h).

Section 588FJ deals specifically with the invalidation of circulating security interests.

Under s 588FJ(2), a circulating security interest created during the six months ending on the relation-back day is void as against the company’s liquidator, except so far as it secures:

- an advance paid to the company, or at its direction, at or after that time and as consideration for the circulating security interest; or
- interest on such advance; or
- the amount of a liability under a guarantee or other obligation undertaken at or after that time on behalf of, or for the benefit of, the company; or
- an amount payable for property or services supplied to the company at or after that time; or
- interest on an amount so payable.

Section 588FJ(1) does not apply if it is proved that the company was solvent immediately after the creation of the circulating security interest.

### *Security interests in favour of officers*

**[11.150]** Under s 588FP(1) a security interest granted by a company is void if the secured party is an officer, a former officer or a person associated with an officer or former officer *and* the secured party purports to take a step to enforce the security interest within six months after it is made without the leave of the court. Section 588FP does not apply in relation to a PPSA security interest in PPSA retention of title property: s 588FP(5).

The court may grant leave for the security interest to be enforced if it is satisfied that the company was solvent at the time the security interest was granted and it is just and equitable for the court to do so: s 588FP(4).

Section 588FP supplements the unfair preference provisions and is aimed at situations where an insolvent company borrows money from its directors and grants them a security interest in collateral shortly before going into liquidation. Were it not for s 588FP, a director could gain an unfair advantage over the company's other creditors by appointing a receiver under the security agreement who then obtains control of the company's books. This would present difficulties for the liquidator who would have to apply to the court to set aside the security interest as an unfair preference.

Under s 588FP(3) a secured party is regarded as taking a step to enforce a security interest if the secured party:

- appoints a receiver or a receiver and manager; or
- enters into possession or assumes control of the company's property for the purposes of enforcing the security interest; or
- seizes the property under s 123 of the *PPS Act* for the purposes of enforcing the security interest.

**[11.160]** Where an officer who is entitled to enforce a security interest exercises the right under s 436C of the *Corporations Act* to appoint an administrator, this is not enforcing a security interest for the purposes of s 588FP(1) because the appointment of an administrator may result in the secured party being unable to enforce the security interest at all: *Australian Innovation Ltd v Dean-Willcocks* [2001] NSWSC 1204. A letter threatening to take legal proceedings or seeking an undertaking about future action and advising another party of a claim of an interest in property also does not constitute enforcement of a security interest: *400 Lonsdale Nominees Pty Ltd v Southern Cross Airlines Holdings Ltd* (1993) 11 ACLC 744.

**[11.170]** Section 588FP applies where the secured party was an officer at any time within the six-month period ending at the date of making the security agreement: s 588FP(2)(b). The section also applies where the secured party is associated with a present or former officer: s 588FP(2)(c).

## Registration and priorities of security interests

**[11.180]** The *PPS Act* reforms replaced the previous registration of charges requirements of the *Corporations Act* with revamped rules dealing with registration of security interests.

The *PPS Act* established a real-time, online, publicly accessible Register of Personal Property Securities (PPS Register) maintained by the Registrar of Personal Property Securities. The PPS Register replaced ASIC's Australian Register of Company Charges and the data in the Australian Register of Company Charges was migrated to the PPS Register. The AFSA, a Commonwealth government agency, has the responsibility for the PPS Register and the associated Customer Contact Centres that support it.

The data in the PPS Register includes details of registered security interests in personal property; details of the grantor and the secured party; and a description of the collateral.



While registration is not compulsory, it is in a secured party's interest to register their security interest in personal property. As discussed at [11.95], registration is the most common method of perfecting a security interest. By perfecting their security interest, a secured party gains priority over competing security interests of third parties in the same collateral.

## *Financing statement*

**[11.185]** Registration involves lodging a financing statement that contains prescribed data on the PPS Register. It is not necessary to lodge the actual security agreement that created a security interest. A financing statement can be registered online or by filing a hard copy registration form at a Customer Contact Centre.

Under s 153 of the *PPS Act* a financing statement should include the following information:

- details about the secured party, including the address for service of notices;
- details about the grantor;
- a description of the collateral, including whether the collateral is “consumer property” or “commercial property”;
- registration details such as the end time of the registration (if any); and
- details of any subordination agreements (if any).

After registration, a verification statement that sets out the data that was registered and confirms the registration time is automatically sent to the secured party's nominated address for service. To ensure a grantor is informed when registration is made against their personal property, the secured party must send a notice of the verification to the grantor.

A secured party who has registered a security interest can make updates to its registration by lodging a financing change statement to amend a registered financing statement.

## *When is registration effective?*

**[11.190]** The time of registration is important because it determines priorities among the security interests of different secured parties in respect of the same collateral. The question of priority of security interests arises when a grantor company borrows from two or more lenders and purports to give each of them a security interest in the same collateral. If the grantor defaults on its security agreements, the question arises as to which secured party has priority to enforce their security interest.

As a general rule, registration commences from the moment the description of the collateral becomes available for search on the PPS Register in relation to a particular secured party. Personal property is registrable before or after a security agreement is made describing the property. The Explanatory Memorandum to the PPS Bill gave the following example:

If a lender applies at noon on 1 June 2011 to register a security interest in respect of particular property owned by a company in anticipation of entering a security



agreement, the collateral would be registered at 1 second after noon on 1 June 2011 when it became available for search on the PPS Register.

The precise time of registration is referred to in the *PPS Act* as the “registration time”. Where a secured party has a financing statement recorded on the PPS Register, the registration becomes effective from the registration time. Registration is regarded as ineffective in certain circumstances including where the registration contains a seriously misleading defect in any data relating to the registration, such as an incomplete or inaccurate collateral description.

## Priority rules

**[11.195]** The priority rules become important when two or more security interests attach to the same collateral. Among other things, the priority rules determine the order in which the proceeds of sale of the collateral as part of enforcement proceedings are to be distributed among the secured parties. The *PPS Act* has default priority rules and several specific rules for certain types of security interests. The priority rules may be replaced by an agreement to the contrary between secured parties and the grantor.

The default priority rules are:

- The priority between unperfected security interests in the same collateral is determined according to the order of attachment of the security interest: s 55(2).
- A perfected security interest has priority over an unperfected security interest in the same collateral: s 55(3).
- Where two or more security interests are perfected, priority is determined by the “priority time” for each security interest: s 55(4). Under s 55(5) the priority time for a security interest in collateral is the earliest of the following times in relation to the security interest:
  - the registration time for the collateral; or
  - the time the secured party first perfects the security interests by taking possession or control of the collateral; or
  - the time the security interest is temporarily perfected, or otherwise perfected, by force of the *PPS Act*.
- A security interest that is perfected by control has priority over a security interest perfected by any other means: s 57(1).

### *Re Maiden Civil (P & E) Pty Ltd [2013] NSWSC 852*

**[11.198]** Queensland Excavation Services Pty Ltd (QES) purchased three Caterpillar vehicles in 2010 and leased them to Maiden Civil (P & E) Pty Ltd under a verbal lease. QES did not register its interest as lessor in the vehicles under the pre-*PPS Act* register of assets.

Maiden used the Caterpillars for its business and made lease payments to QES on a periodic basis. In 2012 Maiden borrowed funds from Fast Financial Solutions

Pty Ltd (Fast), which took security over all of Maiden's property, including the Caterpillars. Fast registered its security interest in Maiden's property on the PPS Register. Maiden defaulted on the loan and Fast appointed receivers who took possession of the Caterpillars. One of the main issues in this case was whether QES's interest as lessor of the Caterpillars was superior to Fast's security interest.

The court held that QES had a security interest in the Caterpillars under the *PPS Act*. Under s 13(1), QES's lease of the Caterpillars to Maiden was a "PPS lease" and therefore it was a "security interest" under s 12(1). Fast also had a security interest in the vehicles by virtue of its financing agreement. Under s 21, Fast's security interest was perfected because it was registered. Under s 55(3), Fast's perfected security interest had priority over QES's unperfected security interest in the Caterpillars. This meant that Fast's receivers were entitled to retain possession of the vehicles, sell them and repay the loan to Fast.

## *Super priority of PMSIs*

**[11.200]** Subject to certain requirements, a perfected PMSI in collateral or its proceeds has priority over a perfected security interest in the same collateral that is not a PMSI: *PPS Act*, s 62. This is referred to as a "super priority". A PMSI includes RoT arrangements, hire-purchase and lease financing agreements and commercial consignments. The term "purchase money security interest" is defined in s 14(1) to mean any of the following:

- a security interest taken in collateral, to the extent that it secures all or part of its purchase price;
- a security interest taken in collateral by a person who gives value for the purpose of enabling the grantor to acquire rights in the collateral, to the extent that the value is applied to acquire those rights;
- the interest of a lessor or bailor of goods under a PPS lease; or
- the interest of a consignor who delivers goods to a consignee under a commercial consignment.

Where the PMSI is in inventory or its proceeds, the PMSI has super priority if the PMSI is perfected by registration and the registration that perfects the PMSI states that the interest is a PMSI: s 62(2). Under s 62(3) where the PMSI is an interest in personal property or its proceeds other than inventory, the PMSI has super priority if:

- the PMSI is perfected by registration before the end of 15 days after the grantor obtains possession of the goods or, in the case of other property, the day the interest attaches to the property; and
- the registration that perfects the PMSI states that the interest is a PMSI.

## *Vesting of security interests if not registered within time*

**[11.205]** Section 588FL of the *Corporations Act* and s 267 of the *PPS Act* encourage a secured party to register its PPSA security interest and to do so promptly. Failure to register the security interest at all, or failure to register within the deadline, results in the security interest vesting in the grantor company with the consequence that the secured party loses its right to enforce the security interest.

Section 267 of the *PPS Act* deals with the situation where a security interest has not been registered before a grantor company goes into liquidation, or voluntary administration, becomes subject to a deed of company arrangement or appointed a restructuring practitioner, or becomes subject to a restructuring plan. Under s 267(2) the security interest vests in the grantor company immediately before:

- an order is made, or a resolution is passed, for the winding up of the company; or
- a voluntary administrator of the company is appointed; or
- a company executed a deed of company arrangement; or
- a restructuring practitioner for a company is appointed; or
- a company makes a restructuring plan.

Under s 588FL(4), where registration of a PPSA security interest occurred outside the registration time for the collateral, the PPSA security interest vests in the grantor company immediately before the date the grantor company went into liquidation, or voluntary administration, became subject to a deed of company arrangement, appointed a restructuring practitioner, or a company made a restructuring plan. This date is referred to as the “critical time”. Under s 588FL(2)(b) the registration time is after the latest of the following times:

- six months before the critical time;
- at the end of 20 business days after the security agreement that gave rise to the security interest came into force, or the critical time, whichever is earlier; or
- a later time ordered by the court under s 588FM.

Section 588FM(2)(a) gives the court the power to extend the time for registration on the application of the grantor company or any interested person. The court may extend the time for registration if it is satisfied that the failure to register the collateral was:

- accidental or due to inadvertence or some other sufficient cause (s 588FM(2)(a)(i)); or
- not of such a nature as to prejudice the position of creditors or shareholders (s 588FM(2)(a)(ii)).

The court may also extend the time for registration if it is just and equitable to do so: s 588FM(2)(b).

*Re Appleyard Capital Pty Ltd* [2014] NSWSC 782

**[11.210]** The Supreme Court of NSW held that the grounds for relief under s 588FM(2)(a)(i) and (ii) are alternate grounds. Brereton J stated (at [29]–[30]):

The fact that absence of prejudice to creditors is an alternative ground for relief (s 588FM(2)(a)(ii)) indicates that it was not intended that relief from accident or inadvertence be granted only where there is no prejudice to creditors.

Thus, although I accept, as the authorities make clear, that the presence or absence of prejudice to unsecured creditors is a relevant discretionary consideration, relevant prejudice is not necessarily established merely by showing that the dividend to unsecured creditors will be less if the security interest does not vest in the company; the unsecured creditors may well have

been in no different a position had the security interest been timely registered. The type of prejudice that is of particular relevance is prejudice attributable to the delay in registration, rather than prejudice from making the order (which is inevitable).

### *Re Accolade Wines Ltd* [2016] NSWSC 1023

**[11.215]** A financier was granted security interests by a number of grantor companies in respect of PPS leases. A review of the financing statements that an external consultant of the financier's solicitors registered, revealed that the financing statements incorrectly referred to the ABNs of the grantor companies instead of their ACNs. Under the *PPS Act*, the failure to include the grantors' ACNs meant that the initial financing statements were ineffective. As a result the financier failed to register the security interests within 20 business days after the security agreements came into force so that those interests would vest in the grantor companies if they went into liquidation or voluntary administration within six months of their ultimate registration. On discovering the defects, the financier lodged new financing statements and applied to the court to extend the time for registration under s 588FM(2)(a)(i) on the grounds of inadvertence.

In granting the extension the court noted that bona fide attempts to register the financing statements had been made; there was evidence that the common practice of secured creditors who searched the PPS register was to check ABNs as well as ACNs; none of the grantor companies were in insolvent administration at the time of the court hearing and it was unlikely that this would occur within six months of the initial registration date, and hence, it did not appear that creditors would have been prejudiced by the delay in gaining effective registration.

## Tutorial questions

1. No-Cal Foods Pty Ltd was a family company that marketed meals for dieters. Its directors were Caroline and Herbert. Herbert owned the majority of the company's shares. There had recently been a worrying fall in business and an advertising campaign aimed at male dieters was planned. Caroline, the independently wealthy wife of Herbert, agreed to lend the company the necessary funds for the campaign. Under the security agreement, the loan was repayable on demand and was secured by a circulating security interest over the company's inventory. Two months later, Caroline discovered Herbert's longstanding affair with his secretary and demanded immediate repayment of the loan. No-Cal Foods Pty Ltd was unable to comply with this demand, and Caroline exercised her right under the loan agreement and appointed a receiver to take possession and sell the company's inventory.

Explain how the *Corporations Act* affects Caroline's security interest in these circumstances.

2. On 18 February, Milder Pty Ltd borrowed \$1 million from Able Finance Company. Under the security agreement, the loan was secured by a circulating security interest over the company's inventory and fleet of vehicles. Due to an administrative oversight this security interest was not registered until 25 April.

On 26 February, Milder Pty Ltd borrowed \$80,000 from Beta Finance Company. This was also secured by a circulating security interest over the company's personal property and was registered on 27 February.

Milder Pty Ltd was adversely affected by a change in government policy in June and fell into financial difficulties. Later that month Miller, a director of the company, who was owed \$120,000 in consideration for transferring assets to the company, was granted a circulating security interest in respect of the debt.

In July, Milder Pty Ltd went into liquidation, and it is apparent that there are insufficient funds available to pay all secured creditors in full.

Advise the liquidator of the respective rights of:

- (a) Able Finance Company;
- (b) Beta Finance Company; and
- (c) Miller.

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.
- For further corporations law links and material refer to the Understanding Company Law website at <http://www.uclaw.com.au>.





## Chapter 12

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# The board of directors

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## Key points

- The definition of “director” is broad, and in addition to persons appointed to that position it also includes those who act as directors, described as *de facto* and shadow directors. There are different types of directors reflecting the different roles directors may play on a board of directors. A board may form committees to which particular areas of responsibility are delegated.
- The two organs of a company are the board of directors and the general meeting of shareholders. The constitution, replaceable rules, *Corporations Act 2001* (Cth) and Australian Securities Exchange Listing Rules determine the respective powers of the board and the general meeting. The board nearly always has the power of management of the business of the company as well as a number of ancillary powers.

- The power of management is very broad and the general meeting cannot interfere with the exercise of this power. Shareholders, however, generally have the power to remove directors.
- Directors exercise their powers collectively at board meetings. Generally, the directors determine how board meetings are to be conducted. Because the legal rights of shareholders may be affected by board decisions, board meetings must comply with certain procedural rules in order to pass valid resolutions.
- Directors are generally appointed by resolution of the general meeting.
- A person may be disqualified by the court or ASIC from acting as a director so as to protect the public from directors who have committed certain offences or been involved with insolvent companies.
- Directors may only be removed in accordance with the constitution and, in the case of public companies, by resolution of the general meeting.
- The company secretary is the company's chief administrative officer with responsibility over the company's internal administration and compliance matters.

## Introduction

**[12.05]** All companies must have directors. The directors are collectively referred to as a “board of directors”. Proprietary companies need only have one director: s 201A(1). Public companies must have at least three directors: s 201A(2). The initial directors are those persons named with their consent in the application for registration of the company: s 120(1). Subsequent appointments of directors may be made in accordance with the company’s constitution (if any) or replaceable rules contained in ss 201G and 201H.

A company consists of two components or organs:

- the board of directors; and
- the members in general meeting.

The ability of either of these organs to act as the company depends on the division of power between the board of directors and the members in general meeting and the extent of authority bestowed on them by the replaceable rules, the company’s constitution (if any) or the *Corporations Act 2001* (Cth) (*Corporations Act*).

## Who is a director?

### Section 9 definition

**[12.10]** A director of a company is defined in s 9 as a person who is appointed to the position of a director or alternate director regardless of the name given to their position. The s 9 definition also regards certain persons to be directors even though they have not been validly appointed.

A person may be regarded as a director even though that person has not been appointed to that position.

Unless the contrary intention appears, a person who has not been validly appointed as a director can also be regarded as a director if:

- they act in the position of a director (“de facto director”); or
- the directors are accustomed to act in accordance with the person’s instructions or wishes (“shadow director”).

Determining whether a person is a de facto or shadow director is important where statutory duties are imposed on directors such as in s 588G, which imposes a duty to prevent insolvent trading. A de facto or shadow director may breach this duty and be held liable even though that person has not been validly appointed as a director. The *Corporations Act* also imposes duties on “officers”, especially the main statutory duties contained in ss 180–183. The s 9 definition of officer includes directors whether they be validly appointed or de facto or shadow directors.

According to the note in the s 9 definition of director, the following provisions of the *Corporations Act* are examples of where a contrary intention excludes a de facto director or shadow director from being treated as a director:

- s 249C (power to call meetings of a company's members);
- s 251A(3) (signing minutes of meetings); and
- s 205B (notice to Australian Securities and Investments Commission (ASIC) of a change of a director's personal details such as address).

ASIC may ask a person to inform it whether they are a director or secretary of a particular company: s 205E. Where the person has ceased to be a director or secretary, ASIC may ask the date when this occurred.

## De facto directors

**[12.15]** A director includes persons who act in the position of a director even though they have not been appointed to that position: s 9. These are referred to as “de facto” directors.

In *DFC of T v Austin* (1998) 16 ACLC 1555, Madgwick J said that it is not practicable to formulate a general statement as to what constitutes “acting as a director”. This often involves a question of degree requiring a consideration of the actual functions and duties performed in the context of the operations and circumstances of the company, rather than specific actions looked at in isolation or the job description of the person. A necessary condition of acting as a director is that the person has exercised top level management functions. In the case of a small company, where a person has acted as the company in relation to important matters, this may indicate the person has acted in the capacity of a director. In the case of a large company, many important matters are delegated to employees and the exercise of such discretions does not necessarily indicate that the person is a director.

A person may be regarded as a de facto director if the person is the driving force behind the company business despite not having been appointed to that position, or continues to participate in the management of the company, as if still a director, after the expiration or cessation of the term of appointment: *Corporate Affairs Commission v Drysdale* (1978) 141 CLR 236. A person may also be a de facto director if held out by the company as a director (*Grimaldi v Chameleon Mining NL (No 2)* [2012] FCAFC 6), or if outsiders reasonably perceive the person to be the manager or director of the company (*Chameleon Mining NL v Murchison Metals Ltd* [2010] FCA 1129).

In *Grimaldi v Chameleon Mining NL (No 2)* [2012] FCAFC 6, it was held that a person who had been designated as a “consultant” could be found to be a de facto director. The determination of whether such a person is “acting in the position of a director”, and thereby within the s 9 definition of director, depends on the nature and extent of the functions to be performed, both in and beyond the consultancy, and on the constraints imposed on them. A person acting under a limited and specific consultancy is unlikely to be regarded as a director. Whereas a person acting under a general and unconstrained consultancy, under which that person is permitted to take an active part in directing the affairs of the company, even if not necessarily on a full-time basis, is more likely to be found to be a director.

## Shadow directors

**[12.20]** As noted at [12.10], the s 9 definition of director includes persons who act as “shadow” directors. These are persons whose instructions or wishes are customarily

followed by the directors of a company. A person is not regarded as a director merely because the directors act on advice given by the person in the performance of functions attaching to the person's professional capacity, or the person's business relationship with the directors.

### *ASIC v King* [2020] HCA 4

**[12.21]** The High Court gave a wide construction in determining whether someone was an “officer” for the purposes of the s 9 definition. The term “officer” includes directors. The court held that the term “officer” is not limited to those holding a named office or recognised position with rights and duties attached to it. It also includes a person who has engaged in management of the corporation and has the capacity to influence the directors. Management is distinct from the day-to-day running of the business of the corporation. It involves the formulation of policy and significant decision-making. It is a question of fact in determining whether a person has the requisite capacity to significantly affect the company's financial standing under part (b) of the definition. In this case the CEO of a holding company, who was “overall boss of the group”, had the requisite capacity and assumed overall responsibility for the subsidiary and so was an officer of the subsidiary. The term “officer” is discussed at [13.20].

**[12.22]** A body corporate can be a shadow director: *Standard Chartered Bank of Australia Ltd v Antico* (1995) 38 NSWLR 290. Therefore a holding company may be a “shadow” director of a subsidiary if the directors of the subsidiary are nominee directors who customarily follow the holding company's directions or instructions. A person may be a shadow director without necessarily exercising influence or control over the whole field of the company's activities: *Ho v Akai Pty Ltd* [2006] FCAFC 159. The influence or control may be of a broad strategic nature or instrumental in arranging for the company to enter into significant transactions: *ASC v AS Nominees Ltd* (1995) 62 FCR 504.

A creditor may be a shadow director of a company where the directors of the company are accustomed to act in accordance with the creditor's instructions or wishes as to how they should act. However, a creditor will not be a shadow director merely because the directors of the company feel obliged to comply with conditions imposed by that creditor in commercial dealings with the company: *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd* [2010] NSWSC 233.

## Types of directors

### Managing directors

**[12.25]** Many companies have a managing director or chief executive officer (CEO) who is put in charge of managing the company's regular business. The replaceable rules allow the directors to appoint one or more of themselves to the office of managing director: s 201J. A managing director may be conferred with any of the powers that the directors can exercise: s 198C. Company constitutions usually have similar provisions.

A managing director is in charge of managing the company's regular business.

A managing director performs a vital role. In large companies it is impractical for the board to actively carry out daily management, and so it delegates its management function to the managing director who leads the senior management or executives and is accountable to the board. The respective functions and roles and the relationship of the board and managing director are important corporate governance issues. Corporate governance best practice is discussed in Chapter 14.

A managing director is generally assumed by those dealing with the company to have wide authority to bind the company. The customary authority of a managing director is discussed at [5.340].

## Chair of directors

**[12.30]** The replaceable rule in s 248E provides that the directors may appoint a director to chair directors' meetings and an individual may be elected by the directors to chair meetings of the company's members: s 249U. Minutes must be signed by the chair of the meeting or the chair of the next meeting: s 251A(2). The chair has a casting vote at directors' meetings: s 248G(2). Typically, company constitutions make little further mention of the chair.

The chair is responsible for exercising procedural control over a meeting: *Woonda Nominees Pty Ltd v Chng* [2000] WASC 173.

The chair exercises procedural control over a meeting.

The exercise of procedural control over meetings includes nominating who speaks, dealing with the order of business, putting questions to the meeting, declaring resolutions to be carried or defeated, asking for general business and closing the meeting: *Kelly v Wolstenholme* (1991) 9 ACLC 785. In exercising procedural control over a general meeting, the chair must act honestly and bona fide.

*Colorado Constructions Pty Ltd v Platus* [1966] 2 NSW 598

**[12.35]** A board meeting had been convened but arguments developed as to who was to assume the chair. Two of the directors left after a brawl developed. The remaining directors continued and purported to pass a resolution. When this was challenged, the court held that as no chair had been appointed, no valid meeting passing the resolution had occurred. Street J considered the role of chair:

It is an indispensable part of any meeting that a chairman should be appointed and occupy the chair. In the absence of some person (by whatever title he be described) exercising procedural control over a meeting, the meeting is unable to proceed to business. This may perhaps require some qualification if all present are unanimous. And, in a small meeting, procedural control may pass from person

to person according to who for the time being is allowed by the acquiescence of those present to have such control. But there must be some person expressly or by acquiescence permitted by those present to put motions to the meeting so as to enable the wish or decision of the meeting to be ascertained.

The chair is often given special powers which go beyond the supervision of meetings.

**[12.40]** In practice, the chair is often given special powers which go beyond the supervision of meetings, and in listed public companies, the position carries important corporate governance responsibilities including formulating the policies of the board and promoting the position of the company.

In *ASIC v Rich* [2003] NSWSC 85, Austin J thought it appropriate to consider corporate governance literature and best practice in determining the special responsibilities of the chair for the purposes of determining whether a chair had breached a duty of care. This duty is discussed in Chapter 17. These sources indicate that among other things, a chair of a listed company is responsible to a greater extent than any other director for ensuring that the board is properly informed, familiar with the financial circumstances of the company and the board properly meets its supervisory duties.

Austin J described the specific responsibilities of the Chair to include:

- the general performance of the board;
- the flow of financial information to the board (including information about cash reserves, actual segment performance and key transactions);
- the establishment and maintenance of systems for information flow to the board; and
- making recommendations to the board as to prudent management of the group.

## Executive, non-executive and independent directors

**[12.45]** The boards of many companies, particularly large listed companies, often comprise executive directors and non-executive directors. The courts acknowledge that the two types of directors have different roles and functions within the company.

### Executive directors.

Executive directors are full-time employees who have significant management and administrative functions. The company's CEO or managing director is the leader and most senior member of the management team. Executive directors, other than the CEO, may include the company's chief finance officer and other senior executives.

### Non-executive directors.

Non-executive directors are not directly involved in the day-to-day management of the company's business. They have a part-time, intermittent role in the company that



is usually performed at periodic board meetings and at meetings of board committees which are usually comprised largely of non-executive directors. Non-executive directors have an important role in monitoring the activities of the management team headed by the CEO and in approving strategy plans.

It is a question of fact whether a person is an executive director or non-executive director: *AIG Australia Ltd v Jaques* [2014] VSCA 332. The essential element of the distinction is whether the director is performing executive functions in the management and administration of the company. A person is regarded as an executive director if the evidence shows that the company has conferred executive powers in relation to management and administration on the person. In the absence of some further authority conferred upon a director by the company, be it under a contract of employment, a service agreement, or via an express delegation or acquiescence in a director's exercise of executive powers, the director should generally be treated as a non-executive director.

|                                      |
|--------------------------------------|
| Independent non-executive directors. |
|--------------------------------------|

There are two types of non-executive directors – affiliated non-executive directors and independent non-executive directors. An affiliated non-executive director has a present or previous connection with the company as a former executive or a significant shareholder or is, or has been, in a material business relationship with the company. A person is regarded as an independent non-executive director if that person is independent of management and does not have any business or other relationship that could materially interfere with, or be reasonably seen as interfering with, their independent judgment. As discussed at [14.40] the Australian Securities Exchange (ASX) *Corporate Governance Principles and Recommendations* (4th ed) recommends that a majority of the directors of a listed company should be independent non-executive directors. This recommendation seeks to enhance the effectiveness of the board in monitoring the activities of the company's management, providing independent judgment and dealing with sensitive situations such as where conflicts of interest arise or where the interests of management and the company as a whole diverge. Examples of such situations may arise in relation to remuneration of executives, related party transactions, approval of financial statements and board succession planning. The ASX *Corporate Governance Principles and Recommendations* (4th ed) recommends that these types of issues, as well as safeguarding the integrity of the company's financial reporting processes and the internal audit and risk management functions of the board, are most effectively dealt with by board committees comprising a majority of independent non-executive directors.

The ASX *Corporate Governance Principles and Recommendations* (4th ed) is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## Alternate directors

**[12.50]** Company constitutions often provide for the appointment of alternate directors. For example, the replaceable rule in s 201K(1) provides that a director may, with the approval of the other directors, appoint an alternate to exercise some or all of the director's powers. The appointment of an alternate allows for a replacement where a director is unable to attend board meetings or otherwise exercise powers as a director.

ASIC must be given notice of the appointment and termination of appointment of an alternate director: s 205B(2) and (5). Where an alternate director exercises a director's powers, this exercise of powers is as effective as if exercised by the director: s 201K(3).

The alternate director has no legal status whenever the director for whom the alternate acts is present at a board meeting.

Alternate directors come within the s 9 definition of “director” and are subject to the same fiduciary and statutory duties any director owes to their company: *Markwell Bros Pty Ltd v CPN Diesels (Qld) Pty Ltd* [1983] 2 Qd R 508. Directors' duties are discussed in Chapters 13–18.

## Nominee directors

[12.55] Sometimes a director is appointed to represent the interests of a particular shareholder or creditor on the board of directors. Such directors are sometimes referred to as “nominee directors”.

A holding company usually has power to appoint directors to the board of its subsidiary companies. In such cases, the subsidiary's directors may be nominees of the holding company. In the case of companies formed to carry out a joint venture, it is usual for each of the parties to have the right to nominate a specified number of nominees as directors. Where directors are appointed to represent sectional interests, there may be a conflict of interest and the question that may arise is to whom the director primarily owes duties – the company or the person who appointed them. The duties of nominee directors are discussed at [15.55].

## Key management personnel

[12.60] As discussed at [12.295]–[12.310], details of the remuneration and other benefits paid to the “key management personnel” of listed and unlisted companies must be disclosed. The term “key management personnel” has the same meaning as in the accounting standards: s 9. According to accounting standard AASB 124 *Related Party Disclosures* at [9], “key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity”. This definition makes it clear that some senior managers as well as directors are regarded as key management personnel for purposes of the remuneration disclosure requirements.

## Functions and powers of the board

[12.65] In the case of large organisations, and listed companies in particular, the board plays a crucial corporate governance role by setting the direction of the company and holding its management accountable. The powers of the board are determined by the replaceable rules, the company's constitution (if any) and the *Corporations Act*. Usually, the board is given a broad power of management. The shareholders typically have the power to appoint or replace the directors.

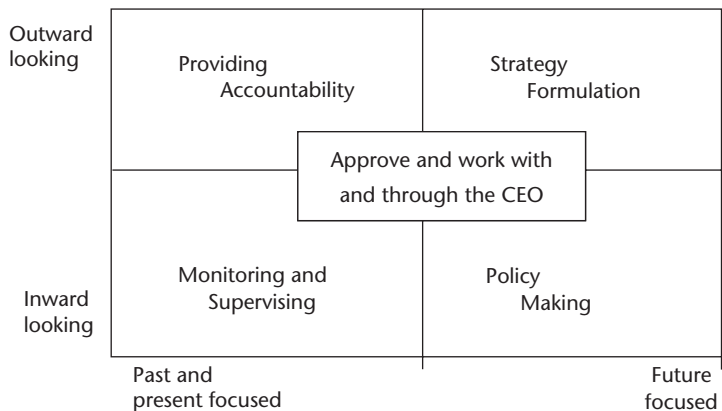
## Functions of the board

[12.70] The essential functions of the board are to provide leadership and set the company's strategic objectives and monitor management. Recommendation 1.1 of the *ASX Corporate Governance Principles and Recommendations* (4th ed) suggests that a listed company should establish and disclose the respective roles and responsibilities of its board and management. The company should also disclose those matters expressly reserved to the board and those expressly delegated to management. Articulating the division of responsibilities between the board and management helps those involved to more clearly understand their respective roles.

The Commentary to Recommendation 1.1 acknowledges that the nature of matters reserved to the board and those delegated to management will depend on the size, complexity and ownership structure of the company and will be influenced by its history and corporate culture and by the respective skills of directors and management. The Commentary sets out a number of usual responsibilities of the board. These are set out at [14.35].

The *ASX Corporate Governance Principles and Recommendations* (4th ed) may be accessed on the ASX website, which is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>. Corporate governance is discussed in Chapter 14.

**Figure 12.1: Board functions**



Source: Bob Tricker *Corporate Governance: Principles, Policies and Practices* (4th ed, Oxford University Press, 2019) p 180.

In Figure 12.1, Tricker compartmentalises the important functions performed by the board according to whether they are future-focused or past- and present-focused and whether they have an inward- or outward-looking perspective. Therefore, future-focused concerns include the board's involvement in formulating strategy. This involves identifying the company's core purpose and values and establishing its direction. Once strategy is formulated, a board has an inward-looking policy-making responsibility,

including the creation of a corporate culture. The board's function in this respect is to ensure that the company has appropriate rules, procedures and systems in place to guide managers' decision-making. Past and present focuses include monitoring and supervision of management and ensuring the organisation is accountable to external stakeholders.

One of the most important functions of the board is appointing and (if necessary) removing the CEO.

The function of the board that is generally regarded as the most important of all is the appointment of the CEO. This appointment has major implications for all the other board functions.

Another way of categorising the functions and roles of the board set out in Figure 12.1 is to distinguish between the performance and conformance functions of the board. The performance function involves tasks such as formulating strategies and determining policies. A board's conformance function involves monitoring and supervising management and holding it accountable. How boards balance their conformance and performance functions differ from company to company. Some boards are actively involved in determining strategy and so are directly involved in the performance of the company. Other boards take a lesser role in formulating strategy, which is largely delegated to senior management. Such boards focus on their conformance role, which includes establishing a corporate governance framework and ensuring compliance with corporate governance procedures and practices.

## The power of management

**[12.75]** The replaceable rule in s 198A states that the business of a company is to be managed by, or under the direction of, its directors who may exercise all the company's powers except any powers that the *Corporations Act* or the company's constitution (if any) requires the company to exercise in general meeting. The constitutions of most companies give the directors similar wide management powers.

The replaceable rule in s 198A states that the business of a company is to be managed by, or under the direction of, its directors.

The scope of the management power in s 198A is extremely broad. It includes changing the direction of the company or selling the only business carried on by it. Directors of unlisted companies do not have to obtain shareholder approval to sell the company's only business: *Strong v J Brough & Son (Strathfield) Pty Ltd* (1991) 9 ACLC 1018.

ASX Listing Rules give shareholders of listed companies a vote on significant management decisions. For example, under Listing Rule 11.1, the ASX may require shareholder approval if a listed company proposes to make a significant change to the nature or scale of its activities. Further, Listing Rule 11.2 requires shareholder approval if the significant change involves the company disposing of its main undertaking.

The constitutions of some companies permit management of the company's business to be delegated to a management company. The replaceable rules and the constitution (if any) also confer various specific powers on the board of directors which complement, or are incidental to, the power of management. Table 12.1 sets out the important powers of the board. These powers are conferred on the directors as a board and not on individual directors.

**Table 12.1: Powers of the board**

|                                     |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        |
|-------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Management                          | The replaceable rule in s 198A(1) gives the directors the power to manage the business of the company. It is extremely common for directors to be given similar broad management powers in a company's constitution.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |
| Company's powers                    | The replaceable rule in s 198A(2) provides that directors may exercise all the powers of the company except any powers that the <i>Corporations Act</i> or the company's constitution requires the company to exercise in general meeting. For example, directors may issue shares or debentures and borrow money on the company's behalf. They may also make calls on partly paid shares.                                                                                                                                                                                                                                                                                                                                                             |
| Delegation of powers                | Section 198D provides that unless the company's constitution provides otherwise, the directors may delegate any of their powers to a committee of directors, a director, an employee or any other person. In addition, the replaceable rule in s 198C gives the directors the power to confer any of their powers on a managing director.                                                                                                                                                                                                                                                                                                                                                                                                              |
| Registration of transfers of shares | As discussed in Chapter 9, a person transferring shares remains the holder of the shares until the transfer is registered and the name of the transferee is entered in the company's share register. The replaceable rule in s 1072F gives directors the power to register transfers of shares.<br><br>Under s 1072F(3) they may refuse to register a transfer of shares if the shares are not fully paid or the company has a lien on the shares. The replaceable rule in s 1072G, which applies to proprietary companies, enables directors to refuse to register a transfer of shares for any reason.<br><br>Directors may also suspend registration of transfers of shares for periods not exceeding 30 days in any one calendar year: s 1072F(4). |
| Calling meetings                    | The replaceable rules set out the requirements for convening directors' and members' meetings. Section 248C allows a director to call a directors' meeting by giving reasonable notice individually to every other director. A director may also call a meeting of the company's members: s 249C. Members' meetings are discussed in Chapter 21.                                                                                                                                                                                                                                                                                                                                                                                                       |
| Dividends                           | The replaceable rule in s 254U gives directors the power to determine that a dividend is payable. They may also fix the amount, the time for payment and the method of payment. Dividends are discussed in Chapter 10.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
| Execute documents                   | Under s 127(1), a company may execute a document without using a common seal if the document is signed by:<br><br>– two directors; or                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |

Table 12.1: (cont).

|                        |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               |
|------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                        | <ul style="list-style-type: none"><li>– a director and a company secretary; or</li><li>– in the case of a proprietary company that has a sole director who is also the sole secretary – that director.</li></ul> <p>A company with a common seal may execute a document if the seal is affixed to the document, and the fixing is witnessed by the people listed above: s 127(2).</p> <p>A person who has dealings with a company is able to assume that a document that appears to be executed in accordance with either s 127(1) or (2) is properly executed even if the signatories do not have authority to sign: s 129(5) and (6). The s 129 assumptions are discussed in Chapter 5.</p> |
| Negotiable instruments | According to the replaceable rule in s 198B, any two directors of a company that has two or more directors, or the director of a proprietary company that has only one director, may sign, draw, accept, endorse or otherwise execute negotiable instruments such as company cheques and bills of exchange.                                                                                                                                                                                                                                                                                                                                                                                   |

## Shareholders cannot override management decisions

**[12.80]** If the board has full management powers, as is usually the case, shareholders cannot override the directors and involve themselves in the management of their company. It is also improper for shareholders to propose a non-binding advisory resolution that purports to express their opinion on how directors should exercise their management powers: *NRMA v Parker* (1986) 6 NSWLR 517. Shareholders’ limited rights to propose and vote on resolutions at general meetings are further discussed at [21.40].

Shareholders cannot override the directors and involve themselves in the management of their company.

### *Automatic Self-Cleansing Filter Syndicate Co v Cunninghame* [1906] 2 Ch 34

**[12.85]** The directors of a company were ordered by a general meeting to sell the company’s property. The directors refused to do this, relying on a provision in the constitution similar to s 198A. The members argued that the constitution was subject to the overriding rule that the directors, as agents of the company, were obliged to follow the instructions of their principal, the company; the will of the company being a resolution of the general meeting. The Court of Appeal rejected this argument. It held that the directors were not agents of the shareholders and so the directions of the general meeting could be ignored by the directors. The constitution gave management powers to the board of directors, which included the power to sell the company’s property. The members could not interfere with the directors in this respect as they were contractually bound by the constitution.

**[12.90]** This principle was applied to prevent an attempt by a general meeting to override a decision of the board to bring legal actions against some of the directors. The court held that the board of directors was properly exercising the powers of management vested in it by the constitution and the general meeting could not usurp this power: *John Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 KB 113.

If the directors purport to exercise a power that should properly have been exercised by the general meeting, their action can be ratified by an ordinary resolution of the general meeting and the improper exercise of power becomes valid. The power of the general meeting to ratify the actions of the directors is discussed at [20.05]–[20.20].

## Separation of ownership and management

**[12.95]** The conferral of wide powers of management on the board of directors is a central aspect of the separation of ownership and management and is a universal characteristic of the corporate model. Ownership, in an economic but not in a legal sense, vests in the shareholders. This separation between ownership and management is an important difference between companies and partnerships, as partnership law presumes that all partners have a right to participate in management.

The board's wide powers of management is central to the separation of management and ownership.

In the case of large, public companies, it is an essential feature that management vests in the board of directors. Where there are large numbers of shareholders, it would obviously be unworkable if the general meeting had the power to manage the company on a day-to-day basis or interfere with the board's power of management.

From an economics perspective, the separation of ownership and control raises conflict of interest problems, in particular, the possibility that management may act in its own interests in ways which may not be in the interests of the shareholders.

The interests of management may diverge from the interests of the shareholders.

For example, management may have an interest in maximising short-term profits and their own remuneration, while this may not be in the shareholders' longer term interests. The increased interest in corporate governance reflects higher expectations by the public and the investment community that greater efforts should be made by listed public companies to develop structures and procedures to ensure management is effective, acts in the interests of shareholders and adopts appropriate standards of corporate behaviour. Corporate governance is discussed in Chapter 14.

These concerns stemming from the separation of ownership and management do not apply to small proprietary companies. These companies have usually evolved from sole traders or partnerships, and even after incorporation they continue to function much

as they did before. The directors of such companies are usually also its shareholders. As in the case of partnerships, the shareholders are few in number and generally continue to participate to some degree in management. In practice this means that in proprietary companies, there is no separation of management and ownership; however, to meet the requirements of the *Corporations Act*, the distinction between members in general meeting and directors is maintained even if it is very often a largely fictional distinction. The *Corporations Act* sometimes recognises this, for example it allows the existence of proprietary companies with a single director who is also the sole shareholder and generally does not require proprietary companies to hold annual general meetings, as in most cases, they are unnecessary.

## Board procedure

### Directors' meetings

**[12.100]** Directors exercise their powers by making decisions and passing resolutions at board meetings. The rules governing directors' meetings 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. The courts generally require adherence to these rules because resolutions of the board may affect the legal and financial rights of shareholders, directors and the company. In order to be valid, board meetings require broad compliance with procedural rules which aim to ensure that meetings are fairly conducted.

Directors exercise their powers and make decisions by passing resolutions in board meetings.

A board meeting of a company with more than one director requires more than the directors meeting together informally to discuss the company's affairs. According to *Petsch v Kennedy* [1971] 1 NSWLR 494, a discussion between directors will not amount to an effective directors' meeting unless the directors are aware, before proceeding to business, that the occasion is to be a directors' 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.

A directors' meeting does not mean that the directors have to be physically present in the one place. For example, a directors' meeting can take place using teleconferencing or video-conferencing technology. Section 248D permits a directors' meeting to be called or held using any technology consented to by all directors. The consent may be a standing one. A director may only withdraw their consent to such a meeting within a reasonable period before the meeting. Where a directors' meeting takes place in circumstances where not all directors are physically present in one place, each participating director must be able to hear and be heard by every other participating director for the duration of the meeting. Each participating director must also be able to see the contents of any document that is tabled or discussed: *Gillfillan v ASIC* [2012] NSWCA 370.



## Resolutions

**[12.105]** Directors make decisions at board meetings by passing resolutions. The replaceable rule in s 248G provides that a directors' resolution must be passed by a majority of the votes cast by directors entitled to vote on the resolution. The chair has a casting vote if necessary, in addition to any vote they have in their capacity as a director: s 248G(2).

The aim of board meetings is not for directors to consult together for the purpose of reaching a consensus. Rather, the aim is for directors to consult together for the purpose of forming individual views about the matters that are under consideration. The procedures adopted for passing resolutions at board meetings must allow each director to communicate their vote and have that vote taken into account. A statement by the chair after discussion of a proposal that "I think we are all agreed on that" should be supplemented by the appropriate formality of a recorded vote: *Gillfillan v ASIC* [2012] NSWCA 370.

## Resolutions without meetings

**[12.110]** Directors may pass resolutions without a physical meeting being held by passing a circulating resolution. According to the replaceable rule in s 248A, a resolution of directors can be passed if all the directors entitled to vote on the resolution sign a document containing a statement that they are in favour of the resolution set out in the document. The resolution is passed when the last director signs: s 248A(3). Separate documents may be used for signing by directors if the wording of the resolution and statement is identical in each copy: s 248A(2).

A single director proprietary company obviously does not have directors' meetings. Under s 248B, the sole director may pass a resolution by recording it and signing the record.

## Notice of board meetings

**[12.115]** As a general rule, all directors must receive notice that a board meeting has been convened: *Petsch v Kennedy* [1971] 1 NSWLR 494. The replaceable rules and constitution (if any) specify the notice requirements. The replaceable rule in s 248C permits a directors' meeting to be called by a director giving reasonable notice individually to every other director. The frequency of board meetings is usually a matter for the directors to decide. It is common practice for companies to hold board meetings at regular fixed dates.

Notice to a director may be dispensed with if the director is not "within reach of notice". This is determined by having regard to modern means of communication. Notice of each meeting is not, however, necessary if the constitution or the directors set regular fixed meetings.

The amount of notice must be in accordance with the constitution (if any) or be fair and reasonable in light of the practice of the directors of the particular company: *Toole v Flexihire Pty Ltd* (1992) 10 ACLC 190.

In relation to the contents of the notice of a board meeting, the requirements correspond to those applicable to notices of general meetings. As discussed in Chapter 21, a notice of

meeting must contain a clear and full summary of the business to be dealt with. This is to enable recipients of notice to decide whether they should attend: *Devereaux Holdings Pty Ltd v Pelsart Resources NL* (1986) 4 ACLC 12. In *Jenashare Pty Ltd v Lemrib Pty Ltd* (1993) 11 ACLC 768, the proceedings of a board meeting were void because the notice of meeting made no mention of business to be considered by the meeting.

If notice of a board meeting is required but is not given, the meeting is irregular. The irregularity, however, cannot be used against outsiders. A person dealing with the company may presume that the company's constitution and any applicable replaceable rules have been complied with: s 129(1). This is discussed at [5.240].

A directors' meeting may be called or held using any technology consented to by all the directors. The consent may be a standing one and may only be withdrawn within a reasonable period before the meeting: s 248D.

## Quorum

**[12.120]** A quorum is the minimum number of directors required for a valid meeting. The replaceable rules and constitution (if any) specify how many directors constitute a quorum for a valid board meeting. The replaceable rule in s 248F provides that the quorum is two directors unless the directors determine otherwise. The quorum must be present at all times during the meeting.

*Mancini v Mancini* [1999] NSWSC 799

**[12.125]** A divorced husband and wife were the only directors of three companies. The wife sought to remove the husband as a director at meetings of the directors of the companies, at which the husband was not present. The resolutions removing the director were invalid for a number of reasons, including the lack of a quorum. The constitutions of the companies provided for a quorum of two. This requirement was not satisfied by the presence of one director who also purported to act as a delegate of another.

|                       |
|-----------------------|
| Interested directors. |
|-----------------------|

**[12.130]** A company's constitution may permit it to have a quorum of just one director: *Gosford Christian School Ltd v Totonjian* [2006] NSWSC 725. The directors constituting the quorum must be entitled to vote on the matters discussed at board meetings. Thus, if the meeting is to consider whether the company should enter into a contract in which a particular director has an interest, that director is ineligible to vote and accordingly is not counted for the purpose of making up the quorum: *Re Austplat Minerals NL* (1990) 2 WAR 289.

Section 195 prohibits a public company director from being present and voting at board meetings where a matter in which the director has a material personal interest is considered. The interested director does not count for the purpose of a quorum.

## Minutes

**[12.135]** Proceedings and resolutions of directors' meetings, including meetings of a committee of directors, must be recorded in the company's minute book: s 251A(1)(b). The minute book should also record circulating and other resolutions passed by directors without a meeting: s 251A(1)(d). 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). Minutes of shareholders' meetings are discussed at [21.195].

Information required to be recorded in a minute book can be recorded in electronic form as long as it is readily accessible and useable for later reference: s 253S(1).

## Committees of the board

**[12.140]** Companies often delegate various board functions to committees of directors. This delegation is permitted by s 198D. A committee must exercise the powers delegated to it in accordance with any directions of the board. The effect of the committee exercising a power in this way is the same as if the board exercised it. Proceedings and resolutions of a committee must be recorded in the company's minute book: s 251A(1)(b).

The main reasons for the establishment of board committees are to ensure that important matters are given full attention, the workload of the board is effectively distributed, and non-executive directors make effective contributions in areas requiring independent judgment. For this reason, committees will often comprise at least a majority of independent non-executive directors.

The most common committees are the audit, remuneration and nomination committees.

As discussed in Chapter 14, the *ASX Corporate Governance Principles and Recommendations* (4th ed) recommends that listed companies should have an audit committee, a remuneration committee, a nomination committee and a risk committee. Audit committees are discussed at [14.60], remuneration committees at [14.80], nomination committees at [14.50] and risk committees at [14.70].

## Appointment of directors

**[12.145]** Section 201A requires a proprietary company to have at least one director and a public company must have at least three directors. It appears that where the number of validly appointed directors falls below the minimum numbers specified in s 201A, purported acts of the board such as passing resolutions, are invalid; however, the court may validate such an irregularity under s 1322(4): *Gosford Christian School Ltd v Totonjian* [2006] NSWSC 725. The first directors are the people named as such in the application for registration of a company: s 120(1).

## Director identification number

**[12.147]** A director identification number (DIN) is a unique identification number that is issued to individuals after they have established their identity: s 1272. Directors are required to have a DIN: s 1272C. This requirement is a civil penalty provision and a strict liability offence: s 1272C(4) and (5). A person appointed as a director, or who intends becoming a director within 12 months, may apply for a DIN, unless they already have one: s 1272A(1). The registrar may direct a director to apply for a DIN: s 1272A(2). The director must then apply for a DIN within 28 days or such longer period as the registrar allows. Failing to do so also attracts a civil penalty: s 1272D. A person is prohibited from knowingly applying for multiple DINs (s 1272G) and misrepresenting a DIN to a government or registered body: s 1272H. The legislation also provides for the issue of infringement notices under s 1272F.

The DIN allows the regulator to trace an individual director's identity and to link individuals to the companies of which they are, or have been, a director. This assists the regulator to better track directors of failed companies, detect illegal "phoenixing" and other dishonest activities, and improve the quality of corporate data. Phoenix companies are discussed at [18.55]–[18.83]. The Treasury proposals paper, "Combatting Illegal Phoenixing" (2017), is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## Who may be appointed?

**[12.150]** Persons under the age of 18 years cannot be appointed as directors: s 201B(1). A director cannot be a body corporate but must be a natural person.

At least two directors of a public company must ordinarily reside in Australia. In the case of a proprietary company, at least one director must reside in Australia: s 201A(1) and (2). A person may be a director of more than one company. The same person may be both a director and secretary of a company.

A holding company that does not formally hold office as a director of its subsidiary may nevertheless be regarded as a "shadow" director for the purpose of owing duties to the subsidiary. As discussed at [12.20]–[12.22], a company can be held liable as a shadow director even though it is unable to be formally appointed.

The requirement that a director must be a natural person does not apply to Corporate Collective Investment Vehicles (CCIV). The sole director of a CCIV must be a public company that holds an Australian financial service licence authorising it to operate a CCIV: s 1222. CCIVs are discussed in Chapter 27.

## Consent

**[12.155]** A director must consent in writing to being appointed to the position. The company must keep a copy of the consent but it does not have to be lodged with ASIC. The applicant for registration of a new company must have the consent when the application is lodged with ASIC: s 117(5). A company contravenes s 201D if a person does not give the company a signed consent to act as a director before being appointed.

## Lodgment of directors' names and details

**[12.160]** The application for registration of a new company must set out the name, address, date and place of birth of each person who consents in writing to become a director: s 117(2)(d) and (f). A company must lodge a notice with ASIC, in the prescribed form, of the personal details of new directors within 28 days after they are appointed: s 205B(1). The personal details include the director's name, address, date and place of birth: s 205B(3). A company must also lodge notices with ASIC within 28 days if a director's personal details change or a person stops being a director: s 205B(4) and (5). Directors are required to have a DIN which will allow regulators, including ASIC, to link those directors to all the companies they control and so better detect illegal phoenix and other dishonest activities. This is discussed at [12.147]. Phoenix companies are discussed at [18.55]–[18.83].

Companies do not have to lodge notices of cessation of company office holders with ASIC where the office holders have themselves notified ASIC.

## Appointment by general meeting

**[12.165]** According to the replaceable rule in s 201G, subsequent appointments of directors may be made by a shareholders' resolution passed in general meeting.

In some companies, such as incorporated joint ventures, certain shareholders may be given the power under the constitution to appoint a number of their nominees as directors. This ensures representation on the board commensurate with the extent of their shareholding or to represent their interests as shareholders.

In the case of public companies, where appointment of directors is by the general meeting, each director must be individually appointed by separate resolution: s 201E. More than one director may be appointed by a single resolution if the general meeting has first unanimously agreed to a resolution to that effect: s 201E(1). This section prevents the voting in of a director who is on a joint ticket with another who may have strong support. The appointment of a director in contravention of this section is void.

## Casual vacancies

**[12.170]** The replaceable rule in s 201H makes provision for the directors to appoint other directors to fill a casual vacancy. A casual vacancy is any vacancy in the office of director arising otherwise than by retirement at the end of the term. This occurs if a director dies, resigns or is otherwise unable to continue to act as a director. In the case of a proprietary company, the appointment of a director by the other directors must be confirmed by resolution of the shareholders within two months after the appointment is made: s 201H(2). If the company is a public company, the appointment by the directors must be confirmed by the members at the company's next annual general meeting: s 201H(3).

## Appointment by sole director/shareholder

**[12.175]** A single director/shareholder of a proprietary company may appoint another director by recording the appointment and signing the record: s 201F.

If a sole director/shareholder of a proprietary company dies, becomes mentally incapable or becomes bankrupt, their personal representative or trustee may appoint a person as a director of the company: s 201F(2) and (3). The person so appointed holds that office as if they had been properly appointed in the usual way.

## Share qualification of directors

[12.180] The constitution of a company may require a director to hold a minimum number of shares in the company. This required number of shares is called the “director’s share qualification”. A share qualification serves two purposes. It may provide directors with an added incentive to ensure the financial success of their company. It is also attractive to shareholders to see that directors are risking their own money as well as that of the members.

## Disqualification from managing a corporation

[12.185] Part 2D.6 of the *Corporations Act* contains a number of provisions under which a person may be disqualified from managing corporations. Section 206B automatically disqualifies a person from managing corporations if the person is convicted of serious criminal offences, becomes bankrupt or is disqualified under an order made by a foreign jurisdiction. The court also has the power to disqualify a person from managing corporations:

- for contravention of a civil penalty provision (s 206C);
- if the person was an officer of two or more failed companies (s 206D);
- if the person repeatedly contravened the *Corporations Act* (s 206E); or
- if the person has been disqualified from managing corporations under the law of a foreign jurisdiction (s 206EAA(1)).

ASIC has the power to disqualify a person from managing corporations if the person was an officer of two or more companies that became insolvent: s 206F.

A person who is disqualified from managing corporations under Pt 2D.6 may only be appointed as a director of a company if the appointment is made with ASIC’s permission under s 206F(5) or with court leave granted under s 206G: s 201B(2).

Section 1274AA requires ASIC to keep a register of persons disqualified from managing corporations. This register is available for public inspection.

## Purpose of disqualification provisions

[12.190] *Rich v ASIC* [2004] HCA 42 identified three main purposes of the disqualification provisions in the *Corporations Act*:

- to protect a company’s shareholders against further abuse;
- to punish an offender; and
- generally deter improper behaviour.

Deterrence, both personal and general, is a central factor for a court to consider in determining whether a disqualification order should be made and for what period. The main purpose of disqualification orders is to protect the public by providing a deterrent to other persons involved in the management of corporations: *ASIC v Beekink* [2007] FCAFC 7.

## Managing a corporation

**[12.195]** The meaning of “managing corporations” for the purposes of Pt 2D.6 of the *Corporations Act* is explained in s 206A. Under that provision, a person who is disqualified from managing corporations commits an offence if they:

- make, or participate in making, decisions that affect the whole or a substantial part of the corporation’s business;
- exercise the capacity to affect significantly the corporation’s financial standing; or
- communicate instructions or wishes to the directors knowing that they are accustomed to act in accordance with those instructions or wishes or intending that the directors will act in accordance with those instructions or wishes.

*Commissioner for Corporate Affairs v Bracht* [1989] VR 821

**[12.200]** The Supreme Court of Victoria held that a bankrupt participated in making decisions that affected a substantial part of the company’s business and was therefore involved in managing a corporation under a predecessor of s 206A in the following circumstances. The person negotiated credit facilities with a company’s suppliers and a rent increase with a lessor of the factory leased to the company and held discussions with the company’s bank manager regarding the obtaining of bank guarantees. “Managing a corporation” involves more than performing merely clerical or administrative acts. While it requires the exercise of some responsibilities, it need not involve the exercise of control.

## Automatic disqualification

### *Convicted persons*

**[12.205]** Under s 206B(1), a person is automatically disqualified from managing corporations if they are convicted of certain criminal offences that:

- concern the making of decisions that affect the business of the corporation or concern an act that has the capacity to affect significantly the corporation’s financial standing (s 206B(1)(a));
- are a contravention of the *Corporations Act* that is punishable by imprisonment for a period greater than 12 months or other offence involving dishonesty that is punishable by imprisonment for at least three months (s 206B(1)(b)); or
- is convicted of an offence against the law of a foreign country that is punishable by imprisonment for a period greater than 12 months (s 206B(1)(c)).



If the person is imprisoned, the period of disqualification is five years from their release from prison. If the person did not serve a term of imprisonment, the period of disqualification is five years from the date of conviction: s 206B(2). ASIC may apply to the court before the expiration of the first year of automatic disqualification to extend the disqualification period for up to a further 15 years: s 206BA.

### *Undischarged bankrupt*

**[12.210]** Section 206B(3) automatically disqualifies a person from managing corporations if they are an undischarged bankrupt. Similar automatic disqualification applies to persons who executed deeds of arrangement under Pt X of the *Bankruptcy Act 1966* (Cth) that have not been fully complied with or whose creditors accepted compositions and final payment has not been made: *Corporations Act*, s 206B(4).

### *Disqualified by a court of a foreign jurisdiction*

**[12.212]** Section 206B(6) automatically disqualifies a person from managing corporations if the person is disqualified, under an order made by a court of a foreign jurisdiction that is in force, from being a director of a foreign company or being concerned in the management of a foreign company.

## **Disqualification by court order**

### *Contravention of a civil penalty provision*

**[12.215]** Section 206C(1) gives the court the power to disqualify a person from managing corporations where a court has declared under s 1317E that the person contravened a civil penalty provision.

Applications for a disqualification order under s 206C can only be made by ASIC. Disqualification under s 206C is further discussed at [19.138].

The court must be satisfied that a disqualification order is justified. In determining whether this is the case, s 206C(2) directs the court to have regard to the person's conduct in relation to the management, business or property of any corporation and any other matters considered appropriate.

Unlike automatic disqualification under s 206B, there is no fixed duration of a disqualification for contravention of a civil penalty provision. Under s 206C(1) disqualification is for a period that the court considers appropriate.

#### *Rich v ASIC [2004] HCA 42*

**[12.220]** McHugh J commented that the approach of the courts in determining the period of disqualification is similar to that adopted in sentencing in criminal cases:

Elements of retribution, deterrence, reformation and mitigation as well as the objective of the protection of the public inhere in the orders and periods of disqualification made under the legislation ... They take into account



factors such as the size of any losses suffered by the corporation, its creditors and consumers, legislative objectives of personal and general deterrence, contrition on the part of the defendant, the gravity of the misconduct, the defendant's previous good character, prejudice to the defendant's business interests, personal hardship and the willingness of the defendant to render assistance to statutory authorities and administrators.

Relevant factors in determining period of disqualification.

**[12.225]** Santow J in *Re HIH Insurance Ltd; ASIC v Adler* [2002] NSWSC 483 set out the factors which lead to the longest periods of disqualification. These include:

- large financial losses;
- high likelihood that the defendant will continue to engage in similar conduct;
- the activities were undertaken in areas where there was potential to cause great harm;
- lack of contrition or remorse;
- disregard for the law;
- dishonesty and an intention to defraud; and
- previous contraventions.

### *Failed companies*

**[12.230]** Section 206D(1) gives the court the power to disqualify a person from managing corporations for up to 20 years if, within the last seven years, the person has been an officer of two or more failed companies and the court is satisfied that the manner in which the corporation was managed was responsible for it failing. Applications for a disqualification order under s 206D can only be made by ASIC.

Under s 206D(2), a corporation is regarded as having failed if, for example, it is compulsorily wound up on grounds of its insolvency or it enters voluntary administration and its creditors are unlikely to be fully paid.

The court must be satisfied that a disqualification order is justified. In determining whether this is the case, s 206D(3) states that the court may have regard to the person's conduct in relation to the management, business or property of any corporation and any other matters considered appropriate.

### *Repeated contraventions of the Corporations Act*

**[12.235]** Section 206E(1) gives the court the power to disqualify a person from managing corporations if the person has at least twice:

- been an officer of a body corporate that has contravened the *Corporations Act* and each time the person failed to take reasonable steps to prevent the contravention; or
- contravened the *Corporations Act* while he or she was an officer.

Applications for a disqualification order under s 206E can only be made by ASIC. The court must be satisfied that a disqualification order is justified. In determining whether this is the case, s 206E(2) directs the court to have regard to the person's conduct in relation to the management, business or property of any corporation and any other matters considered appropriate.

There is no fixed duration of the disqualification under s 206E. Disqualification is for a period that the court considers appropriate.

### *Disqualification under a law of a foreign jurisdiction*

**[12.240]** Section 206EAA gives the court a similar power to disqualify a person from managing corporations if the person is disqualified under the law of a foreign jurisdiction from being a director of, or being concerned in the management of, a foreign company.

## **ASIC's power of disqualification**

**[12.245]** Section 206F gives ASIC the power to disqualify a person from managing corporations for up to five years. In order to exercise that power, ASIC must give the person a "show cause" notice requiring the person to demonstrate why they should not be disqualified and an opportunity to be heard on the question: s 206F(1)(b).

ASIC may give notice under s 206F to a person if within the last seven years he or she has been an officer of two or more companies that were wound up and whose liquidators lodged reports under s 533(1) about their inability to pay debts. As discussed in Chapter 32, s 533 requires liquidators to lodge reports with ASIC if the company is unable to pay its unsecured creditors more than 50 cents in the dollar.

If ASIC disqualifies a person from managing corporations under s 206F, it must serve a notice on the person advising them of the disqualification which takes effect from the time the notice is served.

While the grounds for disqualification under s 206F are similar to the court's power to disqualify a person under s 206D, s 206F disqualifications have a number of advantages for ASIC. ASIC must make an application to the court for an order to disqualify a person from managing corporations under s 206D, and ASIC has the onus of satisfying the court that disqualification is justified. However, s 206F proceedings do not require ASIC to apply to the court for a disqualification order and the person served with the "show cause" notice has the onus of demonstrating why they should not be disqualified.

An order may be made against a person under s 206F without the need to show breaches of commercial morality or gross incompetence. It need only be shown that the director was the subject of two or more reports that were lodged by a liquidator under s 533 (*Laycock v Forbes and ASC* [1997] FCA 1322) and that ASIC is satisfied that the disqualification is justified.

In determining whether disqualification is justified, ASIC must have regard to whether any of the corporations that failed were related to one another: s 206F(2)(a). ASIC may also have regard to the director's conduct in relation to the management, business or property of any corporation, whether the directors had met the standards that the

community expects a director to reach, whether disqualification would be in the public interest and any other matters that ASIC considers appropriate: s 206F(2)(b).

The maximum period of disqualification is five years. This length of term should be reserved for the worst cases involving dishonesty or a large number of offences.

### *Delgona v ASC* (1995) 13 ACLC 246

**[12.255]** A disqualification of two-and-a-half years was imposed in this case. Matters taken into account were that the transgressions were serious and the director showed a lack of understanding of the way a company should operate. This included a lack of knowledge of accounting requirements, failure to hand over books to the liquidator and lack of knowledge that a company of which the person was a director, was insolvent.

## Leave to manage

**[12.260]** Under s 206G(1), a person who is disqualified from managing corporations may apply to the court for leave to manage corporations or a particular corporation. The person must lodge a notice with ASIC at least 21 days before applying for court leave: s 206G(2). In exercising its discretion to grant leave to manage a corporation, the court considers the circumstances of the disqualification, the nature of the applicant's involvement and their general character and conduct since disqualification. The court also takes account of the structure of the companies and their businesses and the interests of their shareholders, creditors and employees including an assessment of any risks to those persons and the public which could arise from the applicant obtaining leave: *Adams v ASIC* [2003] FCA 557.

The order granting leave may be expressed to be subject to exceptions and conditions determined by the court. In *Application of Chapman* [2006] NSWSC 99, leave was granted on condition that the applicant was not the only director resident in Australia and also that he was not the sole signatory for bank accounts. If leave is granted, the person may be appointed as a director or secretary of a company.

Where ASIC has disqualified a person from managing corporations, s 206F(5) allows ASIC to give the disqualified person written permission to manage a particular corporation or corporations. The permission may be expressed to be subject to exceptions and conditions determined by ASIC.

## Managing a corporation while disqualified

**[12.265]** A person who manages a corporation while disqualified commits an offence: s 206A(1). In addition, s 588Z enables a liquidator to apply to the court for an order that a person who contravened s 206A be made personally liable for a specified part of the company's liabilities. A person may be liable under this section if they managed a corporation within four years of the relation-back day, usually the day of filing the application for a winding up order. In exercising its discretion whether to impose liability

on a disqualified person, the court should consider whether there is some relevant connection between the debts and liabilities of the company and the role of the person in the management of the company: *Nilant v Shenton* [2001] WASCA 421.

## Termination of appointment as director

**[12.270]** A director may be appointed for such a term as is provided by the constitution. To meet the needs of particular companies, the constitution may allow directors to be appointed for life, for an indefinite term or for a certain prescribed term. If a director is appointed for a particular term, the appointment terminates at the expiration of that term. Where the constitution provides for the retirement of directors at the conclusion of an annual general meeting and no annual general meeting is held, the directors are taken to vacate their office at the end of the period during which the annual general meeting should have been held in accordance with the *Corporations Act* or company constitution: *Gosford Christian School Ltd v Totonjian* [2006] NSWSC 725.

A director may also resign from office. Under the replaceable rule in s 203A, a director may resign by giving a written notice of resignation to the company at its registered office. Directors are unable to resign from a company, if doing so, would leave the company without a director (unless the company is being wound up): s 203AB(1) and (2). Directors are prevented from backdating their resignations to avoid personal liability. Where a notification of a resignation of a director is received by ASIC more than 28 days after the resignation was purported to have occurred, the resignation will take effect from the date it is reported to ASIC: s 203AA(1).

## Removal of directors

**[12.275]** The rules that regulate removal of directors are different for public companies and proprietary companies. Removing proprietary company directors is regulated by the proprietary company's constitution, replaceable rules or a separate agreement between its shareholders: *Re BG Iron & Steel Pty Ltd* [2014] NSWSC 1283. The *Corporations Act* sets out the requirements for removal of public company directors.

## Proprietary company directors

**[12.280]** Proprietary company shareholders can remove a director only if they are given that right in the replaceable rules or constitution (if any).

The replaceable rules or constitution govern removal of proprietary company directors.

While most proprietary company constitutions give shareholders this power, some proprietary company constitutions may permit a director to be removed from office in other ways, such as by a majority vote of the other directors.

In *Cao v Apollo Phoenix Resources Pty Ltd* [2018] FCA 1445, the court upheld the right of the directors of Apollo Phoenix Resources Pty Ltd ("Apollo") to declare the office of one

of the directors vacant. Apollo's constitution contained a clause allowing the directors to declare a director's office vacant if that director was absent from meetings of the directors for six consecutive months without permission from the directors.

The proprietary company replaceable rule in s 203C permits the shareholders to remove a director and appoint another person by resolution. If the replaceable rule in s 203C applies, a resolution of the board of directors to remove a director from office will be ineffective: *BI Constructions Pty Ltd v Shad; Bayeh v BI Constructions Pty Ltd* [2010] NSWSC 484.

The removal of directors contrary to a provision in the replaceable rules or constitution (if any) may result in the company breaching the statutory contract contained in s 140(1)(b) or an outside contract such as a co-operation agreement between shareholders, the company and the directors: *Re BG Iron & Steel Pty Ltd* [2014] NSWSC 1283. The statutory contract contained in s 140(1)(b) and the operation of outside contracts are discussed at [4.145]–[4.170].

## Public company directors

**[12.285]** Removing a public company director can be done by resolution of the shareholders even if such removal is contrary to a provision in either the public company's constitution or a separate agreement between the director and the company: s 203D. The office of director becomes vacant on the passing of the resolution. This is not the case if the director was appointed to represent the interests of a particular class of shareholders or debenture-holders. In such a case, the resolution to remove the director does not take effect until a successor has been appointed: s 203D(1). This ensures that the particular class of shareholders or debenture-holders is represented by a director at all times.

Public company directors may be removed by shareholders' resolution.

Notice of the intention to move the resolution removing a public company director must be given to the company at least two months before the meeting is to be held: s 203D(2). A copy of the notice must also be given to the director concerned who is given the right to put their case to members: s 203D(3) and (4). The director is entitled to put their case to members by giving the company a written statement for circulation to members and speaking to the motion at the meeting whether or not the director is a member of the company: s 203D(4). The director's statement does not have to be circulated to members if it is more than 1,000 words long or defamatory: s 203D(6).

It has been suggested that where a shareholders' meeting has been called to consider a resolution to remove a director, the board should act in a caretaker role so that it is subject to restrictions on its powers to make fundamental or significant decisions, act outside the ordinary course of the company's business or alter the balance of voting power. This is especially so where there is a controlling shareholder and the likely decision of the general meeting is not in doubt. The caretaker principle may also have some application even in cases where there is no controlling shareholder: *Woonda Nominees Pty Ltd v Chng* [2000] WASC 173.

Section 203D permits a public company in general meeting to remove all appointed directors, despite its reference to a singular director. This would not result in a breach of s 201A(2), which requires public companies to have at least three directors, if it is proposed to immediately replace the removed directors: *Claremont Petroleum NL v Indosuez Nominees Pty Ltd* [1987] 1 Qd R 1.

Where a director is removed prior to the expiry of their term, the question arises whether the director can restrain the company from so acting or obtain damages for wrongful dismissal. A director cannot prevent the company from exercising its right of removal. The equitable remedies of injunction and specific performance are usually not granted to enforce personal relations on unwilling parties: *Atlas Steels (Aust) Pty Ltd v Atlas Steels Ltd* (1948) 49 SR (NSW) 157. A company's constitution may contain a clause that sets out an alternate procedure for removing directors of public companies, provided that the alternate procedure is not inconsistent with the operation of s 203D. In *State Street Australia Ltd v Retirement Villages Group Management Pty Ltd* [2016] FCA 675, Beach J stated that s 203D did not provide the only mechanism by which a director of a public company could be forcibly removed. "[A]lthough s 203D(1) is mandatory in the sense that it overrides a company's constitution to the extent of any inconsistency, it does not provide an exhaustive codification of the mechanism for removal."

Section 203E prevents a majority of public company directors from removing a director unless the shareholders agree. A director of a public company cannot be removed by the other directors notwithstanding anything in the constitution or any agreement to that effect.

## Payment and disclosure of remuneration and other benefits

### Fixing remuneration

[12.290] We discuss at [13.10] the fact that directors have a fiduciary relationship with their company. One consequence of this is that they are not entitled to receive any remuneration from the company unless this is specifically permitted by the shareholders, the replaceable rules or the company's constitution: *Re George Newman & Co* [1895] 1 Ch 674.

The replaceable rule in s 202A provides that the directors are to be paid the remuneration that the company determines by resolution. That replaceable rule also sanctions the payment of travelling and other expenses properly incurred by the directors in connection with the company's business.

It is common for constitutions to provide that the remuneration of a managing director or executive directors employed by the company will be fixed by the board of directors under a contract of employment. It is contrary to good corporate governance practice, but not in breach of the law, to provide in the constitution that the directors may fix their own remuneration: *Sali v SPC Ltd* (1991) 9 ACLC 1511. This practice contains an inherent conflict of interests.

The *ASX Corporate Governance Principles and Recommendations* (4th ed) in relation to remuneration, is discussed at [14.30].

In *Guinness Plc v Saunders* (1990) 8 ACLC 3061, a director was paid by the company an amount approved by a member of a board committee. The House of Lords held that the company was entitled to have the payment returned because, under the constitution, only the board could authorise special remuneration to a director. This could not be done by a committee of the board of directors or the chief executive.

The payment of excessive remuneration to directors may constitute oppressive or unfair conduct under s 232, especially where dividends are either not paid or reduced to a small amount. This may be oppressive to, or unfairly discriminatory against, a shareholder who is prevented from being a director. This is discussed at [24.125]–[24.145]. Where a company goes into liquidation, s 588FE(6A) provides that unreasonable director-related transactions entered into during the four years prior to a company's winding up are voidable. The company's liquidator can apply for a court order under s 588FF(4) requiring repayment of these unreasonable amounts. An unreasonable director-related transaction includes unreasonable payments to directors or their close associates: s 588FDA. Such transactions are discussed at [32.550].

## Disclosure of remuneration, margin loans and other benefits

**[12.295]** Shareholders, especially of listed companies, have a right to know the remuneration and other benefits paid to directors. This information enables them to ascertain whether the directors' remuneration is justified by the company's performance.

Shareholders have a right to know the remuneration and other benefits paid to directors, especially of listed companies.

The *Corporations Act* and accounting standards require details of directors' remuneration to be disclosed in the company's annual financial report. The extent of the remuneration disclosures vary depending on whether the company is listed or unlisted as there are greater and more detailed remuneration disclosures for listed companies.

### *Unlisted companies*

**[12.300]** Details of compensation, being remuneration and other benefits, paid to directors and other key management personnel must be set out in the financial statements of public companies and large proprietary companies in accordance with accounting standards: s 296(1). See [12.60] for the definition of "key management personnel". Paragraph 17 of Accounting Standard AASB 124 *Related Party Disclosures* requires that an unlisted company's financial statements must disclose key management personnel compensation in total, and for each of the following five categories:

- short-term employee benefits (including wages, salaries and bonuses (if payable within 12 months of the end of the year));
- post-employment benefits (including pensions and other retirement benefits);
- other long-term benefits (including long service leave benefits and bonuses that are not payable within 12 months after the end of the year);
- termination benefits; and
- share-based payments.



Section 300(1)(d) also requires the annual directors' report to disclose prescribed details of options over unissued shares granted to the directors and the five most highly remunerated officers as part of their remuneration.

## *Listed companies*

**[12.305]** The *Corporations Act* and ASX Listing Rules impose more detailed remuneration disclosures on listed companies than on unlisted companies. As well as complying with the remuneration disclosures discussed at [12.300], the annual directors' reports of listed companies must provide details of contracts to which directors are a party or under which directors are entitled to a benefit: s 300(11)(d).

The annual directors' report of a listed disclosing entity must also provide the additional specific remuneration disclosures mentioned in s 300A. These must be set out in a separate and clearly identified section of the directors' report under the heading "remuneration report": s 300A(1A).

Listed companies must prepare and disclose a remuneration report.

## *Contents of remuneration report*

**[12.310]** Among other matters, the remuneration report of a listed disclosing entity must include the following information:

- A discussion of the board policy for determining the nature and amount of remuneration of the key management personnel of the company (s 300A(1)(a)(i)) or consolidated entity (s 300A(1)(a)(ii)). See [12.60] for the definition of "key management personnel".
- A discussion of the relationship between the board remuneration policy and the company's performance: s 300A(1)(b).
- If an element of the remuneration of a member of the key management personnel is dependent on the satisfaction of a performance condition, details of that performance condition must be set out together with an explanation of why it was chosen: s 300A(1)(ba).

The remuneration report must also contain prescribed details in relation to the remuneration of each member of the key management personnel: s 300A(1)(c). The prescribed details that must be disclosed are set out in reg 2M.3.03 of the *Corporations Regulations 2001* (Cth). These include short-term employee benefits, post-employment benefits such as superannuation, long-term incentive plans, termination benefits and share-based payments.

Many companies provide their key management personnel with performance-based pay that may be linked to both financial and non-financial performance indicators. Often, the amount of remuneration key management personnel receive is directly linked to performance indicators contained in the company's financial reports. In the event that there is a material misstatement in the financial reports, key management personnel may



be overpaid. Disclosing entities are not required to disclose the policies that are in place to allow them to claw back any such overpayments from key management personnel.

### *Non-binding vote on remuneration report*

**[12.315]** At a listed company's annual general meeting a resolution that the remuneration report be adopted must be put to the vote: s 250R(2). Prior to voting, the annual general meeting's chair must provide shareholders a reasonable opportunity to ask questions about, or make comments on, the remuneration report: s 250SA. This allows shareholders to express an opinion on, and hold directors accountable for, their remuneration policies. The notice of meeting must inform shareholders that such a resolution will be put: s 249L(2)(a). Even if a majority shareholders' vote is against the adoption of the remuneration report, s 250R(3) makes it clear that the vote is advisory only and does not bind the directors or the company.

### *Two strikes and re-election*

**[12.316]** The non-binding shareholder vote on the remuneration report forms part of a "two-strikes and re-election" process. This process enables shareholders to force the directors to stand for re-election if there is a significant "no" vote over two consecutive years.

A "first strike" occurs if the non-binding resolution as to whether the shareholders should adopt the remuneration report receives a "no" vote of 25 per cent or more. If this occurs the company must include in its remuneration report in the following year an explanation of the board's proposed actions in response to the "no" vote or an explanation of why no action has been taken: s 300A(1)(g).

A "second strike" occurs if the subsequent remuneration report also receives a "no" vote of 25 per cent or more: s 250U. Where a second strike occurs, a resolution must be put to the shareholders at the same annual general meeting to determine whether the directors are required to stand for re-election: s 250V. This type of resolution is called a "spill resolution". If the spill resolution is passed with 50 per cent or more of the eligible votes cast, a meeting to re-elect the directors must be held within 90 days: s 250W(2). The meeting to re-elect the directors is called a "spill meeting".

Key management personnel and their closely related parties are prohibited from casting a vote in the non-binding resolution on the remuneration report and the resolution to determine whether the directors are required to stand for re-election: ss 250R(4) and 250V(2). An exception to this requirement arises where a shareholder gives an undirected proxy to the chair and expressly authorises the chair to exercise the proxy: s 250DW(2). This exception enables the chair to vote undirected proxies for the non-binding remuneration resolution required under s 250R where expressly authorised by the shareholder to do so, even though the chair is a member or a closely related party of the key management personnel: s 250R(5).

The "two-strikes and re-election" process was introduced to address community concern that executive remuneration had become excessive and there were a number of publicised instances of large payments being made to directors, despite poor company performance. The legislation is based upon the Productivity Commission's report *Executive*

*Remuneration in Australia* which may be accessed via the link on the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## *ASX listing rules on remuneration*

**[12.320]** Several ASX Listing Rules deal with executive remuneration in listed companies. Remuneration agreements may constitute price-sensitive information for the purposes of the continuous disclosure obligations set out in Listing Rule 3.1. The ASX indicated that it regards the remuneration details of the contract of appointment of a new CEO as being information which a reasonable person could expect to have a material effect on the price of the company's securities and the key terms and conditions of the contract should be disclosed. The continuous disclosure regime is discussed at [22.135] onwards.

The issue of equity securities, such as shares, to directors generally requires listed company shareholder approval under Listing Rule 10.11 and there are restrictions on increasing directors' fees and conferring of termination benefits without shareholder approval under Listing Rules 10.17, 10.18 and 10.19.

## *Other remuneration disclosures*

**[12.325]** Shareholders with at least 5 per cent of the votes that may be cast at a general meeting or at least 100 members are given the right under s 202B to direct the company to disclose the remuneration paid to each director of the company or its subsidiaries. The company must disclose all remuneration paid to the directors regardless of whether it is paid to the directors in their capacity as directors or another capacity. The statement must be audited, sent to the members and laid before the next general meeting: s 202B(2).

Certain other payments and financial benefits given to directors and related parties by public companies and their related entities are regulated by Ch 2E. These provisions require such financial benefits that could diminish or endanger the company's resources to be disclosed to, and approved by, the general meeting before they are given. These provisions are in addition to the fiduciary and statutory duties of officers. This is discussed at [16.40] onwards.

## *Disclosure of margin loans*

**[12.330]** ASIC and ASX jointly issued Companies Update 02/08 in February 2008 dealing with when disclosure of directors' margin loans should be made under the continuous disclosure obligations contained in Listing Rule 3.1. The guidance was a response to a number of situations where directors' shares were sold under the terms of margin loans, leading to major falls in the companies' share price. The guidance states that where a director has entered into a margin loan or similar financing arrangement over a material number of securities, this may have a material effect on the company's share price and key terms of the arrangements should be disclosed under Listing Rule 3.1. Listing Rule 3.1 is discussed at [22.140]–[22.144].

## **Termination payments and benefits**

**[12.335]** Termination payments to directors and executives are a significant corporate governance issue. Excessive termination payments may be regarded as a reward for

failure and by their nature they do not link remuneration to performance. For this reason certain termination payments require shareholder approval.

Sections 200–200J regulate the circumstances in which shareholder approval is required before a benefit may be given to directors and persons holding managerial or executive office, as compensation for the loss of office or is in connection with the person’s retirement from office: s 200A(1)(a). A benefit includes a payment or other valuable consideration, any kind of interest in real or personal property or any legal or equitable right: s 200AB. In determining whether a benefit has been paid, the court considers the economic and commercial substance of the conduct, rather than the legal form: *Discovery Africa Ltd v Nichol* [2015] FCA 1497.

The Regulations specify that a benefit includes a pension, payment of superannuation in excess of the statutory amount and an amount paid as a voluntary out of court settlement. It does not include deferred bonuses and payments from a benefits superannuation scheme that was in existence before the regulations commenced: *Corporations Regulations 2001* (Cth), reg 2D.2.01.

Termination payments cannot be made unless prior shareholder approval is obtained.

Under s 200B(1), termination payments cannot be made unless prior shareholder approval in accordance with s 200E is obtained. The approval of the shareholders must meet a number of conditions that are set out in s 200E(1) and (2). Termination payments must be approved by a resolution passed at a general meeting and the details of the benefit must be set out in, or accompany the notice of general meeting. The need for shareholder approval under s 200E is not satisfied by the passing of a non-binding resolution on a remuneration report that contains the details of the retirement benefit. There must be a separate resolution that is specifically directed to the approval of the retirement benefit: *Nair v Arturus Capital Limited* [2010] NSWSC 329. The s 200B shareholder approval requirements apply to benefits given by a company, an associate of a company, or a superannuation fund in relation to the company: s 200B(1AA). A company can recover termination payments to a director that had not been approved by shareholders in contravention of s 200B.

Section 200C also prohibits the giving of benefits to a director in connection with the transfer of the whole or any part of the undertaking or property of a company. This prohibition seeks to ensure that sales of a company’s property are not improperly influenced by the making of payments to directors, relatives or associates. The prohibition is subject to shareholder approval; however, this approval does not relieve a director of any of the duties owed to the company in connection with the giving of the benefits: s 200E(2). Directors must act bona fide in the best interests of the company.

Exempt benefits.

Certain benefits are excluded from the operation of s 200B(1) and therefore do not need shareholder approval. These are defined as “exempt benefits” in s 200F(1) and (2)(a) and include payments or other benefits:

- that are genuine payments by way of damages for breach of contract; and
- given under an agreement before the director took up office, as part of the consideration for agreeing to hold office.

Under s 200F(2)(b), where a payment is made pursuant to one of the s 200F(1) and (2)(a) exemptions, shareholder approval is still required if the payment exceeds one year's base salary calculated in accordance with the formulae specified in s 200F(3) and (4) which take into account the number of years the office has been held.

Shareholder approval is also not required for genuine payments by way of pension or lump sum payments in respect of past services and superannuation payments up to a maximum amount determined by a formula set out in s 200G(2) and (3) of the *Corporations Act*.

|                                     |
|-------------------------------------|
| Contravening benefit held on trust. |
|-------------------------------------|

Under s 200J(1) where a benefit is given that contravenes s 200B, the amount of the benefit or its value is taken to have been received on trust for the company and is a debt that must be immediately paid back to the company: *Queensland Mining Corporation Ltd v Renshaw* [2014] FCA 365. The penalties for contravention of the termination benefits provisions are 180 penalty units for natural persons and 1800 penalty units for a body corporate. There is also provision for imprisonment of up to six months.

Even if a termination payment does not require shareholder approval under s 200B because the payment is below the prescribed threshold, directors who authorise the payment may nevertheless breach their fiduciary duty to act in the best interests of their company. They may also contravene ss 181 and 182. For example, in *Re Cummings Engineering Holdings Pty Ltd* [2014] NSWSC 250 a family company paid its managing director a \$250,000 “golden handshake” after the company sold its business and terminated his services. The court noted that sometimes “golden handshakes” may be justified in the interests of the company on the basis that they preserve goodwill, avoid disputation, and encourage continuing employees. These considerations did not apply in this case as the company was closed down after its business was sold so maintaining goodwill was irrelevant. Further, it no longer had continuing employees to encourage.

ASX Listing Rules also require a listed company to obtain shareholder approval for officers' termination benefits if the total of all officers' termination benefits would exceed 5 per cent of total share capital and reserves: Listing Rule 10.19.

## Company secretary

**[12.340]** A public company must have at least one secretary. If it has more secretaries, at least one of them must ordinarily reside in Australia: s 204A(2). A proprietary company is not required to have a secretary, but if it does have one or more secretaries, at least one of them must ordinarily reside in Australia: s 204A(1).

The term “secretary” is not defined in the *Corporations Act*. However, a secretary of a corporation is included within the s 9 definition of “officer” and is subject to the statutory duties of officers and employees in Ch 2D. This is discussed in Chapters 15–18.

## Appointment of secretaries

**[12.345]** The first secretary of a company is the person specified in the company’s application for registration with their consent as the proposed company secretary: s 120.

Section 204D requires the subsequent secretaries to be appointed by the directors. The board of directors usually determines the secretary’s term of office and conditions of employment. The replaceable rule in s 204F provides that a secretary holds office on the terms and conditions (including as to remuneration) that the directors determine.

A company contravenes s 204C if it is not given a signed consent to be secretary before the person is appointed. The company must keep the consent. A director of a company may also be its secretary.

Neither the *Corporations Act* nor the replaceable rules specify who has the power to dismiss the secretary, though this power is probably within the board’s management powers. A secretary may normally resign on reasonable notice to the board of directors. In *Northside Developments Pty Ltd v Registrar-General* (1987) 5 ACLC 642, resignation notified to a de facto managing director without authority to accept it was held to be invalid.

Section 205B requires a company to lodge a notice of the personal details of the secretary within 28 days after they are appointed. This does not apply to the first secretary named in the application for registration of the company.

### Who may be appointed?

**[12.350]** A secretary must be an individual who is at least 18 years of age: s 204B(1). A person who is disqualified from managing corporations under Pt 2D.6 may only be appointed as a secretary with permission of either ASIC or the court under ss 206F and 206G.

As is the case with directors, the *Corporations Act* does not require the secretary to have any special skills or qualifications. However, large companies often require their secretary to have accounting, finance or legal qualifications.

## Role and responsibilities of secretary

### *Administrative role of secretary*

**[12.355]** The role of the company secretary has become increasingly important as corporate governance and compliance issues have become more significant and complex.

The company secretary is the company’s chief administrative officer.

The company secretary, particularly in large companies, is now regarded as the company's chief administrative officer with customary authority to make contracts connected with the administration of the company. A secretary also usually has the power to be co-witness to the affixation of the company seal pursuant to a resolution of the board of directors. This is discussed at [5.115] onwards.

The nature of the secretary's duties varies from company to company. Responsibilities are imposed upon the secretary by the *Corporations Act*, the constitution or the appointing board of directors. In *Shafroon v ASIC* [2012] HCA 18 the High Court held that the responsibilities of a secretary of a listed company include transmitting the company's continuous disclosure announcements to the ASX and maintaining appropriate board records.

### *Statutory responsibilities*

[12.360] Section 188(1) makes a company secretary responsible for the following matters:

- the s 142 requirement for the company to have a registered office;
- the s 145 requirement for a public company's registered office to be open to the public;
- the s 346C requirement to respond to an extract of particulars;
- the s 348D requirement to respond to a return of particulars;
- the lodgment of the various notices with ASIC under ss 146, 178A, 178C, 205B, 254X and 349A; and
- the lodgment of financial reports with ASIC under ss 319 and 320.

Section 188(1) is a civil penalty provision. The consequences of contravening a civil penalty provision are discussed at [19.120]–[19.150]. Section 188(3) gives the secretary a defence if the secretary took all reasonable steps to ensure that the company complied with the section.

If a proprietary company does not have a secretary, s 188(2) makes each of its directors responsible for ensuring compliance with the matters listed in s 188(1).

The secretary is also ordinarily responsible for keeping minutes of the general meeting and meetings of the board of directors.

## **Defective appointments**

[12.365] The *Corporations Act*, the replaceable rules and the company's constitution (if any) impose formal requirements with respect to the appointment and qualification of directors. These requirements are discussed at [12.145]. In some cases, directors or secretaries may act in their roles despite the fact that there is a technical defect in their appointment.

Sections 201M and 204E deal with the effectiveness of acts done by invalidly appointed directors and secretaries. According to those provisions, an act done by a director or secretary is effective even if their appointment is invalid because the company, the director or secretary did not comply with the company's constitution (if any) or a provision of the *Corporations Act*.

According to the notes to these sections, the kinds of acts that they validate are those that are only legally effective if the person doing them is either a director or secretary. For example, s 249C allows a director to call a meeting of the company's members. If the person who called the meeting was not validly appointed as a director, s 201M says the act of calling the meeting is still effective.

Sections 201M and 204E do not deal with the question whether an effective act by a director or secretary binds the company in its dealings with outsiders or makes the company liable to a person dealing with the company. Such matters are dealt with by ss 128–130 which contain assumptions that those dealing with a company and its officers are entitled to make. These assumptions are discussed at [5.235] onwards.

In *Weinstock v Beck* [2013] HCA 14, the sole director of a company purported to appoint his wife as co-director pursuant to a clause in the company's constitution. The wife's appointment was challenged on the basis that while her husband had acted as the sole director for more than 30 years, his initial appointment had lapsed because he had not been reappointed at an annual general meeting as required by the company's constitution. It was therefore argued that since the husband had not been reappointed as a director, the company's constitution did not give him the power to appoint his wife as co-director. The High Court held that s 1324(4)(a) gave the court the power to validate the wife's appointment as a director even though she had not been appointed in accordance with the company's constitution.

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.
- For further corporations law links and material, please refer to the Understanding Company Law website at <http://www.uclaw.com.au>.



## Chapter 13

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# Overview and summary of directors' duties

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## Introduction

[13.01] This chapter provides an overview and summary of corporate governance and the duties of directors and other officers. Chapters 14–20 present more detailed discussions of each of these topics. Chapter 12 considers the various types of directors, the functions and powers of the board, and the role and function of company secretaries.

## Regulation of corporate governance

[13.05] The expression “corporate governance” is not a legal term and has no precise definition. It is concerned with the way a corporation is governed rather than the way the business of the corporation is managed. The term “corporate governance” may be used to describe the relationships among the various participants or stakeholders of a corporation and their roles in determining the direction and performance of the corporation. The main participants are the board of directors, management and shareholders. Other stakeholders who have an interest in the performance of the corporation include employees, creditors and sometimes the general community. Corporate governance principles seek to allocate roles, responsibilities and accountability between the participants.

Corporate governance is regulated by a mix of legal regulation and self-regulation.

Corporate governance is regulated by a mix of legal regulation and self-regulation. Legal regulation is the core of corporate governance. The law, particularly the fiduciary and *Corporations Act* duties of directors, in effect, imposes minimum corporate governance requirements. These legal requirements and the consequences of a breach of these duties are summarised at [13.25]–[13.190] and are discussed in detail in Chapters 15–20.

The self-regulatory aspects of corporate governance involve voluntary codes of recommended “good” governance practices such as the ASX Corporate Governance Council *Corporate Governance Principles and Recommendations* (4th ed). As discussed in Chapter 14, ASX listed companies are required to disclose in their annual reports the extent to which they have followed the *Corporate Governance Principles and Recommendations* (4th ed). If they do not comply with the various principles and recommendations they must disclose why they do not do so.

## Directors' fiduciary duties

[13.10] Directors have a fiduciary relationship with their company and owe various fiduciary duties to it. Senior managers of a company are also regarded as having a similar fiduciary relationship. Other examples of fiduciary relationships are trustees and beneficiaries of the trust and partners with one another. In *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41, Mason J said the critical feature of a fiduciary relationship was that:

the fiduciary undertakes or agrees to act for or on behalf of or in the interests of another person in the exercise of a power or discretion which will affect the interests of that other person in a legal or practical sense. The relationship is therefore one which gives the fiduciary a special opportunity to exercise the

power or discretion to the detriment of that other person who is accordingly vulnerable to abuse by the fiduciary of his position ...

It is partly because the fiduciary's exercise of the power or discretion can adversely affect the interests of the person to whom the duty is owed and because the latter is at the mercy of the former that the fiduciary comes under a duty to exercise his power or discretion in the interests of the person to whom it is owed.

Directors and senior managers owe fiduciary duties to their company which includes a duty of loyalty. The concept of "loyalty" has a number of different aspects. In *Bristol & West Building Society v Mothew* [1998] Ch 1 Millett LJ explained:

The distinguishing obligation of a fiduciary is the obligation of loyalty. The principal is entitled to the single minded loyalty of his fiduciary. This core liability has several facets. A fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or for the benefit of a third person without the informed consent of his principal.

The fiduciary duties stem from equitable principles developed through case law.

Directors' fiduciary duties require them to:

- act in good faith in the best interests of the company;
- exercise their powers for proper purposes;
- retain their discretionary powers; and
- avoid undisclosed conflicts of interest.

Directors also owe a duty of care to their company.

## Fiduciary overlap with Corporations Act duties

**[13.15]** The fiduciary duties are supplemented by various statutory duties contained in the *Corporations Act*. The most important of these duties are contained in Ch 2D, especially ss 180–183, which largely restate but do not replace or override the fiduciary duties. The Ch 2D duties have effect in addition to the fiduciary duties owed to a corporation: s 185.

In [13.25]–[13.55] and Chapter 15, we discuss the fiduciary duties of directors of a company to act in good faith in the best interests of the company and to exercise their powers for proper purposes. Section 181, which imposes concurrent statutory duties on directors and other officers, is also discussed at [13.25]–[13.55] and [15.235].

Directors' fiduciary duties to avoid undisclosed conflicts between their personal interests and the interests of their company are complemented by ss 182 and 183. These provisions prohibit improper use of position and improper use of information, respectively. The fiduciary and statutory duties in relation to conflicts of interest and disclosure obligations are discussed at [13.60]–[13.110] and in Chapter 16.

Directors also owe a duty at common law and under s 180(1) to exercise reasonable care, skill and diligence. This duty is concerned with questions such as whether a director exhibited appropriate levels of care and judgment in matters such as making business decisions, gaining knowledge of the company's business and financial position,

making inquiries where necessary and relying on others. This duty is discussed at [13.115]–[13.140] and Chapter 17.

The duties of directors of insolvent companies are discussed in [13.30] and Chapter 18. When a company becomes insolvent or experiences financial difficulties, its best interests increasingly correspond with the interests of creditors rather than its shareholders. The interests of creditors become paramount because of the low likelihood that there will be company assets left beyond the claims of creditors. If the company goes into liquidation, the liquidator is conferred with wide powers to bring actions against directors on behalf of the company for the benefit of its creditors. Directors prejudice the interests of the company's creditors if they dispose of company assets for less than market value. This may amount to a breach of duty, an uncommercial transaction or an unreasonable director-related transaction. Uncommercial transactions and unreasonable director-related transactions are examined at [32.520] and [32.550]. In addition, s 588G imposes a statutory duty on directors to prevent their company incurring debts when there are reasonable grounds to suspect that it is insolvent. Directors' liability for insolvent trading is considered at [13.155]–[13.190] and in Chapter 18 ([18.100] onwards).

The company has a range of remedies if directors breach their fiduciary duties. These are discussed at [13.145] and Chapter 19. The various Ch 2D duties and other statutory duties are designated civil penalty provisions, and ASIC may apply to the court for a civil penalty order against directors and others who either contravene or are involved in a contravention of them. A company may also apply to the court for a s 1317H compensation order against directors and others who contravene a civil penalty provision: *Mernda Developments Pty Ltd v Rambaldi* [2011] VSCA 392. Criminal liability can also be imposed if dishonesty is an element in a contravention of certain civil penalty provisions. The remedies and penalties for breach of duty are discussed in [13.145]–[13.150] and Chapter 19.

Chapter 20 discusses the power of shareholders to exonerate breaches of directors' duties. This chapter also looks at directors' and officers' insurance.

## Who owes Corporations Act duties?

**[13.20]** The duties in ss 180–184 are imposed on both directors and other “officers of a corporation”. Employees of a corporation are also subject to the duties in s 182 (improper use of position) and s 183 (improper use of information).

The definition of “director”.

As discussed at [12.10]–[12.20], s 9 defines the term “director” to include a person who has been appointed to the position of director. It also includes a person who has not been validly appointed but acts in the position of director (a *de facto* director) as well as a person on whose instructions or wishes the directors of a company are accustomed to act (a shadow director). *De facto* and shadow directors are discussed at [12.15]–[12.20].

Section 9 defines the term “officer of a corporation”.

## The definition of “officer”.

In part (a) of the definition it includes persons who hold certain specified positions including the directors or secretary of the corporation. Certain other persons involved in managing a company in an insolvency context, such as a receiver, administrator, restructuring practitioner and liquidator, are also included in the definition of officer.

Part (b) extends the s 9 definition of “officer of a corporation” to include those who do not occupy a named position but act as directors or company executives who hold senior positions and have significant roles in the corporation or who work behind the scenes in controlling the board’s decision-making. To be classified as an “officer of a corporation”, the executive must be a person:

- who makes or participates in making decisions that affect the whole or a substantial part of a company’s business; or
- who has the capacity to affect significantly the company’s financial standing; or
- in accordance with whose instructions or wishes the directors are accustomed to act (a “shadow” officer).

The s 9 definition makes clear that the term “officer” is not limited to those holding a named office or recognised position with rights and duties attached to it. It also includes a person who has engaged in the management of the corporation in a significant way and has the capacity to influence the directors. Management involves more than the day-to-day running of the business of the corporation. It involves the formulation of policy and strategy, management of risk and significant decision-making. It is a question of fact in determining whether a person has the requisite capacity to significantly affect the company’s financial standing under part (b) of the definition: *ASIC v King* [2020] HCA 4.

**[13.23]** The s 9 definition of “officer” does not appear to include middle managers of a company who do not report directly to the board. Their responsibilities are usually confined to segments of the company’s business or financial affairs and therefore are unlikely to be involved in making decisions that affect the *whole or a substantial* part of the company’s business. Middle managers are also unlikely to have the capacity to *significantly* affect the company’s financial standing. In *Windbox Pty Ltd v Daguragu Aboriginal Land Trust (No 3)* [2020] NTSC 21, a manager of a remote cattle station was held not to be an officer. He had almost complete control over the day-to-day running of the cattle station however he did not have any role in managing the corporation’s financial affairs, had authority to spend only relatively small amounts and did not attend meetings of the board.

This means that while middle managers may have a contractual duty to the company to exercise their powers with a reasonable degree of care and diligence and to act in good faith in the best interests of the company, they cannot be liable for civil penalties or criminal offences for contravening ss 180 (care and diligence) or 181 (good faith, best interests of the company) of the *Corporations Act*.

Many companies engage external consultants, financiers or contractors who advise or who may influence management, especially where the company is in financial difficulties. For example, a lender may manage the way in which a company attempts

to work its way out of financial difficulties. The High Court in *ASIC v King* [2020] HCA 4 suggested that while it may be possible for bankers and other third parties to come within the definition of “officer”, this will not usually arise because the third party is generally not “of” the corporation in the sense of being engaged in the management of its affairs. Third parties are not officers just because they exercise, or threaten to exercise, their contractual legal rights. Giving advice does not in itself amount to involvement in the management of a corporation unless the adviser is able to ensure the advice will be followed. Whether a person meets the criteria of part (b) of the definition of “officer” is a question of fact which in some circumstances may be difficult to determine.

The remainder of this chapter contains a summary of the duties that are owed by directors and other officers.

## Summary of the duties of directors and other officers

### Good faith and proper purpose

[13.25] Directors are under a fiduciary duty to act in good faith in the best interests of the company and for a proper purpose. The equivalent statutory duty is contained in s 181(1) which states that a director or other officer of a corporation must exercise their powers and discharge their duties in good faith in the best interests of the corporation and for a proper purpose. Section 181 is essentially the same as the fiduciary duty. Consequently, the legal principles discussed in this section are applicable to both the fiduciary and statutory duties.

The courts are not settled on whether the duty to act in good faith in the best interest of the company involves a subjective or objective test. Some cases assert that the test of whether directors act in good faith in the best interests of their company is subjective in the sense that directors comply with this duty if they genuinely believe that they are acting in the best interests of the company. They breach their duty where they engage deliberately in conduct, knowing that it is not in the interests of the company: *ASIC v Maxwell* [2006] NSWSC 1052.

Other cases argue that there is an objective test of whether directors acted in good faith in the best interests of the company. Directors will not comply with their duty merely by saying they have an honest belief that their actions are in the best interests of the company. The duty is breached if a director acts in a way that no rational director would have considered to be in the best interests of the company: *ASIC v Adler* [2002] NSWSC 171.

### Best interests of the company

[13.30] A difficult question arises as to what is meant by the phrase “the best interests of the company”. The courts have held that the interests of the company to which the duty is owed “include the interests of the corporate entity itself, the shareholders and, at least where the financial position of the company is precarious, the creditors of the company”: *Cassimatis v ASIC* [2020] FCAFC 52; *Vrisakis v ASC* (1993) 9 WAR 395.

The duty to act in the best interests of the company is owed to the company, not the shareholders. Directors will only owe fiduciary duties to particular shareholders in special circumstances: *Percival v Wright* [1902] 2 Ch 421; *Coleman v Myers* [1977] 2 NZLR 225.

When a company is solvent, the best interests of the company correspond with the best interests of its shareholders as a collective group. When a company is insolvent or in financial difficulties, the interests of the company correspond to the interests of its creditors, and directors will have a duty to exercise their powers in a way that does not prejudice the company's ability to pay its creditors: *Walker v Wimborne* (1976) 137 CLR 1. Directors prejudice creditors' interests if they cause their company to enter into arrangements that reduce the pool of company assets that would otherwise be available to be shared among creditors when the company is wound up.

The directors' duty not to prejudice creditors' interests also arises in the context of corporate groups, particularly where the companies in a group enter into business transactions with one another. For example, one company in a group may lend money to another company in the same group. This occurred in both *Walker v Wimborne* (1976) 137 CLR 1 and *Ring v Sutton* (1979) 5 ACLR 546. If the lending company is in financial difficulties, its directors prejudice the interests of the lending company's creditors if the interest rate on the loan is not on commercial terms or if the borrowing company is, or becomes, insolvent and cannot repay the loan.

## *Directors' duties and environmental, social and governance considerations*

[13.40] It is now increasingly accepted that companies and directors have wider social responsibilities and should consider the interests of other important stakeholders such as employees, customers and suppliers, the environment, regulators and other government agencies, and the broader community. In *Cassimatis v ASIC* [2020] FCAFC 52, the majority held that the interests of a company are broader than the interests of its shareholders, rejecting the proposition that the interests of a company were co-incidental with, or predominantly informed by, the wishes of its shareholders.

## *Duty to exercise powers for proper purposes*

[13.45] As discussed at [12.75], certain powers are conferred on the board of directors by the replaceable rules and constitution (if any). These generally include broad powers of management. Examples of specific powers conferred on directors include the power to issue shares and to refuse to register transfers of shares.

Directors owe fiduciary and statutory duties to exercise their powers for proper purposes.

The fiduciary duty of directors and s 181 require directors to exercise their powers for proper purposes. In cases where it is alleged that the directors have exercised their powers for improper purposes, the courts consider two matters: the objective purpose for which the power was granted and the purpose which actually motivated the exercise of the power. The courts are generally reluctant to interfere in the internal management of a company unless improper purposes are clearly demonstrated. Section 181 is further discussed at [15.235]–[15.255].



[13.50] The duty to act for proper purposes may arise in a large variety of situations; however, many court cases involving allegations of breach of the directors' duty to act for proper purposes concern the issue of shares. The power to issue shares is ordinarily conferred for the purpose of raising capital for the company. Other proper purposes for issuing shares include providing consideration for the purchase of property and providing a means of remunerating employees of a company.

Directors breach their fiduciary and statutory duties to exercise their powers for a proper purpose if they issue shares to maintain control of the company's management or majority shareholding or create or destroy the voting power of majority shareholders: [15.155]–[15.160].

Shareholders may ratify an improper share issue. Shareholder ratification of directors' breaches of duty is discussed at [20.05].

[13.55] When directors exercise their powers to issue shares, they may be motivated by a number of purposes. The courts will only determine that the duty has been breached where it is established that the directors' motivating purpose is improper. That is, where shares are issued for both proper and improper purposes, the allotment of shares will be invalidated if the court is satisfied that the shares would not have been issued if the improper purpose had not existed: *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285.

The duty to exercise powers for proper purposes is further discussed at [15.145]–[15.230].

## Conflicts of interest and disclosure

[13.60] As fiduciaries, directors owe two core fiduciary obligations:

- Directors must not allow a situation to develop where there is a conflict or real possibility of conflict between their duties to the company and their personal interests (the no conflict rule).
- Directors must not improperly make a profit or benefit which arises out of their office (the no profit rule).

Where such a situation arises, the director is obliged to disclose the relevant circumstances. As discussed at [13.110], there are both common law and statutory disclosure requirements which arise when conflict of interest situations occur.

The duty of directors to avoid a conflict of interest is strictly applied. It prevents directors putting themselves in a position where it appears that they may act in their own interests. Directors cannot avoid liability by claiming they acted honestly, they did not make a profit, their company did not suffer any loss or that the contract was a fair one.

Situations where directors will be in breach of their fiduciary duty to avoid conflicts of interest include the following.

### *Self-interested transaction with the company*

[13.65] Directors breach their fiduciary duty if they have undisclosed interests in transactions with their company because they are then in a position where their personal interests conflict or may conflict with the company's interests. Directors should act in

the interests of the company and not be seen to put themselves in a position where they may further their own interests.

Directors must disclose their interests in transactions with their company.

Undisclosed self-interested transactions are discussed at [16.20]–[16.90].

### *Personal profits arising from acting as a director*

**[13.70]** Directors are under a fiduciary duty not to make undisclosed personal profits while acting in their position. This equitable principle applies even where the company has not suffered any loss, and even if the transaction was fair from the company's point of view. Directors must be seen to act in good faith and cannot place themselves in a position where it may appear that they are motivated by considerations other than the best interests of the company: *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134. The gaining of personal profits derived while acting as a director is discussed at [16.105]–[16.115].

### *Bribes and other undisclosed benefits*

**[13.75]** An obvious example of making an undisclosed personal profit arising from acting in the position of director occurs when a director is paid a bribe or secret commission in order to procure a particular course of action by the company or to influence the director in a particular way. The receipt of the payment would also amount to a breach of the duty to act in good faith in the best interests of the company as well as ss 181 and 182. Directors who derive an undisclosed personal benefit breach their fiduciary and statutory duties irrespective of whether the company suffered loss as a result. This is further discussed at [16.190]–[16.205].

### *Misuse of company funds*

**[13.80]** Directors are under a fiduciary duty to act in their company's interests with respect to the use of the company's funds, which must be used for the company's legitimate business purposes. Directors are also under a duty not to mix the company's funds with their own. In some instances this may also amount to theft or embezzlement.

A conflict of interests arises whether the company's funds are mixed with the director's personal funds or with the funds of another company in which the director has an interest: *Totex-Adon Pty Ltd v Marco* (1982) 1 ACLC 228. This is further discussed at [16.210]–[16.225].

### *Taking up a corporate opportunity*

**[13.85]** A director breaches the duty to avoid a conflict of interests where the director, without appropriate disclosure or approval, takes up an opportunity that should have been taken up by the company. Directors who take up a corporate opportunity in breach of their fiduciary duty to avoid conflicts of interest will also breach their fiduciary duty to act in good faith in the best interests of the company as well as ss 181 and 182.

A breach of the fiduciary duty regarding corporate opportunities occurs where a director, while negotiating a contract for the company, without appropriate disclosure

and approval, arranges for the contract to be diverted from the company to the director personally or to another company in which the director is involved: *Cook v Deeks* [1916] 1 AC 554.

Directors who take up a corporate opportunity avoid breaching their fiduciary duty if they make full disclosure and the company gives its approval or consent: *Queensland Mines Ltd v Hudson* (1978) 52 ALJR 399. A company need not suffer any loss to establish a breach of duty: *Green v Bestobell Industries Pty Ltd* [1982] WAR 1. This is further discussed at [16.230]–[16.285].

### *Misuse of confidential information*

**[13.90]** Directors have a fiduciary duty not to misuse confidential company information for their own benefit without appropriate disclosure and approval. This includes the misuse of trade secrets, lists of customers and suppliers and other confidential information. The duty not to misuse confidential information often arises when a director leaves one company to commence work for a competitor. A director or an employee after ceasing employment is not permitted to use confidential information obtained in the course of that employment for the purpose of competing with their former employer: *Faccenda Chicken Ltd v Fowler* [1987] 1 Ch 117. Misuse of confidential information is discussed at [16.290]–[16.350].

### *Improper use of position and improper use of information*

**[13.95]** The duty to avoid conflict of interests is also governed by the *Corporations Act*, especially ss 181–183. These duties overlap with each other as well as with the fiduciary duties. The duty under s 181 is the broadest duty that is breached when an officer fails to act in good faith in the best interests of the company or for a proper purpose. Section 181 is discussed at [13.25] and [15.235].

**[13.100]** Section 182 prohibits directors, secretaries, officers or employees of a corporation from improperly using their position to gain an advantage for themselves or for any other person or to cause detriment to the corporation.

Officers and employees must not improperly use their position: s 182.

Section 182 is the statutory version of the fiduciary principle applied in *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134 that directors are under a duty not to make undisclosed personal profits arising from their position. However, s 182 is wider in that it applies to employees as well as officers. Further, s 182 is breached if officers or employees improperly use their position to gain an advantage for others. Section 182 is discussed at [16.120]–[16.180].

**[13.105]** Section 183 supplements the fiduciary duty regarding the misuse of confidential information.

Officers or employees must not improperly use information: s 183.

**[13.107]** Section 183 is wider than the fiduciary duty in that it also applies to employees. Under s 183, a person who obtains information because they are or have been a director, officer or employee of a corporation must not improperly use the information to make a gain for themselves or any other person or to cause detriment to the corporation. It is clear that s 183 applies to former directors, officers and employees as well as current directors, officers and employees. Section 183 is discussed at [16.315]–[16.355].

## Disclosure

**[13.110]** Directors who enter into a self-interested transaction with the company or otherwise put themselves in a conflict of interest situation which amounts to a breach of their fiduciary duty must disclose the details of their personal interest and obtain the company's fully informed consent if they are to avoid liability for the breach.

As a general rule, directors' fiduciary obligations require them to make full disclosure of their potential conflicts of interest to the company's shareholders at a general meeting and obtain their consent (also referred to as "ratification"). The company's constitution may specify a different procedure. In addition, under s 191 directors who have a material personal interest in a matter that relates to the affairs of the company have a duty to disclose that to the other directors. Disclosure to the ASX may also be required. Under s 205G, directors of listed companies must notify the ASX of relevant interests they hold in securities of the company or a related body corporate.

In the case of directors of proprietary companies who have a material personal interest, the replaceable rule in s 194 provides that if disclosure is made to the directors in accordance with s 191, the director may retain the benefits under a transaction that relates to the material personal interest and the company cannot avoid the transaction just because of the interest.

Disclosure of interests is discussed at [16.385]–[16.425].

## Duties of care, skill and diligence

**[13.115]** Directors and other officers are under a duty to exercise a reasonable degree of care and diligence. These duties are imposed by s 180(1) as well as the common law tort of negligence and the equitable duty of care. The substance of the fiduciary and statutory duties is the same: *Vines v ASIC* [2007] NSWCA 75.

Section 180(1) provides that:

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.

The common law and s 180(1) both impose an objective "reasonable person" standard. Section 180(1)(a) recognises that a corporation's circumstances are one of the factors to be taken into account when deciding the degree of care and diligence which a reasonable

person would exercise in a particular case. Section 180(1)(b) makes it clear that the office held by a director or officer and their responsibilities in the corporation are relevant factors in deciding the degree of care and diligence which a reasonable person would exercise in a particular case. Section 180(1) is further discussed at [17.15]–[17.30].

This requirement recognises that the standard of care, skill and diligence that a reasonable person would exercise may vary from company to company and depends on the type of office a particular director occupies and their responsibilities.

Even though the standard of care is variable, the leading cases, such as *Daniels v Anderson* (1995) 37 NSWLR 438, make it clear that the law imposes minimum standards of care and diligence on directors. All directors, whether executive or non-executive, must take reasonable steps to place themselves in a position to guide and monitor the management of a company: *Daniels v Anderson* (1995) 37 NSWLR 438. Directors have a responsibility to read and understand the content of the company's financial statements and make further inquiries if necessary: *ASIC v Healy* [2011] FCA 717. Directors also have a duty to safeguard the company's interests: *ASIC v Adler* [2002] NSWSC 171 and not to expose the company to criminal or civil liabilities: *Cassimatis v ASIC* [2020] FCAFC 52.

One factor which impacts the applicable standard of care is the particular role held by a director or officer.

### *Non-executive directors*

**[13.120]** The standard of care of non-executive directors recognises that their duties are of an intermittent nature to be performed at periodic board meetings and at meetings of any committee of the board to which the director has been appointed: *AWA Ltd v Daniels* (1992) 7 ACSR 759. While non-executive directors do not expect to be informed of the minute details of how the company is managed, they expect to be informed of anything untoward or anything appropriate for consideration by the board.

Even though the law does not require non-executive directors to have any particular educational qualifications or business experience, reflecting changing community attitudes and expectations of the modern directors' duty of care, cases such as *Daniels v Anderson* (1995) 37 NSWLR 438 set out minimum standards of care and diligence applicable to non-executive directors of listed public companies.

Directors of listed companies are required to take reasonable steps to place themselves in a position to guide and monitor the management of a company. In particular, directors must become familiar with the company's business and financial position, keep themselves informed about the company's business operations and cannot shut their eyes to corporate misconduct. Directors are allowed to make business judgments and take commercial risks but ignorance and a failure to inquire are not protection against liability for negligence. Directors with special skills or experience in an aspect of the company's business may also be expected to pay attention to other aspects of the company's business where necessary to ensure that the company is being properly run.

A non-executive director who has special skills or experience in the company's business has a duty to give the company the benefit of that skill or experience and cannot avoid liability for negligence simply by asserting that they relied on the company's executive directors and officers: *Gold Ribbon (Accountants) Pty Ltd v Sheers* [2006] QCA 335.

## Chair

**[13.122]** The chair of a listed company has special responsibilities and therefore is subject to a higher standard of care and diligence than is applicable to non-executive directors. The functions of the chair include managing the conduct of board meetings, ensuring the board has sufficient information and time to properly deliberate and make decisions, ensuring harmonious working relations between directors and between the board and executives, maintaining corporate culture and governance, identification and development of directors, and ensuring appropriate communication with members and outside parties: *ASIC v Mitchell (No 2)* [2020] FCA 1098.

## Executive directors and officers

**[13.125]** Executive directors not only occupy a position on the board, they are also full-time employees of the company to whom the board has delegated particular managerial responsibilities. Their involvement in management means that executive directors have special responsibilities commensurate with their positions and have a greater knowledge of the daily operations of the company. They are therefore subject to higher standards than non-executive directors. Non-director officers are in a similar position in relation to their duty of care as executive directors.

The duty of care owed by different types of directors and other officers is discussed at [17.35]–[17.97].

## The business judgment rule

**[13.130]** Directors and other officers will avoid liability for breaching their duties of care and diligence if they are able to satisfy the business judgment rule defence in s 180(2).

The business judgment rule is a defence against actions for breaches of the duty of care.

Section 180(2) provides that a director or other officer who makes a business judgment will not be in breach of the duty of care and diligence in respect of the judgment where all the following elements can be shown:

- the judgment was made in good faith and for a proper purpose;
- there was no material personal interest in the subject matter of the judgment;
- the directors and officers informed themselves about the subject matter of the judgment to the extent they reasonably believed to be appropriate; and
- the judgment was rationally believed to be in the best interests of the corporation.

The business judgment rule provides directors with a “safe harbour” from personal liability in relation to informed, rational business decisions made in good faith and in the best interests of the company. The rule was adopted to acknowledge that directors should not be liable for business decisions that may have turned out badly but were made in an honest, informed and rational way.

The business judgment rule protects directors and officers against liability for breaches of the statutory duty of care and the common law equivalent; it does not operate in

relation to breaches of other duties such as ss 181(1), 182(1), 183(1) or the s 588G duty to prevent insolvent trading.

The business judgment rule is discussed at [17.160]–[17.170].

## *Reliance on others: s 189*

**[13.135]** Section 189 provides a reliance defence.

Section 189 provides that a director may rely upon information or advice provided by:

- an employee whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned (s 189(a)(i)); or
- 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 (s 189(a)(ii)); or
- another director or officer in relation to matters within the director's or officer's authority (s 189(a)(iii)); or
- a committee of directors on which the director did not serve in relation to matters within the committee's authority (s 189(a)(iv)).

Under s 189(b), the reliance must be made in good faith and after making an independent assessment of the information or advice, having regard to the director's knowledge of the corporation and the complexity of its structure and operations.

The protection afforded to directors who reasonably rely on information or advice arises in proceedings to determine whether the directors have breached their duties under the *Corporations Act* (ss 180(1), 181(1), 182(1) and 183(1)) and the equivalent general law duty: s 189(c). Section 189 is discussed at [17.175]–[17.185].

## *Responsibility for actions of delegates: s 190*

**[13.140]** Section 198D authorises the directors of a company to delegate any of their powers to a committee of directors, a director, an employee of the company or any other person.

If directors delegate a power under s 198D, they are responsible for the exercise of power by the delegate as if the power had been exercised by the directors themselves: s 190(1). However, under s 190(2), a director is not liable for a breach of duty committed by the delegate if the director believed on reasonable grounds that the delegate would exercise the power in conformity with applicable duties, in good faith, after making proper inquiry if the circumstances indicated the need for inquiry and the delegate was reliable and competent in relation to the power delegated.

Section 190 is discussed at [17.200].

## **Consequences of contravention**

### *The company's remedies*

**[13.145]** As a general rule, the company is the proper plaintiff to remedy wrongs done to it by the directors. This is because the duties are owed to the company and it is regarded as



a legal entity separate from its members. If the company is in liquidation, its liquidator can bring an action in the name of the company against present or former directors.

If a director or officer breaches any of the fiduciary duties, the company has a variety of remedies available. The appropriate remedy depends on the circumstances. In some cases, a company may have more than one remedy available, and it may choose to apply to the court for the remedy that achieves the best result from its point of view.

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| The company's remedies. |
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The available remedies include:

- compensation or damages;
- account of profits where a director makes an undisclosed profit from a conflict of interest situation;
- rescission of a contract where a director has breached their duty by having an undisclosed interest in a contract with the company;
- an injunction to prevent future or threatened breaches; and
- an order requiring property to be returned to the company where a director acquires property as a consequence of a breach of duty.

If a director or officer breaches any of the statutory duties, the company can apply for a compensation order under ss 1317H and 1317J(2).

### *ASIC's remedies*

**[13.150]** A breach of various sections specified in s 1317E(1) attracts the civil penalty provisions of Pt 9.4B. The statutory duties which trigger the civil penalty provisions include:

- care and diligence (s 180);
- good faith and proper purpose (s 181);
- improperly using position (s 182);
- improperly using information (s 183); and
- insolvent trading (s 588G).

If a civil penalty provision has been contravened, ASIC can apply to the court for the following:

- an order that an individual pay a pecuniary penalty of an amount up to a maximum of the greater of 5,000 penalty points (currently \$1.565 million) or, if the court is able to calculate it, three times the benefit gained or loss avoided as a result of the contravention (s 1317G);
- a relinquishment order requiring payment of an amount equal to the benefit derived and detriment avoided because of a contravention of a civil penalty provision under s 1317GAB(1);
- a disqualification order (s 206C); and
- compensation for damage suffered (s 1317H).



Under s 184, contravening the duties in ss 181–183 is regarded as a criminal offence if the director or other officer did so recklessly or was intentionally dishonest. Contravention of the statutory duty of care and diligence in s 180(1) is not a criminal offence.

The various remedies available for breach of duty are further discussed in Chapter 19.

## Duty to prevent insolvent trading

**[13.155]** A director is under a duty to prevent the company incurring debts if there are reasonable grounds for suspecting that it is insolvent: s 588G. This is referred to as “insolvent trading”. The elements that must be satisfied before insolvent trading has occurred are as follows:

- the defendant was a director of the company when it incurred a debt;
- the company was insolvent at the time the debt was incurred;
- there were reasonable grounds for suspecting insolvency;
- the director failed to prevent the company incurring the debt; and
- the director was aware, or a reasonable person would have been aware, that grounds existed for suspecting that the company was insolvent.

Subject to four alternative defences set out in s 588H, contravening directors are liable to pay compensation to the company of an amount equal to the loss or damage suffered by unsecured creditors in relation to the debts so incurred because of the company's insolvency: ss 588J, 588K and 588M. In addition, contravention of s 588G may result in directors being liable for a civil penalty order pursuant to Pt 9.4B or a criminal sanction under s 588G(3).

### *Who is liable?*

**[13.160]** The duty to prevent insolvent trading applies to a person who is a director at the time when the company incurs the relevant debt: s 588G(1)(a). Persons not formally appointed as directors but who act as either “de facto” or “shadow” directors are also subject to the duty because they come within the wide definition of “director” in s 9.

### *The company incurs a debt*

**[13.165]** An essential element in establishing a contravention of s 588G is the requirement that a company incurs a debt. According to the dictionary definition, a debt is an obligation by one person to pay a sum of money to another: *Powell v Fryer* [2001] SASC 59.

Most reported insolvent trading cases involve a company contracting with a supplier to buy goods or services on credit terms; however, the expression “incurs a debt” also covers a variety of other situations such as entering into a lease or giving a guarantee: see [18.110]. A debt is usually incurred at the time the contract is entered into.

### *The company was insolvent at the time the debt was incurred*

**[13.170]** Section 588G(1)(b) requires proof that the company was insolvent at the time the debt was incurred or became insolvent by incurring that debt.

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| Definition of insolvency. |
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The s 95A definition of insolvency has regard to the company's inability to pay its debts as and when they become due and payable. A person is solvent if, and only if, the person is able to pay all their debts, as and when they become due and payable: s 95A(1). A person who is not solvent is regarded as being insolvent: s 95A(2). This implies that solvency is determined by a cash flow test.

The courts determine whether a company is insolvent by considering the presence of a number of indicators of insolvency. These include dishonoured cheques, continuing losses, unpaid taxes, inability to raise further capital and suppliers refusing to supply unless the goods are paid for prior to delivery or by cash on delivery.

### *Reasonable grounds for suspecting insolvency*

**[13.175]** Directors do not contravene s 588G merely because the company is insolvent at the time a debt is incurred. Section 588G(1)(c) requires that there must be reasonable grounds for suspecting that the company was insolvent at the time the debt was incurred.

### *Failure to prevent incurring of debt*

**[13.180]** Section 588G(2) requires proof that a director failed to prevent the company incurring the debt. The expression "failing to prevent" covers inactivity or the failure to attempt to prevent the company from incurring the debt: *ASIC v Plymin* [2003] VSC 123. A director fails to prevent the company incurring a debt if the director acquiesced in the company continuing to incur all such debts as it would incur in the ordinary course of business. It is not necessary for a plaintiff to prove that a director had the power to prevent the company incurring debts or continuing to trade. Nor is it necessary to prove that an individual director failed in their duty to take a particular step that would have been effective to prevent the company incurring the debt: *Elliott v ASIC* [2004] VSCA 54.

### *Defences*

**[13.185]** Section 588H sets out four alternative defences available to directors who otherwise contravene s 588G:

- it is a defence if the director proves that, at the time when the debt was incurred, the director 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 (s 588H(2));
- it is a defence if a director has delegated the monitoring of the company's financial position to others upon whom the director relies. The director must prove that at the time when the debt was incurred, the director had reasonable grounds to believe, and did believe, that a competent and reliable person was responsible for providing the director with adequate information about whether the company was solvent and that the other person was fulfilling that responsibility (s 588H(3));

- it is a defence if a director is absent from management because of illness or for some other good reason at the time when the company incurs the debt in question (s 588H(4)); and
- it is a defence if the director proves that they took all reasonable steps to prevent the company from incurring the debt (s 588H(5)). In determining whether a defence under s 588H(5) has been proved, s 588H(6) directs the court to have regard to matters including any action the director took with a view to appointing an administrator of the company or a restructuring practitioner for the company, when that action was taken and the results of that action.

### *Safe harbour defence*

**[13.186]** Section s 588GA contains a “safe harbour” for directors from civil liability for insolvent trading. That section provides that s 588G(2) does not apply to a person and a debt if:

- (a) at a particular time after the person starts to suspect the company may become or be insolvent, the person starts taking one or more courses of action that are reasonably likely to lead to a better outcome for the company; and
- (b) the debt is incurred directly or indirectly in connection with any such course of action during the period starting at that time, and ending at the earliest of any of the following times:
  - (i) if the person fails to take any such course of action within a reasonable period after that time – the end of that reasonable period;
  - (ii) when the person ceases to take any such course of action;
  - (iii) when any such course of action ceases to be reasonably likely to lead to a better outcome for the company; or
  - (iv) the appointment of an administrator, or liquidator, of the company.

According to s 588GA(2), in working out whether a course of action is reasonably likely to lead to a better outcome for the company, regard may be had to whether the person:

- is properly informing himself or herself of the company's financial position; or
- is taking appropriate steps to prevent any misconduct by officers or employee of the company that could adversely affect the company's ability to pay all its debts; or
- is taking appropriate steps to ensure the company is keeping appropriate financial records consistent with the size and nature of the company; or
- is obtaining advice from an appropriately qualified entity who was given sufficient information to give appropriate advice; or
- is developing or implementing a plan for restructuring the company to improve its financial position.

Section 588GAAB also provides a “safe harbour” for directors from civil liability for insolvent trading if a debt is incurred by a company under restructuring. For the s 588GAAB exemption from liability to apply, the debt must have been incurred in the ordinary course of the company's business or with the consent of the restructuring practitioner. The restructuring process is further discussed at [31.390] onwards.

A similar safe harbour protection applies in the case of a holding company's liability for debts incurred by its insolvent subsidiary under s 588V.

## *Consequences of contraventions*

**[13.190]** Several consequences may flow from a contravention of s 588G. If the company that incurred the debt has been placed in liquidation, s 588M gives the liquidator the ability to seek compensation from a director who contravenes s 588G.

Directors may be liable for compensation.

The court may order the director to pay compensation to the company's liquidator who then distributes the compensation to all unsecured creditors. The amount of compensation is generally the amount of the unpaid debt less the payments made to unsecured creditors in the liquidation or administration. In addition, since s 588G is a civil penalty provision, contravention may also result in the imposition of a pecuniary penalty order under s 1317G or disqualification from managing corporations under s 206C. Further, under s 588G(3) contravention is a criminal offence, punishable by a fine or imprisonment (or both) if a director's failure to prevent the company incurring the debt in breach of s 588G was dishonest.

The duty to prevent insolvent trading is further discussed at [18.100]–[18.240].

## **Phoenix companies**

**[13.195]** The term “phoenix company” describes a situation where a company is subject to financial difficulties, and in order to avoid paying the creditors, the directors form a new company to carry on the old company's business. When the old company is wound up by its creditors, they receive little or nothing in the liquidation. Phoenix company arrangements that are aimed at avoiding payment of creditors' claims are regarded as an abuse of the corporate form and the principle of limited liability.

Legislation that specifically deals with phoenix companies was introduced in 2020. Among its measures were the requirement for all directors to have a director identification number (DIN) to prevent the use of false identities and allow ASIC to better track directors of multiple failed companies.

A prohibition was introduced against officers who engage in conduct that results in a company making a creditor-defeating disposition of company property: s 588GAB(1). These dispositions involve transferring company assets for undervalue with the result that the property is prevented from becoming available to meet the claims of the company's creditors.

These offences are subject to several safeguards to ensure they do not apply to legitimate businesses and transactions, including legitimate business restructures and deeds of company arrangement: s 588GAB(3).

These provisions are discussed at [18.57].

## Tutorial questions

1. Eiffel Towers Ltd, a listed company, was a builder and property developer specialising in projects in Melbourne's central business district. It has five directors. Giscard (Eiffel Towers Ltd's managing director) and Henri (the company's chief finance officer), were the only executive directors on the board. The others, all experienced business people, were non-executive directors and attended the monthly board meetings.

Over the past two years, Eiffel Towers Ltd's financial position had worsened. Apart from Henri, the directors were unaware that Eiffel Towers Ltd's liabilities vastly exceeded its assets and that it had difficulties paying its subcontractors and suppliers on time. Henri made sure the other directors were kept in the dark about this and did not give them meaningful or accurate financial information. The directors were satisfied with Henri's false assurances that the company's finances were satisfactory.

Several months ago at an Eiffel Towers Ltd's board meeting Giscard asked the board to approve the acquisition of a development site owned by Blue Sky Pty Ltd for \$90 million, to be borrowed from Eastpac Bank. He explained that this site was suitable for a 50-storey office building. The board agreed with his suggestions, notwithstanding that Giscard provided only sketchy details. In particular, the directors were unaware that Blue Sky Pty Ltd was controlled by Henri's wife and the company had been trying unsuccessfully to sell the development site for \$20 million. The board was also unaware that the zoning laws did not permit the construction of a 50-storey building on the site.

Not long ago the non-executive directors ordered an investigation of Eiffel Towers Ltd's finances and for the first time became aware of the zoning laws. They forced Giscard to resign and reported the matter to ASIC. Henri was last seen at the airport boarding a plane to Brazil.

Advise ASIC whether there have been breaches of the *Corporations Act* in the above circumstances. In your answer consider the positions of each of the directors.

2. Vineyard Ltd operated a wine-producing business and owned vineyards around Australia. It had the following five directors on its board:
  - Adam, the company's non-executive director chairman;
  - Barbara, the company's managing director;
  - Jonathan, the company's chief financial officer;
  - Felicity and Paul, non-executive directors. Paul was previously the managing director of Vineyard Ltd and had a detailed knowledge of the company's business operations and the wine industry generally.

At Paul's suggestion, a proposal for Vineyard Ltd to acquire the plastic wine cork manufacturing businesses owned by Laurie's Corks Pty Ltd for \$50 million was an agenda item at Vineyard Ltd's board meeting a few months ago. At the meeting, because it was late in the day and all the directors were anxious to leave, Adam allowed only 10 minutes for Barbara to present a business plan for the proposed acquisition. Jonathan's financial report on the impact of the acquisition was tabled at the board

meeting but he was not allowed to speak or answer questions. After a few minutes' discussion, the directors approved the acquisition and Barbara subsequently signed a contract to buy the business on behalf of Vineyard Ltd.

Subsequently, the board discovered that Jonathan's financial analysis had obvious mistakes and that therefore the \$50 million purchase price was grossly excessive. Unfortunately, this discovery was made only after Barbara signed the purchase of business contract on behalf of Vineyard Ltd. The board was also unaware that Paul's family company owned most of the shares in Laurie's Corks Pty Ltd.

Assume that:

- Vineyard Ltd completed the \$50 million purchase of business from Laurie's Corks Pty Ltd; and
- The purchase of the business proved to be a financial disaster for Vineyard Ltd with the result that the shareholders replaced the whole board with new directors.

Advise the new directors of Vineyard Ltd whether its former directors breached any of their duties in relation to the decision to purchase the business from Laurie's Corks Pty Ltd. Your answer should also consider whether the directors are able to rely on the business judgment rule or any other defences to avoid liability.

3. Groovy George Ltd ("GG") is a company that installs kitchen cupboards. GG has appointed four directors, Ann, Mark, John and Lynn. Lynn has been appointed as managing director. John is appointed to the board because of his accountancy skills. The company was originally extremely profitable, however, recently the company has experienced a number of problems.

Ann, a professional dancer, rarely attends board meetings due to her punishing training schedule. Some time ago she took one of the company's 4WD vehicles for her private use.

Following a board decision to offer customers a complete kitchen and bathroom installation package, Mark has negotiated an exclusive contract with Bathrooms Galore Pty Ltd. Mark has not informed the board that Bathrooms Galore is actually owned by Mark's family. John suspects that Mark is personally connected with Bathrooms Galore, however, he has not told the other directors about his suspicion.

Despite the company's persistent negative cash flow, Lynn proposes to the other directors that the company should expand its operations into oven and dishwasher installations. Mark questions whether the company can afford the costs associated with the expansion. The board delegates to John the task of investigating Lynn's proposal.

John undertakes the investigation the following week, however, he spends very little time doing so because he is busy with other matters. He hastily prepares a report for the next board meeting, recommending that the proposal be accepted. It later turns out that his report is misleading as he has overlooked many of the additional costs involved in the expansion.

The next board meeting is very long and the consideration of Lynn's proposal and John's report is the last item on the agenda. The directors are anxious to finish the meeting so they spend five minutes considering the proposal and John's report before

voting in favour of it. Ann was not present at the meeting as she was holidaying on Fraser Island in the company-owned 4WD.

GG went ahead with the expansion, with Lynn signing a contract on behalf of GG with Ovens-R-Us Pty Ltd for the purchase on credit of ovens and dishwashers and the associated installation equipment. This debt is never paid.

Six months later the company is placed in liquidation on the application of one of its creditors. Advise the liquidator whether any of the directors of GG Ltd are in breach of any directors' duties owed to the company? If so, what consequences might result? Explain.

## **Bibliography**

There are detailed bibliographies at the end of Chapters 14–20.





## Chapter 14

# Corporate governance

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### Key points

- Corporate governance describes the rules and practices put in place to deal with the relationships between the board of directors, management and shareholders as well as other stakeholders. An important aim of corporate governance practices is to provide assurance that the board operates effectively and monitors and holds management accountable so that it acts in the interests of shareholders and other stakeholders.
- The regulation of corporate governance is a mix of legal regulation and self-regulation.
- The *ASX Corporate Governance Principles and Recommendations* (4th ed) is a voluntary corporate governance code.
- The ASX Listing Rules require the annual report of a listed entity to state the extent to which the company complied with the *ASX Corporate Governance Principles and Recommendations* (4th ed). Where a listed entity chooses not to follow a recommendation, it must explain to the market why it has not adopted the recommendation.

## Introduction

**[14.05]** “Corporate governance” is not a legal term. It describes the rules and practices put in place within a company to deal with the relationships between the board of directors, the management and the shareholders and other stakeholders.

Corporate governance deals with the control of corporations and the accountability mechanisms put in place.

In a more specific sense, it deals with the control of corporations and the accountability mechanisms put in place. In listed companies with widely dispersed share ownership, the interests of directors, managers, shareholders and other stakeholders may diverge. Corporate governance deals with the various checks and incentives put in place to ensure that directors and managers act in the interests of shareholders and other stakeholders. Some listed companies have concentrated share ownership where an individual or family has a controlling interest in its shares. In such companies, there may be a divergence between the interests of the controlling shareholders and the minority shareholders. Good corporate governance in such companies seeks to ensure that the interests of controlling shareholders do not conflict with the interests of minority shareholders.

As discussed at [12.75]–[12.95], the board of directors usually has a broad power of management and shareholders are generally unable to interfere with the board’s exercise of this power. In large companies with complex businesses, it is not practicable for boards to be actively involved in day-to-day management. The board usually delegates its management power and appoints a managing director or chief executive officer (CEO) with responsibility for conducting the business of the company. The law provides little guidance as to the specific roles of the board and management. Various principles of corporate governance practice have evolved which address the roles, functions and structures of the board, its relationship to managers, shareholders and other stakeholders.

Interest in corporate governance has increased because of a combination of various factors that include dramatic corporate collapses in Australia and overseas, instances of scandals and reputational damage and increasing statutory obligations imposed on companies and their directors which have all been amplified by increasing shareholder activism, particularly by institutional investors.

## What is corporate governance?

**[14.10]** “Corporate governance” has different meanings and is a term used in different contexts. Various disciplines such as law, finance, economics and accountancy all present their own perspectives on how they view and analyse corporate governance issues.

Corporate governance is concerned with how corporate entities are governed as distinct from the way the company is managed.

In general terms, it is concerned with how corporations are controlled and the accountability and control mechanisms to which they are subjected. These mechanisms aim to ensure that the board is accountable to shareholders and other stakeholders and that management is accountable to the board.

The Foreword to the *ASX Corporate Governance Principles and Recommendations* (4th ed) quotes Justice Owen in the HIH Royal Commission, *The Failure of HIH Insurance*, who described corporate governance as:

the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations. It encompasses the mechanisms by which companies, and those in control, are held to account.

It is helpful to an understanding of corporate governance to appreciate that it is concerned with how corporate entities are governed as distinct from the way the businesses within those entities are managed. Governance relates to where the company is going. Management is concerned with getting the company there. This distinction is central in determining the role and function of the board and its relationship with management.

A common traditional view was that the interests of a company were equivalent to those of the shareholders, and that the role of the directors was to act in the best interests of the shareholders (known as the shareholder primacy view). Milton Friedman famously wrote that “there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud”.

There are doubts about the extent to which this ever accurately reflected the law in Australia. In any case, the shareholder primacy view is increasingly giving way to a view that the interests of a company are not confined to the interests of the shareholders, but include a broader range of stakeholders and interests. This is discussed further at [15.10] and [17.15].

## **Why is good corporate governance important?**

**[14.15]** The G20/OECD *Principles of Corporate Governance* (2015) stated why corporate governance was an important global issue:

The quality of corporate governance affects the cost for corporations to access capital for growth and the confidence with which those that provide capital – directly and indirectly – can participate and share in their value-creation on fair and equitable terms ... As a consequence, good corporate governance will reassure shareholders and other stakeholders that their rights are protected and make it possible for corporations to decrease the cost of capital and to facilitate their access to the capital market.

The *ASX Corporate Governance Principles and Recommendations* (4th ed) makes a similar point when it states that “good corporate governance promotes investor confidence, which is crucial to the ability of entities listed on the ASX to compete for capital”.

The G20/OECD Principles and the ASX *Corporate Governance Principles and Recommendations* (4th ed) are linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

Reasons why good corporate governance practices and procedures are important to individual companies include enhanced reputation, a greater likelihood of long-term trust from various stakeholders, an increased awareness of stakeholder interests and ethical and socially responsible considerations in doing business, better risk management and development of corporate strategies and greater resilience in dealing with sudden shocks and long-term change. Companies that display these characteristics derive a significant competitive advantage over competitors that are seen as having poorer governance arrangements.

## The regulation of corporate governance

**[14.20]** The regulation of corporate governance is a mix of legal regulation and self-regulation. The main regulatory elements are:

- legal obligations largely imposed by the *Corporations Act* and fiduciary duties;
- rules and standards which have legislative recognition and the force of law such as the ASX Listing Rules and accounting and auditing standards; and
- codes of corporate governance such as the ASX *Corporate Governance Principles and Recommendations* (4th ed) which are voluntary, not mandatory.

The regulation of corporate governance is a mix of legal regulation and self-regulation.

ASIC has responsibility for legal regulation and enforcement while, for listed companies, the ASX plays a significant role in corporate governance regulation through the administration of its Listing Rules which include a requirement that listed companies disclose their corporate governance practices. The *Corporations Act* deals with a wide variety of corporate governance issues. These include:

- directors' duties (discussed in Chapters 15–19);
- shareholders' meetings, rights and remedies (discussed in Chapters 21 and 24);
- the continuous and periodic disclosure obligations (discussed in Chapter 22);
- the requirement for, and regulation of, auditors (discussed in Chapter 23); and
- the regulation of takeovers (discussed in Chapter 25).

Legal regulation prescribes minimum standards which if breached may result in civil and, in the worst cases, criminal liability. However, legal regulation alone is insufficient to promote good corporate governance practice. For listed companies, this is best achieved by self-regulation and disclosure of corporate governance practices to the market under the ASX Listing Rules.

The focus of corporate governance is largely on the role, function and composition of the board of directors. A board's functions fall into two distinct and separate categories: *supervisory* and *strategic*. The separation of these roles has led to several

recommended corporate governance practices such as separation of the roles of chair and CEO, the appointment of independent directors and the use of board committees – especially in the areas where management may act in its own interests and not in the interests of shareholders. The features of widely accepted “good” corporate governance practices are discussed in the following sections.

## ASX corporate governance listing rule

**[14.25]** ASX Listing Rule 4.10.3 requires the annual report or the website of a listed company to set out a corporate governance statement that discloses the extent to which it has followed the recommendations in the *ASX Corporate Governance Principles and Recommendations* (4th ed), discussed at [14.30] onwards. Compliance with the *ASX Corporate Governance Principles and Recommendations* is not compulsory. It is recognised that listed companies markedly differ from one another and so what companies consider appropriate for them will also differ depending on their size, complexity, purpose, shareholder composition and other considerations. Where listed companies depart from the *ASX Corporate Governance Principles and Recommendations* (4th ed), they are under an obligation to explain to investors why they have done so.

The “if not, why not” approach.

This is referred to as the “if not, why not?” approach. According to the ASX, this approach puts emphasis on disclosure rather than compliance with prescribed practices, thereby allowing for greater flexibility and adaptation to changes as corporate governance principles evolve.

The ASX Corporate Governance Council, which developed the *ASX Corporate Governance Principles and Recommendations* (4th ed), comprises representatives of 19 business, shareholder and industry groups. The Council’s main aim was to develop a suitable framework for corporate governance which would provide a practical guide for listed companies, investors and other interested persons.

The first version of the ASX Corporate Governance Council’s principles and recommendations was issued in 2003 with major revisions in 2007, 2010 and 2014. The current fourth edition of the *ASX Corporate Governance Principles and Recommendations* was issued in 2019.

ASX Listing Rule Guidance Note 9 *Disclosure of Corporate Governance Practices* assists listed entities in complying with ASX Listing Rule 4.10.3. Where a listed company follows a recommendation, Guidance Note 9 explains that:

rather than simply state that fact, it should explain what policies and practices it has in place in that regard and where applicable, point readers to where they can find further information about those policies and practices.

A listed company that does not follow a recommendation must explain its reasons for this choice. According to Guidance Note 9, the explanation should:

- be reasonably detailed and informative so that the market understands why it is that the entity has chosen not to follow that recommendation; and
- disclose what, if any, alternative corporate governance practices the entity may have adopted in lieu of those in the recommendation, and explain why those practices are considered more appropriate for the entity rather than the ones in the recommendation.

The *Corporate Governance Principles and Recommendations* (4th ed) and the ASX Listing Rule Guidance Note 9 are on the ASX website and are linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## ASX corporate governance principles and recommendations

[14.30] The ASX *Corporate Governance Principles and Recommendations* (4th ed) sets out the following eight principles:

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.
2. **Structure the board to be effective and 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.
3. **Instil a culture of acting lawfully, ethically and responsibly.** A listed entity should instil and continually reinforce a culture across the organisation of acting lawfully, ethically and responsibly.
4. **Safeguard the integrity of corporate reports.** A listed entity should have appropriate processes to verify the integrity of its corporate reports.
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.
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.
7. **Recognise and manage risk.** A listed entity should establish a sound risk management framework and periodically review the effectiveness of that framework.
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.

Each principle has recommendations and commentary that suggest specific practices that listed companies should adopt. The main recommendations are set out in the following sections.

## Roles and functions of the board and management

**[14.35]** Under Recommendation 1.1, a listed entity should disclose the respective roles and responsibilities of its board and its management. The entity should also disclose those matters expressly reserved to the board and those expressly delegated to management.

Companies should clearly delineate the respective roles and responsibilities of its board and management and regularly review their performance.

The Commentary to Recommendation 1.1 articulates the usual responsibilities of the board. The usual responsibilities are:

- demonstrating leadership and setting the entity's 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 when necessary replacing the CEO and other senior executives;
- overseeing management's implementation of the entity's strategic objectives, instilling the entity's values and its performance generally;
- 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 company that a reasonable person would expect to have a material effect on the price or value of the company's securities;
- ensuring the entity has in place an appropriate risk management framework (for both financial and non-financial risks) and setting the risk appetite within which the board expects management to operate;
- satisfying itself that an appropriate framework exists for relevant information to be reported by management to the board;
- whenever required, challenging management and holding it to account;
- satisfying itself that the entity's remuneration policies are aligned with the entity's purpose, values, strategic objectives and risk appetite; and
- monitoring the effectiveness of the entity's governance practices.

The role and responsibility of the board could be set out in a board charter published on the entity's website or in its annual report. The charter could also usefully set out the role and responsibility of the chair as well as the entity's policy on when and how directors may seek professional advice at the entity's expense.

The usual responsibilities of management involve implementing the strategic objectives and operating within the risk appetite set by the board and for all other aspects of the day-to-day running of the entity. The senior executive team is also responsible for providing the board with accurate, timely and clear information to enable the board to perform its responsibilities.



The Commentary recognises that the particular nature of matters reserved to the board and those delegated to management will depend on the size, complexity and ownership structure of the entity and will be influenced by its history and corporate culture and by the respective skills of directors and management.

Directors and senior executives should clearly understand what is expected of their roles and responsibilities. According to Recommendation 1.3, these expectations should be set out in a written agreement. The Commentary to Recommendation 1.3 suggests the information that should generally be set out in the letter appointing a non-executive director.

Recommendations 1.6 and 1.7 provide that listed entities should have and disclose a process for periodically evaluating the performance of the board, its committees, individual directors and senior executives. The Commentary to Recommendation 1.6 suggests that a suitable non-executive director (such as the deputy chair or senior independent director, if any) should be responsible for the performance evaluation of the chair, after having canvassed the views of the other directors.

## Independent directors

**[14.40]** Principle 2 – Structure the board to be effective and add value – suggests that a listed entity should have a board of an appropriate size, composition, skills, commitment and knowledge of the entity and the industry in which it operates to enable it to discharge its duties adequately.

A majority of the board should be independent directors.

One of the key recommendations in relation to board composition is the recommendation about independent directors. Recommendation 2.4 suggests that a majority of the board of a listed entity should be independent directors. According to Recommendation 2.3, the listed entity should disclose the names of the directors the board considers to be independent directors. The Commentary to Recommendation 2.3 indicates that describing:

a director as “independent” carries with it a particular connotation that the director is not allied with the interests of management or a substantial holder and can and will bring an independent judgment to bear on issues before the board.

According to the Commentary “a director should only be characterised and described as independent if that person is free of any interest, position or relationship that might influence, or be reasonably perceived to influence in a material respect their capacity to bring an independent judgment to bear on issues before the board and to act in the best interests of the entity as a whole rather than in the interests of an individual security holder or other party”.

Recommendation 2.3, Box 2.3 gives a number of examples of interests, positions and associations that might cause doubts about the independence of a director. A director would *not* normally be characterised as an independent director under the criteria in Box 2.3 if the director:



- is or has been employed in an executive capacity by the entity or any of its child entities and there has not been a period of at least three years between ceasing such employment and serving on the board;
- receives performance-based remuneration (including options or performance rights) from, or participates in an employee incentive scheme of the entity;
- is or has been within the last three years, in a material business relationship (for example, as a supplier, professional adviser, consultant or customer) with the entity, or any of its child entities, or an officer of, or otherwise associated with, someone with such a relationship;
- has close personal ties with any person who falls within any of the categories described above;
- has been a director of the entity for such a period that his or her independence may have been compromised. The Commentary suggests that the board should regularly assess whether a director who has served in that position for more than 10 years has thereby become too close to management to be considered independent.

Recommendation 2.3 makes it clear that merely because a director has an interest, position, association or relationship described in Box 2.3, this does not automatically compromise the director's independence. It is ultimately for the board to form an opinion whether a non-executive director is independent and disclose the explanation for that opinion.

## Chair

**[14.45]** According to Recommendation 2.5, the chair should be an independent director and, in particular, should not be the same person as the CEO.

The chair should be an independent director.

According to the Commentary, an independent chair may contribute to the culture of openness and constructive challenge that allows for a diversity of views to be considered by the board. If the chair is not an independent director the Commentary suggests that the entity should consider appointing one of the independent directors as the deputy chair or as “senior independent director” who can fulfil the role whenever the chair is conflicted.

The responsibilities of the chair were expressed in greater detail by Austin J in *ASIC v Rich* [2003] NSWSC 85. He summarised the chair's responsibilities as being concerned with:

- the general performance of the board;
- the flow of financial information to the board (including information about cash reserves, actual segment performance and key transactions);
- the establishment and maintenance of systems for information flow to the board;
- the employment of a finance director;
- the public announcement of information;
- the maintenance of cash reserves and group solvency; and
- making recommendations to the board as to prudent management of the group.

The role and responsibilities of the chair are further discussed at [21.120]–[21.140].

These responsibilities are generally best carried out if the chair is an independent director. The proper carrying out of these responsibilities is time consuming so other positions held and their time commitments should be considered.

The roles of chair and CEO should not be exercised by the same person.

Recommendation 2.5 suggests that the roles of chair and CEO should not be exercised by the same person. The separation of these roles indicates that there is a division of responsibility at the head of the entity and the two roles are quite distinct. This increases accountability and recognises that to combine the roles in one person may give rise to an undesirable concentration of power and lead to conflicts of interest. In some cases, it may be necessary to remove the CEO and this may best be done where the roles are separated. The independence of the chair is compromised if the CEO goes on to become chair of the same entity.

## Nomination committee

**[14.50]** A board comprising directors with an appropriate mix of skills, experience and expertise is an essential element of good corporate governance. Recommendation 2.1 suggests that a nomination committee of the board should be established with at least three members, the majority of whom are independent directors. An independent director should chair the nomination committee. According to the Commentary, a nomination committee can “bring transparency, focus and independent judgment needed on decisions regarding the composition of the board”.

The role of the nomination committee.

According to the Commentary, the role of the nomination committee is to review and make recommendations to the board about:

- board succession planning generally;
- induction and continuing professional development programs for directors;
- the development and implementation of a process for evaluating the performance of the board, its committees and directors;
- the re-election of directors and the appointment of new directors; and
- ensuring there are plans in place to manage the succession of the CEO and other senior executives.

## Board skills

**[14.51]** As well as board composition, Principle 2 also emphasises the importance of the skills of the board. Having a board with an appropriate mix of skills is an essential mechanism for ensuring that the board of a listed entity can add value.

Under 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. According to the Commentary, a board skills matrix is a useful tool that can help identify any gaps in the collective skills of the board that should be addressed as part of the entity's professional development initiatives for directors and in its board succession planning.

Recommendation 2.6, which complements the recommendation regarding the board skills matrix suggests that a listed entity should have a program for inducting new directors and provide appropriate professional development opportunities for directors to develop and maintain the skills and knowledge needed to effectively perform their role as directors. According to the Commentary to this recommendation, the board or the nomination committee has the task of regularly reviewing whether the directors have the requisite skills, knowledge and familiarity with the entity's operations. The board or nomination committee should ensure that directors without specialist accounting skills or knowledge are provided with sufficient understanding of accounting matters to fulfil their responsibilities in relation to the entity's financial statements.

## Diversity on boards

**[14.52]** Diversity on boards refers to the mix of backgrounds, perspectives and characteristics of the board members. Gender composition is often seen as the most significant aspect of board diversity but it also includes factors such as age, ethnicity and cultural background. The growing importance of increased diversity on boards is a reaction to traditional boards where directors were often like-minded, from similar backgrounds, predominantly males and often previously known to each other. A criticism of such boards was that they did not encourage independent thought and there was a risk of "groupthink" which hindered creative responses to complex changes in a dynamic environment characterised by trends such as globalisation, technological innovation, climate change, unpredictable shocks and an increasing focus on more sophisticated risk management.

The *ASX Corporate Governance Principles and Recommendations* (4th ed) encourages increased gender diversity on boards. Recommendation 1.5 provides that a listed entity should have a diversity policy which includes requirements for the board or a relevant board committee to set out measurable objectives for achieving gender diversity and to assess annually both the objectives and the entity's progress in achieving them. The policy or a summary of it should be disclosed. Box 1.5 sets out suggestions for the content of a diversity policy. Recommendation 1.5 suggests that ASX300 entities should have a measurable objective for achieving gender diversity in the composition of its board, suggesting that at least 30 per cent of its directors should be from each gender.

The Commentary to Recommendation 1.5 noted that listed entities increasingly see diversity as an asset that is associated with better overall performance.

The ASX website lists a page of resources to assist listed companies in implementing the diversity recommendation in the *ASX Corporate Governance Principles and Recommendations*. This page is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

While there are significantly fewer women than men on boards of listed companies in Australia, their numbers have steadily increased over recent years. The Australian Institute of Company Directors (AICD) publishes a quarterly *Gender Diversity Report* which showed that as at the end of November 2022, 35.7 per cent of ASX 200 board seats were filled by women. In 2015, the corresponding figure was 21.7 per cent. The AICD *Gender Diversity Report* is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## Ethical culture

**[14.55]** Principle 3 says that a listed entity should instil a culture of acting lawfully, ethically and responsibly. The entity should clarify the standards of ethical behaviour required of directors and senior executives and encourage observance of those standards.

Recommendation 3.1 states that listed entities should articulate and disclose their values. Listed entities should also develop and disclose a code of conduct to guide directors, senior executives and employees as to the standards of behaviour expected: Recommendation 3.2. Box 3.2 sets out detailed suggestions for the content of the Code of Conduct.

A whistleblower policy and an anti-bribery and corruption policy should also be enacted and disclosed (Recommendations 3.3 and 3.4).

## Audit committee

**[14.60]** The board should establish an audit committee: Recommendation 4.1. An audit committee is seen as an effective and efficient mechanism to bring transparency, focus and independent judgment needed to oversee the corporate reporting process, including the processes for the appointment and removal of the external auditor and the rotation of the audit engagement partner. The existence of an independent audit committee is widely recognised as an important corporate governance practice.

All entities included in the S&P/ASX All Ordinaries Index (top 500 Australian listed companies) at the beginning of the entity's financial year must have an audit committee under ASX Listing Rule 12.7. Further, listed entities in the S&P/ASX 300 Index must comply with the ASX Corporate Governance Council's recommendations dealing with composition, operation and responsibilities of the audit committee.

|                                 |
|---------------------------------|
| Composition of audit committee. |
|---------------------------------|

Under Recommendation 4.1, the audit committee should be composed of:

- only non-executive directors;
- a majority of independent directors;
- an independent chair who is not chair of the board; and
- at least three members.

It is vital that the audit committee exercises independent judgment. For this reason, it is recommended that only independent directors sit on the audit committee.

The Commentary to Recommendation 4.1 provides that members of an audit committee should have the accounting and financial expertise and a sufficient understanding of the industry in which the entity operates, to be able to discharge the committee's mandate effectively.

|                          |
|--------------------------|
| Role of audit committee. |
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The Commentary to Recommendation 4.1 provides that the role of the audit committee is usually to review and make recommendations to the board in relation to:

- the adequacy of the entity's corporate reporting processes;
- whether the entity's financial statements provide a true and fair view of the entity's financial position and performance;
- the appropriateness of the accounting judgments or choices exercised by management in preparing the entity's financial statements;
- the appointment or removal of the external auditor;
- the scope and adequacy of the external audit including the independence and performance of the external auditor; and
- if the entity has an internal audit function, the objectivity and performance of the internal audit function.

## Timely disclosure

**[14.65]** A listed entity must have and disclose its policy for complying with its continuous disclosure obligations under ASX Listing Rules, particularly Listing Rule 3.1: Recommendation 5.1. This Listing Rule is aimed at ensuring the market has equal and timely access to material information concerning the entity including information about the entity's financial position, performance, ownership and governance. Information should be presented in a timely, factual, clear and balanced way disclosing both positive and negative news so as to enable investors to assess the impact of the information when making investment decisions. Continuous disclosure is discussed at [22.120] onwards.

## Risk management and internal control

**[14.70]** Principle 7 states that a listed entity should establish a sound risk management framework and periodically review the effectiveness of that framework.

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|-----------------|
| Risk committee. |
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According to Recommendation 7.1, the board of a listed entity should have a committee or committees to oversee risk. A risk committee may be established as either a standalone committee or as part of the responsibility of the audit committee. The committee should have at least three members, a majority of whom are independent directors and be chaired by an independent director.

The Commentary to Recommendation 7.1 says that the role of a risk committee is usually to:

- monitor management's performance against the entity's risk management framework, including whether it is operating within the risk appetite set by the board;
- review any material incident involving fraud or a breakdown of the entity's risk controls and the "lessons learned";
- receive reports from internal audit on its reviews of the adequacy of the entity's processes for managing risk;
- receive reports from management on new and emerging sources of risk and the risk controls and mitigation measures that management has put in place to deal with those risks;
- make recommendations to the board in relation to changes that should be made to the entity's risk management framework or to the risk appetite set by the board; and
- oversee the entity's insurance program, having regard to the entity's business and the insurable risks associated with its business.

Under Recommendation 7.3, a listed entity should disclose if it has an internal audit function, how that function is structured and what role it performs.

Before a listed entity's board approves the financial statements, s 295A requires the CEO and CFO to provide a declaration that, in their opinion, the entity's financial records have been properly maintained and that the financial statements comply with the accounting standards and give a true and fair view of the entity's financial position and performance. Under Recommendation 4.2, the CEO and CFO's opinion must have been formed on the basis of a sound system of risk management and internal control which is operating effectively. The purpose of this Recommendation is to encourage management accountability in the integrity of the entity's financial reporting, risk management and internal control processes.

## Remuneration

**[14.80]** As discussed at [12.305], the directors' report of listed companies is required to include a remuneration report in a separate section. The remuneration report must disclose the information specified under s 300A. This information includes the board policy for determining the nature and amount of remuneration of the directors and other key management personnel of the entity; the relationship of such policy and the entity's performance and details of the nature and amount of each element of the remuneration packages of each director and other key management personnel of the entity.

Principle 8, "Remunerate Fairly and Responsibly", states that companies should adopt remuneration policies which ensure that the level and structure of remuneration is sufficient and reasonable to attract quality directors and senior executives and to align their interests with the creation of value for security holders and with the entity's values and risk appetite.

The underlying principle is that the level and form of remuneration should not be determined by the recipients but should be approved by independent persons acting in the interests of the shareholders.

|                         |
|-------------------------|
| Remuneration committee. |
|-------------------------|

Membership of the remuneration committee should comprise a minimum of three directors, the majority being independent. The remuneration committee chair should be independent. Under ASX Listing Rule 12.8, entities included in the S&P/ASX 300 Index at the beginning of a financial year must have a remuneration committee comprised solely of non-executive directors for the entire financial year.

According to the Commentary to Recommendation 8.1, the role of the remuneration committee is usually to review and make recommendations to the board in relation to:

- the entity's remuneration framework for directors, including the process by which any pool of directors' fees approved by security holders is allocated to directors;
- the remuneration packages to be awarded to senior executives;
- equity-based remuneration plans for senior executives and other employees;
- superannuation arrangements for directors, senior executives and other employees; and
- whether there is any gender or other inappropriate bias in remuneration for directors, senior executives or other employees.

Executive remuneration packages should involve a balance between fixed and incentive payments that reflect short- and long-term performance objectives appropriate to the entity. A proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.

|                           |
|---------------------------|
| Share and option schemes. |
|---------------------------|

The major issue which has emerged both in Australia and the United States has been the practice of incorporating share and option schemes in executive remuneration packages. Until recently, such schemes were seen as desirable because they aligned the interests of executives with those of shareholders by providing executives with incentives to lift the share price.

Several corporate collapses in Australia and the United States highlighted the dangers of providing executives with large numbers of options without suitable performance hurdles. In several cases, this provided incentives for executives to adopt strategies which pushed up the share price in the short term but disadvantaged the long-term viability of the entity. This may occur through the use of fraudulent or misleading accounting practices to overstate profits. Stock options were once not expensed and therefore did not reduce stated profits. Accounting Standard AASB 2 *Share-based Payment* now requires Australian companies to value and expense share options. The widespread use of options, particularly in the United States, was also criticised because it had the effect of diluting other shareholdings.

|                                                                         |
|-------------------------------------------------------------------------|
| Separate non-executive and executive director remuneration disclosures. |
|-------------------------------------------------------------------------|

A listed entity should separately disclose its policies and practices regarding remuneration of non-executive directors and the remuneration of executive directors and other senior

executives: Recommendation 8.2. The Commentary notes that the policies and practices should appropriately reflect the different roles and responsibilities of non-executive directors compared with executive directors and other senior executives.

|                          |
|--------------------------|
| Remuneration guidelines. |
|--------------------------|

The Commentary provides guidelines to assist companies in formulating their remuneration policies and practices. For example, under the guidelines:

- Non-executive directors should be remunerated by way of cash fees, superannuation contributions and non-cash benefits in lieu of fees (such as salary sacrifice into superannuation or equity). Non-executive directors should not receive performance-based remuneration as it may lead to bias in their decision-making and compromise their objectivity. While they may receive securities as part of their remuneration, non-executive directors should generally not receive options with performance hurdles attached. They should not receive retirement benefits other than superannuation.
- The remuneration packages for executive directors and other senior executives should include an appropriate balance of fixed remuneration and performance-based remuneration. The performance-based remuneration should be linked to clearly specified performance targets that are aligned to the entity's short- and long-term performance objectives. To discourage "short-termism" or the taking of undue risks, care should be taken to ensure that the design of equity-based remuneration for executive directors and other senior executives are linked to hurdles aligned to the entity's long-term performance objectives.

The global financial crisis in late 2007 and in 2008 increased public disquiet about the high level of executive remuneration. There was a perception that the pay of executives, particularly CEOs, did not reflect the poor performance of their companies. In 2011, a "two-strikes and re-election" process was introduced to strengthen the existing framework which at that time provided for a non-binding shareholder resolution on executive remuneration. The non-binding shareholder resolution and the "two-strikes and re-election" process are discussed at [12.315] and [12.316].

## Environmental, social and governance responsibilities

**[14.85]** It is now increasingly accepted that companies and directors have wider social responsibilities and should consider the interests of other important stakeholders such as employees, customers and suppliers, the environment, regulators and other government agencies, and the broader community.

The CAMAC Report *The Social Responsibility of Corporations* (December 2006) addressed the question whether the *Corporations Act* should be revised to specifically require directors to take into account the interests of various stakeholders and the broader community when making corporate decisions. The report considered that the present law requiring directors and others to act in the interests of the company was sufficiently broad to enable



corporate decision-makers to take into account the environmental and other social impacts of their decisions. This report may be viewed on the CAMAC website, which is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## Environment and climate risk and disclosure

[14.90] There is increasing focus today on the need for companies to address environmental issues and risks. There are also growing expectations that companies will take steps to disclose and manage climate-related risks. This is dealt with primarily by disclosure. A listed entity is required by the *ASX Corporate Governance Principles and Recommendations* to 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: Recommendation 7.4.

According to the Commentary, climate change is a key source of environmental risk, and includes:

- risks related to the transition to a lower-carbon economy; and
- physical risks, such as food security, water availability and quality and extreme temperature changes which may affect an organisation's operations.

The duty of care and diligence likely requires directors to consider, disclose and take appropriate steps to manage foreseeable climate-related risks: see [17.10].

In its report *Climate Risk Disclosure by Australia's Listed Companies* (Report 593, September 2018), ASIC made four recommendations in relation to climate-related risks for listed companies:

- **Consider climate risk:** Directors and officers should monitor and continually reassess climate-related risks to the company's business.
- **Develop and maintain strong and effective corporate governance:** Boards should maintain proper governance in order to ensure better information flows within their company and effective oversight in relation to climate risk.
- **Comply with the law:** Directors of listed companies have obligations to report on the business strategies and prospects for future financial years of their company, and comply with other reporting and disclosure requirements. ASIC considers that the law requires listed companies to discuss climate risks which could affect the company's financial performance.
- **Disclose useful information to investors:** Listed companies should assess and disclose physical and transition risk associated with climate change. On 10 August 2023, the Australian Council of Superannuation Investors (ACSI) released its annual report into the climate change disclosure of ASX200 companies. The report found that nearly 70 per cent of ASX200 companies are currently reporting against the Taskforce for Climate-related Financial Disclosures (TCFD) framework, which "provide[s] investors with decision-useful, comparable and consistent information". This is a major change as fewer than 11 per cent of ASX200 companies were reporting against the TCFD framework in 2017.

## Cyber security

**[14.95]** Cyber security is an increasingly important feature of the corporate landscape in Australia, with cyber crime increasing each year. High-profile cyber attacks have seen personal customer information stolen or compromised.

The duty of care and diligence requires directors to take steps to prevent foreseeable risks of harm to their company, and it is very likely that this requires directors to take appropriate steps to manage cyber-security risks.

As noted at [14.70], listed companies are required by the *ASX Corporate Governance Principles and Recommendations* to review the effectiveness of their risk management framework at least annually: Recommendation 7.2. According to the Commentary, the board of a listed company should satisfy itself that the risk management framework deals adequately with risks including cyber-security risks.

Therefore, good corporate governance practice requires boards of both listed and unlisted companies to implement procedures to minimise the risk of cyber attacks.

## Modern slavery

**[14.100]** The *Modern Slavery Act 2018* (Cth) requires Australian entities which have an annual consolidated revenue of \$100 million or more to report on the risks of modern slavery in their operations, and the actions the entity has taken to address those risks. Other entities may report voluntarily. A review of the Act completed in 2023 recommended, among other things, introducing penalties for non-compliance with statutory reporting requirements, lowering the reporting threshold from \$100 million to \$50 million and amending the Act to require entities to have a due diligence system in place: *Report of the Statutory Review of the Modern Slavery Act 2018* (Cth). Many ASX listed entities are likely to be subject to these requirements.

## Tutorial questions

*Further multi-issue directors' duty questions are located at the end of Chapter 13.*

The following questions dealing with corporate governance may be answered after reading this chapter and considering the internet resources found on the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

1. ASX Listing Rule 4.10.3 requires the annual report of a listed entity to set out the extent to which it complies with *Corporate Governance Principles and Recommendations*. Choose three listed company annual reports (try to include a large and a small company) which may be found by looking at the websites of companies. Compare the corporate governance statements contained in the annual reports that you have chosen in respect of the following matters:
  - (a) amount of detail contained;
  - (b) composition of the board;

- (c) responsibilities and functions of the board;
  - (d) types of committees and their responsibilities; and
  - (e) any matter that is addressed in one annual report that is not mentioned in the others.
2. Provide an overview of the G20/OECD Principles of Corporate Governance. To what extent have these principles been incorporated into Australian legislation or practice?
  3. Select three codes or principles such as the ASX Corporate Governance Council Recommendations, the New York Stock Exchange Corporate Governance Standards and UK Corporate Governance Code and compile a comparative table showing:
    - (a) how each deals with particular issues; and
    - (b) highlighting any significant differences.
  4. What is the role of institutional investors in corporate governance?

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.
- For further corporations law links and material please refer to the Understanding Company Law website at <http://www.uclaw.com.au>.

## Chapter 15

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# Directors' duties of good faith and proper purpose

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## Key points

- Directors are under both a fiduciary and statutory duty to act in good faith and in the best interests of the company.
- The duty to act in good faith in the best interests of the company means that directors must act in the interests of the general body of shareholders. This includes an obligation to act fairly across different classes of shareholders.
- The duty to act in the best interests of the company may cause difficulties for nominee directors and directors of a company that is a member of a larger corporate group. In both cases, it may be difficult for a director to reconcile acting in the best interests of the company with acting in the best interests of the nominee director's appointor.
- Directors have a fiduciary and statutory duty to exercise their powers for a proper purpose and not for the purpose of conferring an advantage on themselves or someone else. This duty may be breached where directors issue shares for the purpose of preventing a takeover or altering the balance of power among shareholders.
- Directors who have mixed purposes (proper and improper) for exercising a particular power will breach their duty if the motivating purpose was improper.
- Shareholders have the power to ratify improper exercises of power by directors.



## Duty to act in good faith in the best interests of the company

**[15.05]** Directors are under a fiduciary duty to act in good faith and in the best interests of the company. Section 181(1)(a), which requires a director or other officer to exercise their powers and discharge their duties in good faith and in the best interests of the corporation, sets out the same requirements as the fiduciary duty. Section 181(1)(a) is discussed at [15.235]. The law set out in the s 181(1)(a) cases is also relevant for the directors' fiduciary duty to act in the best interests of the company.

The broad fiduciary duty requiring directors to act in the best interests of the company encompasses duties to avoid conflicts of interest, not take advantage of their position to make secret profits and not misappropriate the company's assets for themselves: *Chew v The Queen* (1991) 4 WAR 21. The duties to avoid conflicts of interest are discussed in Chapter 16. The requirement of good faith means that directors must act honestly and not pursue their own interests at the expense of the company: *BCEG International (Australia) Pty Ltd v Xiao* (2022) 162 ACSR 601.

Directors who breach the fiduciary duty or the s 181(1)(a) duty to act in the best interests of the company may also, in the same circumstances, breach their duty to avoid conflicts of interest or ss 180, 182 and 183.

### Is the duty subjective or objective?

**[15.06]** The cases are not settled as to whether the duty to act in good faith in the best interests of the company is a subjective duty, such that directors will not breach the duty if they honestly believed they acted in the company's best interests, or an objective duty, such that a director will be found to have breached the duty if the law considers objectively that what a director did was improper, regardless of the director's subjective belief as to the propriety of his or her conduct: *Re Colorado Products Pty Ltd (in prov liq)* [2014] NSWSC 789.

The subjective approach is based on the principle that "[a] director's judgment as to what is in the best interests of the corporation, if exercised in good faith and not for irrelevant purposes, is not open to review in the courts": *VicBeef Holdings Pty Ltd v Chen* [2021] VSC 546; *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483. According to this approach, the duty will only be contravened "where a director engaged deliberately in conduct, knowing that it was not in the interests of the company": *ASIC v Maxwell* (2006) 59 ACSR 373. Cases such as *Westpac Banking Corporation v Bell Group Ltd (in liq) (No 3)* (2012) 44 WAR 1 have adopted this approach. According to the objective approach, the duty to act in good faith in the best interests of the company is breached if a director acts in a way that no rational director would have considered to be in the best interests of the company: *ASIC v Adler* [2002] NSWSC 171. A similar point was made by the Victorian Court of Appeal in *Mernda Developments Pty Ltd (in liq) v Alamanda Property Investments No 2 Pty Ltd* [2011] VSCA 392 where the court held that the test was whether an intelligent and honest man in the position of the directors reasonably believed that their conduct was in the best interests of the company.

The rationale for an objective approach was explained by Bowen LJ in *Hutton v West Cork Railway Co* (1883) 23 Ch D 654:

*Bona fides* (good faith) cannot be the sole test, otherwise you might have a lunatic conducting the affairs of the company, and paying its money with both hands in a manner perfectly *bona fide* yet perfectly irrational.

Under an objective approach, the subjective beliefs of the director may still be relevant. If the directors acted with an honest belief that their conduct was in the company's best interests, then this will be significant in determining whether there has been a breach of the duty: *VicBeef Holdings Pty Ltd v Chen* [2021] VSC 546.

In many cases the distinction between whether the good faith obligation is subjective or objective will not affect the outcome of the case. Where directors promote their own interests in conflict to the interests of the company or cannot provide evidence of a subjective belief that their conduct was in the best interests of the company, the directors will be found to have breached the duty: *Re Sirrah Pty Ltd (in prov liq)* [2021] NSWSC 413.

Directors are presumed to have acted in good faith and in the best interests of their company and those persons alleging a breach of duty bear the onus of proving that this is in fact not the case.

## What are the best interests of the company?

[15.10] A difficult question arises as to what is meant by the phrase “the best interests of the company”. As discussed at [2.45], a company is regarded as a legal entity separate and distinct from its shareholders. The courts have held that the interests of the company to which the duty is owed “include the interests of the corporate entity itself, the shareholders and, at least where the financial position of the company is precarious, the creditors of the company”: *Cassimatis v ASIC* [2020] FCAFC 52; *Vrisakis v ASC* (1993) 9 WAR 395.

### Present and future shareholders

[15.12] The interests of the company will often be broadly consistent with the interests of the shareholders. The courts have sometimes equated the interests of the company with the interests of the shareholders as a collective group.

Evershed MR, in *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286, stated:

[T]he phrase, “the company as a whole”, does not (at any rate in such a case as the present) mean the company as a commercial entity distinct from the corporators: it means the corporators as a general body.

As long as the company is solvent and a going concern, the interests of the company correspond to the interests of its present and future shareholders as well as the company itself as a commercial entity. However, as discussed at [18.10]–[18.95], where the company is in financial difficulties and has insufficient funds to pay its creditors in full, the creditors' interests become paramount. Directors may act in what they consider to be the best interests of the company as a commercial entity, even though this may not be in the short-term interests of shareholders: *Darvall v North Sydney Brick & Tile Co Ltd* (1987) 6 ACLC 154.

In most situations, the interests of the company as a commercial entity and the interests of its shareholders coincide. As a general rule, shareholders' interests are paramount however a company has a legitimate interest in a broad range of matters which extend beyond the company's business and the security of its assets. These may include who its shareholders are, the price of its shares and achieving a proper understanding of the company's business in the investment community.

In *Cassimatis v ASIC* [2020] FCAFC 52, the majority held that the interests of a company are broader than the interests of its shareholders, rejecting the proposition that the interests of a company were co-incidental with, or predominantly informed by, the wishes of its shareholders. The best interests of the company may include the interests of other stakeholders such as customers and the local community. The Senate Standing Committee on Legal and Constitutional Affairs stated in its 1989 Report, *Social and Fiduciary Duties and Obligations of Company Directors*:

The courts have associated directors' duties with "the interests of the company". This does not mean that directors must not consider other interests. The "interests of the company" include the continuing well-being of the company. Directors may not act for motives foreign to the company's interests, but the law permits many interests and purposes to be advantaged by company directors, as long as there is a purpose of gaining in that way a benefit to the company.

Directors' duties and environmental, social and governance considerations are discussed at [15.135].

## Individual shareholders

**[15.15]** Directors' duty to act in good faith in the best interests of the company including its shareholders does not mean that they owe duties to particular shareholders.

*Percival v Wright* [1902] 2 Ch 421

**[15.20]** A director of a company was approached by a shareholder wishing to sell his shares. The director agreed to buy them but did not disclose that there was an impending takeover bid at a substantially higher price. The shareholder afterwards sought to rescind the contract for the sale of his shares on the basis that the director breached his fiduciary duty to him by failing to disclose the information concerning the impending takeover even though it did not eventuate. The court rejected the shareholder's claim. It held that directors only owe fiduciary duties to the company as a whole and not to individual shareholders.

Directors do not owe fiduciary duties to particular shareholders except in special circumstances.

**[15.25]** Under general equity principles dealing with fiduciaries, in certain special circumstances, a director may owe fiduciary duties to an individual shareholder. Such circumstances arise where the member is in a position of vulnerability and depends upon the advice or information provided by the director who is in a position to exercise power where the interests of the member may be affected in a legal or practical sense: *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41. The director must have been

in direct and close contact with the individual member so that the director caused the member to act in a certain way which turned out to be detrimental to the member: *Peskin v Anderson* (2001) 19 ACLC 3001.

*Coleman v Myers* [1977] 2 NZLR 225

[15.30] The managing director of a family company arranged for the company to be taken over at an under-value by a new company controlled by him. It was held that the managing director breached fiduciary duties owed to the minority shareholders of the family company. The managing director failed to disclose material information concerning his potential profits and misled the shareholders as to the true value of the company's assets. Woodhouse J noted the factors that would give rise to a fiduciary duty to individual shareholders:

They include, I think, dependence upon information and advice, the existence of a relationship of confidence, the significance of some particular transaction for the parties and, of course, the extent of any positive action taken by or on behalf of the director or directors to promote it.

*Brunninghausen v Glavanics* [1999] NSWCA 199

[15.35] The New South Wales Court of Appeal held that there were special circumstances which justified a departure from the general rule that a director does not owe a fiduciary duty to act in the best interests of particular shareholders.

In that case, the company had two shareholders who were also its only directors. Glavanics, the minority shareholder, despite being a director, was not involved in the company's management and had no access to its financial records. After a falling out, Brunninghausen, the majority shareholder and managing director, entered into negotiations to buy Glavanics' shares. However, unknown to Glavanics, another person approached Brunninghausen offering to buy all the shares in the company. Eventually Glavanics agreed to sell his shares to Brunninghausen, who subsequently sold all the shares to the third party for a higher price. When Glavanics became aware of this, he sued Brunninghausen for breach of fiduciary duty and claimed equitable compensation.

The Court of Appeal held that while a director's fiduciary duties were generally owed to the company and not individual shareholders, the nature of a transaction may give rise to a director owing fiduciary duties to a shareholder. Brunninghausen possessed special knowledge of a third-party offer acquired while managing the company which provided him with an opportunity to sell the company's business advantageously. This opportunity belonged to the company and directors owe a fiduciary duty to the shareholders in cases where there are negotiations for a takeover or an acquisition of the company's undertaking, which would require the directors to loyally promote the joint interests of all shareholders by treating them equally and disclosing any conflicts of interest. The circumstances which gave rise to a fiduciary duty owed to Glavanics included the relative powerlessness of his

position and his lack of an effective right to be informed of the negotiations being conducted for the sale of the company's business. This made Glavanics vulnerable to abuse and gave Brunninghausen the capacity to adversely affect the interests of Glavanics.

[15.40] Where a company acts as a trustee, directors of the trustee company also owe a duty to act in the best interests of the beneficiaries of the trust: *Hurley v BGH Nominees Pty Ltd (No 2)* (1984) 37 SASR 499.

## Different classes of shareholders

[15.50] The task of ascertaining what constitutes the interests of the company as a whole is particularly difficult where its shares are divided into different classes. In such a case, the exercise of a power by the directors may benefit one class to the detriment of others. Classes of shares are discussed at [8.110].

In *Mills v Mills* (1938) 60 CLR 150, Latham CJ held that the test of whether a director is acting in the interests of the company is not appropriate in such circumstances. Rather, it involves the question of what is fair as between the classes of shareholders. He also stressed that while directors are required to act in the interests of the company, the law does not require them to “live in an unreal region of detached altruism”. If they are also shareholders, they cannot reasonably be expected to disregard their own interests.

As discussed at [24.15]–[24.280], s 232 enables a member to obtain a remedy if the court is of the opinion that a resolution of a class of members was contrary to the interests of the members as a whole, oppressive or unfairly prejudicial or unfairly discriminatory. This may apply where directors exercise their voting rights as holders of a class of shares in a way that is detrimental to holders of other classes of shares.

## Position of nominee directors

[15.55] Nominee directors are sometimes appointed to represent particular interests such as a majority shareholder, a class of shareholders, creditors, a holding company, employees, a government body or the interests of a shareholder in a joint venture company. The position of directors within groups of companies is discussed at [15.90]. In reality, nominee directors are expected to act in the interests of their appointors rather than the company's shareholders generally.

The fiduciary and statutory duties to act in good faith in the best interests of the company as a whole require directors to act in the best interests of the shareholders as a collective group. However, difficulties arise in situations where a nominee director is appointed to represent the interests of particular shareholders. In such cases, it may be problematic to reconcile the expectation that the nominee director will act in the interests of the appointor and the director's duty to act in the interests of the company as a whole.

Nominee directors may act in the interests of their appointor if they honestly and reasonably believe that there is no conflict of interests.

Nominee directors are permitted to act in the interests of their appointor provided that they honestly and reasonably believe that there is no conflict between the interests of their appointor and the interests of the company. In the absence of a clear intention to disregard the interests of the company as a whole, courts are reluctant to find that nominee directors have breached their duty. It is commercially unrealistic to expect nominee directors to approach every company problem with a completely open mind as this would place nominee directors in a very difficult position: *Re Broadcasting Station 2GB Pty Ltd* [1964-1965] NSW 1648.

**[15.65]** A company's constitution or a shareholders' agreement may specifically permit the appointment of nominee directors to represent the interests of a particular shareholder or creditor. In such a case it is implied that the nominee directors were expected to act in their appointor's interests.

*Levin v Clark* [1962] NSW 686

**[15.70]** Levin purchased the majority shareholding in a company and simultaneously mortgaged the shares to the vendor to secure payment of the purchase price. The company's constitution named Clark and Rappaport as the governing directors with wide powers to represent the interests of the vendor and mortgagee only in the event of default in payment of the loan to Levin. Levin defaulted and Clark and Rappaport proceeded to exercise their powers to enforce the mortgage. Levin challenged this exercise of power on the basis that as governing directors, Clark and Rappaport's primary obligation was to the company and not to the mortgagee. The court held that the extent of the fiduciary duties of directors depends on the circumstances and these may include the fact that the constitution provided for the appointment of nominee directors. In this case, it was implied that in accordance with the agreement of the shareholders, the nominee directors, Clark and Rappaport, were expected to protect the mortgagee's interests in the event of default by the mortgagor.

**[15.75]** Nominee directors breach their duty where there is a clear conflict between the interests of the company and their appointor and the company's interests are sacrificed. The duties of nominee directors of non-wholly owned subsidiaries were considered by the English Court of Appeal in *Scottish Co-operative Wholesale Soc Ltd v Meyer* [1958] 3 All ER 66. Lord Denning held that where the interests of a holding company and the subsidiary's minority shareholders do not coincide, nominee directors appointed by the holding company are bound to put the interests of the subsidiary's shareholders ahead of the interests of the majority shareholder.

*Scottish Co-operative Wholesale Soc Ltd v Meyer* [1958] 3 All ER 66

**[15.80]** The minority shareholders of a subsidiary of the Scottish Co-operative Wholesale Society held slightly less than half the issued shares in the subsidiary. Three directors of the subsidiary were appointed as nominees of the holding company and the other two represented the minority shareholders. The subsidiary

operated a profitable textile manufacturing business using yarn purchased from its holding company. After a time, the holding company decided to operate its own textile manufacturing business and stopped supplying yarn to its subsidiary. As a result, the subsidiary's activities were severely curtailed. The action of the holding company had the effect of preventing the subsidiary's minority shareholders from participating in the profits of the textile manufacturing business.

It was held that the subsidiary's directors appointed by the holding company acted contrary to the interests of the shareholders as a whole by failing to defend the subsidiary from the actions of the holding company. Their failure to act, coupled with the holding company's conduct, was regarded as oppressive under the English equivalent of s 232. This is discussed at [24.15]–[24.280].

**[15.85]** This approach was also taken by Street J in *Bennetts v Board of Fire Commissioners of New South Wales* (1967) 87 WN (Pt 1) (NSW) 307, where he stated that a nominee director must put the interests of the company ahead of the interests of the appointor whenever a conflict arises.

Although nominee directors are commonly appointed in a wide variety of situations, the inherent difficulties in determining the extent of the nominee directors' fiduciary duties in a particular case depend on the circumstances and are not easily resolved.

## Company groups

**[15.90]** A holding company will usually appoint its nominees as directors of subsidiaries. In practice, nominee directors on the board of a subsidiary are required by the holding company to act in the best interests of the holding company and the group of companies. For example, a holding company may require the directors of a subsidiary to approve their company's participation in intra-group transactions, such as loans to other companies in the group or guaranteeing the external borrowings of other group members. In most cases, the interests of the holding company and the interests of a wholly owned subsidiary will generally correspond. However, if there is a conflict between the interests of a subsidiary and the group, which can arise where the group is in financial difficulties or the interests of minority shareholders are involved, nominee directors must act in the subsidiary's best interests and not in the interests of the group as a whole: *Walker v Wimborne* (1976) 137 CLR 1. This case is further discussed in the context of directors' duty to creditors at [18.15].

*Mernda Developments Pty Ltd (in liq) v Alamanda Property Investments No 2 Pty Ltd*  
[2011] VSCA 392

**[15.92]** A shadow director of Mernda Developments breached his duty to act in the best interests of the company when he arranged for it to enter into a loan facility agreement under which Alamanda would lend money to Mernda and 24 other companies also controlled by the shadow director. Mernda granted Alamanda a charge over all its assets as security. Under the loan facility agreement, Mernda was



not entitled to draw down any further advances beyond the initial advance and was required to repay to Alamanda not only its own indebtedness but also that of the other borrowing companies. The court held that an intelligent and honest person in the shadow director's position could not have reasonably believed that entering into the facility agreement, whereby Mernda incurred a liability for the debts of other borrowers in circumstances where Mernda was itself not entitled to any further advances, was for the benefit of Mernda.

**[15.93]** While directors of a subsidiary company have a duty to act in the best interests of that company rather than the group as a whole, in some circumstances, even where the group is in financial difficulties, an intra-group transaction that is entered into primarily for the benefit of the group may also have collateral or derivative benefits for the subsidiary. In such a situation, there will be no breach of duty if it can be shown that the subsidiary indirectly benefited from the assistance that was given to other companies in the group. This can occur where the liquidation of the whole group can be forestalled or delayed.

*Equiticorp Finance Ltd (in liq) v Bank of New Zealand* (1993) 32 NSWLR 50

**[15.95]** Funds were transferred from two companies in a group to satisfy the debt of a related company. The New South Wales Court of Appeal held that the dominant director of the group was justified in considering that the welfare of the group was intimately tied up with the welfare of the individual companies. The interests of the two companies were considered because provision was made for compensating them for the loss of the funds. The transactions were justified because the holding company of the group had guaranteed the debt which was repaid. The alternative was possible disaster for the whole group, including the two companies.

**[15.100]** Section 187 assists directors who serve on the boards of wholly owned subsidiaries. Under this provision, a director of a wholly owned subsidiary will be taken to act in good faith in the best interests of the subsidiary where:

- the constitution of the subsidiary expressly authorises the director to act in the best interests of the holding company; and
- the director in fact acted in good faith in the best interests of the holding company.

In order to protect the interests of the subsidiary's creditors, the operation of s 187 is limited to situations where the subsidiary is solvent at the time the director acts and does not become insolvent because of the director's action.

A holding company's nominees on the board of a non-wholly owned subsidiary are in a more delicate position. They must balance the interests of the group with the interests of the subsidiary's shareholders generally, including the minority shareholders. In most situations, the interests of a non-wholly owned subsidiary company and the wider interests of the group coincide. This may not, however, be the case where the various companies in the group are in financial difficulties. The movement of funds from



one company to another group member may prejudice the interests of creditors of the transferring company. The duty of directors to creditors is discussed at [18.10]–[18.95].

It may be detrimental to the interests of minority shareholders if directors fail to act in the interests of a particular company and instead treat the company as part of a group.

*Re Spargos Mining NL* (1990) 3 WAR 166 and *Jenkins v Enterprise Gold Mines NL* (1992) 10 ACLC 136

**[15.105]** A minority shareholder, Jenkins, obtained remedies under the equivalent of s 232 on the grounds that the directors of Spargos and Enterprise Gold Mines had diverted substantial assets that were used for the benefit of the recipient companies in the group. This caused considerable losses to the shareholders not interested in these companies because the transactions were of no commercial benefit to Spargos and Enterprise Gold Mines and their shareholders. These cases are discussed at [24.15]–[24.280].

## Employees

**[15.115]** Directors should not consider the interests of employees at the expense of the interests of the company's shareholders.

*Parke v Daily News Ltd* [1962] Ch 927

**[15.120]** A company that controlled two newspapers sold one of them. The directors intended to distribute surplus proceeds from the sale among its employees by way of compensation for dismissal. A shareholder brought an action to prevent these payments. It was held that the directors breached their fiduciary duties to act in the best interests of the company because the proposed payments were not reasonably incidental to the carrying on of the company's business. They were gratuitous payments to the detriment of shareholders and the company as a whole.

However, in *Re Cummings Engineering Holdings Pty Ltd* [2014] NSWSC 250, the court said that a redundancy payment paid to a departing employee (sometimes called a “golden handshake”) may be in the interests of the company if it preserves goodwill, avoids disputation, and encourages continuing employees.

**[15.125]** In most cases, a payment to employees will be in the interests of the company where their employment continues because its industrial relations may be improved. This did not arise in *Parke v Daily News Ltd* [1962] Ch 927 because the company was in fact selling that part of its business operations. This case is based on the notion of shareholder primacy which places the interests of shareholders over the interests of other stakeholders. This approach has been increasingly questioned and more importance has been placed in recent times on corporate environmental and social responsibility and the interests of employees, customers and other stakeholders. Corporate environmental and social responsibility is discussed at [15.135].

The employee entitlements provisions contained in Pt 5.8A of the *Corporations Act* require directors to consider the interests of employees in certain situations. These provisions were introduced to protect employees by preventing directors of employer companies stripping the companies' assets and making the companies insolvent so as to prevent employees enforcing their entitlements. These provisions are discussed at [18.255] and [32.625].

The United Kingdom's *Companies Act 2006* (UK) requires directors to have regard to the interests of the company's employees and the impact of the company's operations on the community and the environment as well as promoting the success of the company for the benefit of its members as a whole. The Australian position is discussed at [15.135].

## Creditors

**[15.130]** As discussed at [15.05], directors are subject to a fiduciary duty to exercise their powers in good faith and in the best interests of their company. When the company is solvent, the best interests of the company usually correspond with the best interests of its shareholders as a collective group. Different considerations apply if the company is insolvent or in financial difficulties. In such circumstances, the interests of the company are those of its creditors. Directors have a duty to exercise their powers in a way that does not prejudice the company's ability to pay its creditors. Directors' duties not to prejudice their company's creditors are discussed in Chapter 18.

## Directors' duties and environmental, social and governance considerations

**[15.135]** There has been increasing awareness that a focus on the interests of the shareholders to the exclusion of the interests of other stakeholders is too narrow and that companies also have wider environmental, social and governance responsibilities (ESG). It has been increasingly clear that a failure by directors to properly manage ESG risk can result in serious reputational damage to their companies. Reputational damage to a company in turn can have serious consequences where consumers, investors and lenders turn away from doing business with it. Consequently, directors are required to consider the interests of other important stakeholders apart from shareholders when making business decisions. Other stakeholders who have a legitimate interest in a company's activities include:

- the company's employees;
- the company's customers and suppliers;
- the environment;
- regulators and other government agencies; and
- the broader community.

Areas within ESG include climate change risk, employee health and safety, human rights issues in relation to the company, its suppliers and contractors, accounting and disclosure practices and management of corruption and bribery issues.

The *Corporations Act* does not directly address how directors should take ESG matters into account and the various stakeholder interests directors should consider. For listed companies, the increasing importance of ESG considerations in corporate decision-making is reflected in the *ASX Corporate Governance Principles and Recommendations* (4th ed), Principle 7 which is concerned with risk management and disclosure of environmental and social risks. The *ASX Corporate Governance Principles and Recommendations* (4th ed) is discussed at [14.25] onwards.

The United Kingdom's *Companies Act* specifically requires directors to take into account the interests of various stakeholders and the broader community when making corporate decisions.

## Examples of breaches of the duty to act in good faith in the interests of the company

[15.140] In *Wollongong Coal Ltd v Gujarat NRE Properties Pty Ltd* [2020] NSWSC 254, two directors supported a board resolution for their company to purchase a property with the intention of constructing an opulent house in which they could reside indefinitely at no cost to themselves. The court held that the directors had breached the duty to act in good faith in the interests of the company and for a proper purpose, and s 181(1) of the Act.

In *Re ACN 152 546 453 Pty Ltd (in liq)* [2022] NSWSC 974, a director who caused or permitted his company to make payments to companies in which he and his wife held interests was held to have breached his duties to act in good faith in the interests of the company and for a proper purpose because those payments were not in the interests of the company.

*The Checkout Pty Ltd v Cordell Jigsaw Productions Pty Ltd (No 13)* [2022] NSWSC 444

[15.142] Julian Morrow and Nicholas Murray established a company pursuant to a joint venture agreement for the purpose of producing a television series, "The Checkout". Morrow and Murray were directors and, indirectly, shareholders in the joint venture company. After six seasons of the program, Morrow and Murray had a bitter falling out and Murray agreed to sell his interest in the company to Morrow. After the sale, the company, now controlled by Morrow, sought to negotiate a seventh series of "The Checkout" with the ABC. The court held that by entering into negotiations with the ABC to produce a further series without informing the other venturer, Morrow had breached his duties to exercise his powers and discharge his duties in good faith and in the best interests of the company, and to exercise those powers for a proper purpose.

## Duty to exercise powers for proper purposes

[15.145] We saw at [12.75] that certain powers are conferred on the board of directors by the replaceable rules and constitution (if any). These generally include broad powers of

management. Examples of specific powers conferred on directors include the power to issue shares and to refuse to register transfers of shares.

The fiduciary duty of directors requires them to exercise their powers for the purposes for which they were conferred and not for any collateral or improper purposes. The actions of the directors can only be challenged as being for an improper purpose, if it can be shown that the substantial purpose of the directors was improper. Directors may breach this duty even if they honestly believe their actions are in the best interests of the company as a whole.

In cases where it is alleged that the directors have exercised their powers for improper purposes, the courts consider two matters: the objective purpose for which the power was granted and the purpose which actually motivated the exercise of the power: *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821. The onus of establishing that the directors acted improperly rests with those alleging the breach of duty: *Australian Metropolitan Life Assurance Co Ltd v Ure* (1923) 33 CLR 199. The courts are generally reluctant to interfere in the internal management of a company unless improper purposes are clearly demonstrated.

A director may be in breach of the duty to exercise powers for a proper purpose even though the director was not directly involved in a particular transaction. For example, the duty was breached where a director disclosed a conflict of interest and abstained from voting but knew of the improper purpose of the other directors and failed to take steps to prevent the transaction from proceeding. The director was under a positive duty to take steps to protect the company's interests: *Permanent Building Society v Wheeler* (1994) 11 WAR 187.

Under s 181, directors and other officers are under a duty to act in good faith in the best interests of the corporation and for a proper purpose. Breach of this duty to exercise powers for a proper purpose attracts the civil penalty provisions and possibly criminal liability where dishonesty is involved. The civil penalty provisions are discussed at [19.120]–[19.150].

## Issue of shares

**[15.150]** While the duty to act for proper purposes may arise in a large variety of situations, many court cases involving allegations of breach of directors' duty to act for proper purposes have concerned directors exercising the power to issue shares.

The power to issue shares is ordinarily conferred for the purpose of raising capital for the company.

The power to issue shares is ordinarily conferred for the purpose of raising capital for the company. Shares may also be properly issued for the purpose of providing consideration for the purchase of property or as a means of remunerating employees of a company.

Directors breach their fiduciary and statutory duties to exercise their powers for a proper purpose if they issue shares to:

- maintain control of the company's management or majority shareholding;
- defeat a takeover bid; or
- create or destroy the voting power of majority shareholders.

The company has a number of remedies if directors issue shares for improper purposes. The main remedy is to rescind the share issue. A shareholder may apply for court leave under s 236 to sue the directors in the name of the company if it is unwilling to take such action against its directors. Issuing shares for an improper purpose may also constitute oppressive or unfair conduct and enable a shareholder to obtain a remedy under s 232. Sections 232 and 236 are discussed at [24.15] and [24.285], respectively.

If directors suspect that a share issue may result in them breaching their fiduciary duty, they can best protect themselves by obtaining shareholder approval at a general meeting. Shareholder approval is obtained by the passing of an ordinary resolution to ratify the directors' actions.

Shareholders may ratify an improper share issue.

Shareholder ratification of directors' breaches of duty is discussed at [20.05].

To a large extent, the ASX Listing Rules ensure that directors of listed companies do not make significant share issues without obtaining shareholder approval. Under Listing Rule 7.1, share issues exceeding 15 per cent of a listed company's issued capital in a 12-month period require shareholder approval. In addition, Listing Rule 10.11 requires shareholder approval for share issues to related parties of a listed company such as directors.

### *Shares issued to maintain control*

**[15.155]** Directors who issue shares for the purpose of maintaining their position of control of the company breach their fiduciary duty and the share issue may be invalidated.

In *Ngurli Ltd v McCann* (1953) 90 CLR 425, Williams ACJ, Fullagar and Kitto JJ in a joint High Court judgment stated:

The power must be used *bona fide* for the purpose for which it was conferred, that is to say, to raise sufficient capital for the benefit of the company as a whole. It must not be used under the cloak of such a purpose for the real purpose of benefiting some shareholders or their friends at the expense of other shareholders or so that some shareholders or their friends will wrest control of the company from the other shareholders.

### *Creating or destroying a majority of voting power*

**[15.160]** In *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821, the Privy Council held that directors may act for improper purposes even where a share issue is not motivated by self-interest. Directors breach their duty to act for proper purposes if they use their power to issue shares for the purpose of creating a new majority shareholder or to manipulate control within the company. This is so even where the directors may honestly believe their actions are in the best overall interests of the shareholders.

*Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821

**[15.165]** This case arose out of a takeover battle for control of R W Miller (Holdings) Ltd. Its major shareholders were two independent companies, Ampol Petroleum and Bulkships Ltd, which between them controlled 55 per cent of Miller's issued capital. Ampol and Bulkships decided to combine their holdings and made a joint takeover bid for all the other Miller shares. Soon after, Howard Smith, a company friendly to Miller's board, made its own takeover bid offering a higher price. To give Howard Smith's takeover bid a chance of success, Miller's directors issued sufficient shares to it so as to reduce the Ampol-Bulkships majority shareholding to a minority position. When Ampol and Bulkships challenged the validity of the share issue, Miller's directors argued that they were primarily motivated by the fact that their company was in urgent need of funds to finance tankers then under construction and to ease other existing financial problems.

The Privy Council held that Miller's directors had breached their duty and invalidated the share issue to Howard Smith. It did not believe the directors' explanation of their reasons for the share issue. The directors were motivated primarily to reduce the combined majority shareholding of Ampol and Bulkships to a minority position in order to promote the Howard Smith takeover bid. This was improper even though a successful bid by Howard Smith meant that shareholders would have been able to obtain a higher price for their shares. Although Miller was in a position of tight liquidity, its financial position had improved at the time of the share issue partly by it pursuing a policy of raising loan capital.

*Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285

**[15.170]** The facts of this case are unusual in that the decision of the court to invalidate a share issue operated to the advantage of the director who issued the shares and had changed his mind. Carlton Hotel was a family company controlled by the father who was its governing director. Under the articles, this position gave the father the sole power to issue shares. The company's capital was divided into three classes of shares. The father held "A" class shares. His wife owned "B" class shares and his two sons and four daughters each owned "C" class shares, which had no voting rights. While the father was alive only "A" class shares had voting rights. His wife's "B" class shares were given voting rights upon his death.

In 1973, the parents divorced. The daughters sided with their mother and the sons with their father. To ensure that his ex-wife and daughters would not gain control of the company after his death, the father purported to allot further "B" class shares to his sons. This allotment was made without the knowledge of the wife and was not recorded in the company's share register but was noted in several annual returns. In 1980, the father fell out with his sons and purported to annul the allotment of shares to them. The sons brought an action to have the share register rectified so as to reflect the allotment. The company argued that the issue of the "B" class shares was invalid because the father, as governing director, had issued them for the improper purpose of realigning the relative shareholdings upon his death.

By a majority of three to two, the High Court confirmed the company's argument and held that the allotment was invalid as a result of the governing director's breach of duty. The majority followed the *Howard Smith* case and stated that:

it is not part of the function of the directors to favour one shareholder or group of shareholders over others by issuing shares for the purpose of diluting the voting power attaching to the shares held by some shareholders. The majority also said that the motivation of the directors was not relevant, even if the directors genuinely believed that the actions they took were in the best interests of the company.

## Mixed purposes and the "but for" test

**[15.175]** When directors exercise their powers to issue shares, they may be motivated by a number of purposes. In such cases it must be shown that the directors' motivating purpose was improper or collateral to their duties as directors. The issue is not whether a management decision was good or bad but whether the directors breached their duties: *Permanent Building Society v Wheeler* (1994) 11 WAR 187.

The question of mixed purposes may arise where the directors are themselves shareholders in the company. They must exercise their power in the interests of their company, but in doing so they may also promote their own interests as shareholders to the detriment of other shareholders. In such cases, the courts will not intervene unless it is established that their motivating purpose is improper. This is so, even if the directors are also motivated by some subsidiary proper purpose.

The "but for" test.

In *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285, the High Court explained that where there was more than one purpose for a share issue, the "but for" test should be applied to work out whether the directors breached their duty and issued the shares for an improper purpose. Where shares are issued for both proper and improper purposes the allotment of shares will be invalidated when the court is satisfied that the shares would not have been issued if the improper purpose had not existed. Mason CJ, Deane and Dawson JJ stated:

As a matter of logic and principle, the preferable view would seem to be that, regardless of whether the impermissible purpose was the dominant one or but one of a number of significantly contributing causes, the allotment will be invalidated if the impermissible purpose was causative in the sense that, but for its presence, "the power would not have been exercised": *Mills v Mills* (1938) 60 CLR 150 at 186 per Dixon J.

*Hannes v MJH Pty Ltd* (1992) 10 ACLC 400

**[15.180]** It was held that the motivating purpose and the real reason for a governing director's actions to issue shares to himself and enter into a service agreement was



self-interest and the desire to derive additional personal benefits. These motives overshadowed the director's duties to act in the interests of the company. The director breached his duty to act for a proper purpose.

*Kokotovich Constructions Pty Ltd v Wallington* (1995) 13 ACLC 1113

**[15.185]** The New South Wales Court of Appeal applied the “but for” test and held that an issue of shares by a governing director to his children was invalid even though one of the purposes of the issue was to raise capital. On the evidence, the court concluded that but for the governing director's improper purpose of manipulating voting power, the share issue would not have been made.

## Defending hostile takeovers

**[15.190]** The question of whether directors have exercised their powers for a proper purpose has often arisen in the context of defensive measures aimed at defeating a hostile takeover bid. Such measures raise the possibility that the directors may be motivated by a desire to retain control of their company at the expense of their shareholders' interests. If directors do this, they will breach their fiduciary duties.

Duties of target company directors seeking to defeat a hostile takeover.

However, directors of target companies are not powerless in the face of an inadequate takeover bid. They will not breach their fiduciary duties if they engage in defensive measures designed either to maximise the value of members' shares or advance the commercial interests of the company.

A 1986 NCSC discussion paper, *Defensive Schemes and the Duties of Directors*, observed that shareholders have the right to determine the composition of their company's board and that directors should not use their powers to block a takeover substantially as a means of retaining management. On the other hand, defensive measures may be desirable where the effect is to facilitate an auction for the company's shares, thereby maximising the return to shareholders, or to force compliance with disclosure or other legal requirements imposed on bidders.

While the discussion paper did not draw any final conclusions, it noted that the motive of directors was critical. This raises a number of difficulties of proof. The directors' motives must be shown to be incompatible with their duties to shareholders. This is especially difficult to prove in the case of complex business decisions that may involve a number of considerations. This discussion paper may be accessed on the Takeovers Panel website and is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

Actions by target company directors which have the effect of frustrating a takeover bid may result in a declaration of unacceptable circumstances being made by the Takeovers Panel. The situations where this may arise are discussed at [25.245].



## Use of company funds to promote re-election of directors

**[15.195]** Directors may exercise their powers for an improper purpose where they use company funds to promote their own re-election against other candidates.

*Advance Bank Australia Ltd v FAI Insurances Ltd* (1987) 9 NSWLR 464

**[15.200]** The New South Wales Court of Appeal held that while there was no absolute prohibition on the expenditure of company funds in an election for directors, such expenditure should be kept to a minimum and be confined to providing information that promotes an informed decision by shareholders. Self-praise and irrelevant personality issues should be avoided.

The directors breached their duty even though they honestly believed they were acting in the company's best interests because they resolved to form a campaign committee that used company funds to promote the re-election of certain directors and to secure the defeat of candidates nominated by FAI, a substantial shareholder. The information supplied by the committee to shareholders was emotional and misleading.

## Exercise of management powers

**[15.205]** Directors may breach their duty where management powers are exercised for an improper purpose.

*Permanent Building Society v Wheeler* (1994) 11 WAR 187

**[15.210]** The board of a building society caused the society to purchase land at an over-value. The purpose of this transaction was to provide the vendor with money to meet obligations to a company in which the majority of the society's directors had personal interests. The court held that the powers and duties of directors may be exercised only for the purpose for which they were conferred and not for any collateral or improper purpose. In this case, the directors acted for an improper purpose. One of the directors who did not participate in the negotiations was held to have also acted for an improper purpose because he knew of the improper purpose of the other directors and failed to prevent the transaction from proceeding. The court ordered that the directors in breach of duty compensate the society for its losses.

**[15.215]** In *Bishopsgate Investment Management Ltd v Maxwell* (1993) 11 ACLC 3128, a director was held to have used his powers as a director for an improper purpose where he gave away the company's assets to a family company for no consideration.

## Exercising powers for the benefit of others

**[15.220]** Directors may breach their duty if they exercise their powers in the interests of a third party such as a bank or ultimate parent company.

*Bell Group Ltd (in liq) v Westpac Banking Corp (No 9)* [2008] WASC 239

[15.225] The directors of the Bell group of companies were found to have exercised their powers for improper purposes by arranging for the group to enter into certain transactions with its banks. The transactions converted what were unsecured debts into secured debts. The directors entered into these transactions for the purpose of keeping the banks at bay so as to ward off liquidation. The court found that the directors exercised their powers for an improper purpose because they caused the Bell group to enter into transactions which were in the interests of the banks and the ultimate parent company, rather than in the interests of the Bell group and its creditors. Directors of companies in an insolvency context breach their duty to act for proper purposes if they exercise their powers in a way that fails to take into account the interests of creditors as part of their obligation to consider, and act in, the best interests of the company as whole. This decision was upheld on appeal: *Westpac Banking Corp v Bell Group Ltd (in liq) (No 3)*. The duties owed by directors of insolvent companies are discussed at [18.10]–[18.95].

## Directors' refusal to register a transfer

[15.230] The right of a member to transfer shares to another is a feature that distinguishes companies from partnerships. This right may be restricted by the constitution or the replaceable rules. For example, under the replaceable rule in s 1072F directors may refuse to register a transfer of shares if the shares are not fully paid or the company has a lien on the shares: s 1072F(3). In the case of proprietary companies, the replaceable rule in s 1072G gives directors the power to refuse to register a transfer of shares for any reason.

Directors must exercise their discretion to refuse to register transfers of shares in good faith and in the best interests of the company and not for improper purposes. In *Australian Metropolitan Life Assurance Co Ltd v Ure*, Isaacs J discussed this discretionary power. He thought that if directors act honestly upon business considerations such as whether the transferee is solvent and maintaining the reputation of the company, the directors act within their power. Where they are not moved by a legitimate consideration but act upon an extraneous reason, the court can direct the transfer be registered. As discussed at [9.180]–[9.215], s 1071F provides that where directors refuse to register a transfer of shares without just cause, the transferee may apply to the court for an order that the transfer be registered.

A member may also obtain a remedy under s 232 by showing that a refusal to register a transfer of shares is part of conduct that is contrary to the interests of members as a whole, oppressive, unfairly prejudicial or unfairly discriminatory. This is further discussed at [24.15] onwards.

## Statutory duty to act in good faith and for a proper purpose: s 181

[15.235] A director or other officer of a corporation must exercise their powers and discharge their duties in good faith in the best interests of the corporation and for a

proper purpose: s 181(1). Section 181 is essentially the same as the fiduciary duties to act in good faith, in the best interests of the company and for a proper purpose. Consequently the legal principles discussed at [15.05]–[15.230] dealing with the obligation to act in good faith and exercise powers for a proper purpose are applicable to the operation of s 181.

The standards required by s 181 are those that “would be expected of a person in that position by reasonable persons with knowledge of the duties, power and authority of the position”: *Downer EDI Ltd v Gillies* [2012] NSWCA 333.

Like the fiduciary duty, the s 181(1) duty to act in good faith and for a proper purpose may be contravened even if directors believe they are acting in the company's best interests if no rational director could have reached that conclusion: *ASIC v Adler* [2002] NSWSC 171. This is particularly so where directors promote their personal interests in a situation where their personal interests conflict with the interests of the company. Directors must give real and actual consideration to the interests of the company: *Bell Group Ltd (in liq) v Westpac Banking Corp (No 9)* [2008] WASC 239.

A director who incorporates a new entity in order to continue carrying on the business of the company without ensuring that fair market value is paid for the acquisition will be acting in breach of the duty contained in s 181: *Re IW4U Pty Ltd (in liq)* [2021] NSWSC 40.

The statutory duties contained in Ch 2D (ss 180–183) overlap. A director who causes a company to enter into an agreement that confers unreasonable personal benefits on the director and fails to make adequate disclosure of the conflict of interest acts “improperly” for the purposes of s 182 and also lacks good faith for the purposes of s 181. Section 182 is discussed at [16.120]–[16.160].

*ASIC v Adler* [2002] NSWSC 171 (confirmed on appeal [2003] NSWCA 131)

[15.240] HIH Casualty & General Insurance Co Ltd (HIHC), a subsidiary of HIH Insurance Ltd (HIH) provided an undocumented, unsecured \$10 million loan to Pacific Eagle Equity Pty Ltd (PEE), a company controlled by Adler. At the time, Adler was also a non-executive director and, through Adler Corporation Ltd, a substantial shareholder of HIH. After the loan, PEE became trustee of Australian Equities Unit Trust (AEUT) which was controlled by Adler Corporation Ltd. HIHC's \$10 million loan to PEE was then applied to HIHC's subscription for \$10 million worth of AEUT units. Under the trust, Adler was entitled to 10 per cent of the trust's income even though the \$10 million was contributed by HIH. PEE used the \$10 million in the following transactions:

- about \$4 million was used to buy HIH shares on the stock market. PEE later sold its HIH shares at a \$2 million loss. PEE's purchase of HIH shares was designed to give the stock market the false impression that Adler was supporting HIH's falling share price by personally buying its shares;
- nearly \$4 million was used to purchase various unlisted shares in technology and communications companies from Adler Corporation. These shares were purchased at cost even though the stock market for such investments

had collapsed and no independent assessment of their value was made. A total loss was made on these investments; and

- \$2 million was loaned by the trust to Adler and associated interests. These loans were unsecured and not documented.

It was held that Adler breached his duties as an officer of HIH and HIHC under s 181 by reason of all these transactions. There was evidence of a consciousness of impropriety on Adler's part because the normal investment safeguards put in place by HIH, such as the establishment of an Investment Committee, were bypassed in a semi-covert way. A contravention of s 181 does not require the director to gain a benefit from the conduct. It is sufficient to establish that the conduct was carried out in order to gain an advantage.

[15.242] *ASIC v Adler* involved the breach of several duties and is discussed in a number of places in this book. The duties not to improperly use position (s 182) and information (s 183) are discussed at [16.120] and [16.315], respectively; the duty of care and diligence is discussed in Chapter 17 and the civil penalty provisions are discussed at [19.120].

## Directors who permit the corporation to contravene the Corporations Act

[15.245] Directors may contravene the statutory duties owed to the company if they authorise or permit the company to contravene provisions of the *Corporations Act*. In *ASIC v Adler* (discussed at [15.240]) it was held that the s 181 duty may be breached where the interests of the company are put at risk by contraventions of other statutory provisions such as those dealing with related party transactions (s 208) and the financial assistance prohibition: s 260A. The related party transaction provisions are discussed at [16.40] onwards and financial assistance is discussed at [8.325] onwards.

Section 181 does not impose a general duty on directors to conduct the affairs of the company in accordance with the *Corporations Act*. However, according to *ASIC v Maxwell* directors will breach their duty to exercise their powers and discharge their duties in good faith in the best interests of the corporation and for a proper purpose pursuant to s 181(1) if they permit or allow the corporation to contravene the *Corporations Act* and:

- the corporation's interests were jeopardised;
- the risks to the corporation outweighed any potential countervailing benefits to the corporation; and
- there were reasonable steps that could have been taken to avoid those risks.

In *ASIC v Maxwell* [2006] NSWSC 1052, Brereton J said that the interests of the corporation may be jeopardised if it is exposed to actual or potential liability or to civil penalties or other liabilities under the *Corporations Act*. Directors may breach their duty if they permit or authorise the corporation to engage in the contravening conduct where the risk to the company is clear and the countervailing potential benefit to the company is insignificant.

## Consequences of contravening s 181

**[15.255]** Section 181 is a designated civil penalty provision: s 1317E. The court has the power to impose a civil penalty order on any person who is involved in a contravention of s 181(1). A person is involved in a contravention in the circumstances described in s 79. Involvement in a contravention may arise where a person aids and abets, induces or is knowingly concerned in, or party to the contravention.

The civil penalty provisions are discussed at [19.120]–[19.150].

Criminal liability may be imposed under s 184(1) if a director or other officer of a corporation is reckless or intentionally dishonest and fails to exercise their powers and discharge their duties in good faith in the best interests of the corporation or for a proper purpose. This implies that conduct which falls short of the s 184 criminal liability requirements may constitute a breach of s 181 even though the director possessed the subjective belief that they were acting for proper purposes: *ASIC v Adler*. Criminal penalties are discussed at [19.155]–[19.170].

## Duty to retain discretion

**[15.260]** Directors have a fiduciary duty to retain their discretionary powers. Directors will breach this duty if they enter into an agreement with outsiders that requires them to vote in a certain way at future board meetings or to follow directions from another person. Such a contract is ineffective even if the directors are not otherwise in breach of their duties such as acting for an improper purpose. In *ASIC v Macro Realty Developments Pty Ltd* [2016] FCA 292, Macro and 21st Century marketed an investment proposal whereby an investor agreed to become a sole director and shareholder of a company which would be subject to the sole decision-making of Macro, over which the investor had no real or effective control and which had an obligation to finance the acquisition of properties from Macro and assume legal liability for that finance. By entering into such contracts, the investors fettered their powers and breached their duty to retain their discretionary powers. In so doing the directors contravened s 181.

However, directors may enter into contracts on behalf of the company, whereby they agree to vote in favour of a particular course of action if they properly consider this to be in the interests of the company at the time the agreement is entered into: *Thorby v Goldberg* (1964) 112 CLR 597.

A nominee director may be appointed to represent the interests and act on the instructions of the appointor. In such cases, the nominee director's discretion may be fettered, especially where the constitution allows the appointor to remove the nominee. The position of nominee directors is discussed at [15.55].

The replaceable rules and constitution (if any) may authorise the directors to delegate their powers. For example, the replaceable rule in s 201J empowers directors to appoint a managing director. However, the board may at any time revoke the delegation: s 203F.

## Tutorial questions

*Further multi-issue directors' duty questions are located at the end of Chapter 13.*

1. Georgia Ford is a director and 60 per cent shareholder of Ford's Catering Services Pty Ltd. Her sisters Ellen and Molly are the other directors and each own 20 per cent of the shares. For most of this year Ford's Catering Services Pty Ltd has suffered acute financial problems. It has been continually late in paying debts due to its major suppliers.

The directors soon realise that the company's liquidation is imminent but they want to continue trading using the company's name as it is well known to the company's numerous customers. At the suggestion of the company's accountant, a shareholders' meeting of Ford's Catering Services Pty Ltd is convened and a resolution is passed changing the company's name to Black Pudding Pty Ltd. At the same time a new company is incorporated called Ford's Catering Services (Aust) Pty Ltd, with Georgia, Ellen and Molly as its directors and shareholders. After the name change, Black Pudding Pty Ltd ceases operations and the new company simply takes over the business formerly conducted by Black Pudding Pty Ltd.

Recently the court, on the application of Acme Food Suppliers Ltd, orders that Black Pudding Pty Ltd be wound up in insolvency.

Advise the liquidator what legal action, if any, can be taken against Georgia, Ellen and Molly in connection with the transfer of the business and the name Ford's Catering Services to Ford's Catering Services (Aust) Pty Ltd.

2. Backyard Printers Ltd is listed on the stock exchange. Its directors own 25 per cent of the company's issued capital and the remaining 75 per cent is held by a large number of different shareholders. Parton Ltd begins to purchase Backyard Printers shares on the stock exchange, intending to use this shareholding as a base for a future takeover bid.

The directors of Backyard Printers Ltd, fearful that a future takeover bid by Parton Ltd may be successful, begin considering measures to hinder a takeover. At a recent board meeting the directors discuss a proposal that Backyard Printers Ltd should issue 20 million \$1 shares paid to themselves and various employees of the company who are friends of the management. The minutes of the board meeting set out the following reasons for the share issue:

- Backyard Printers Ltd requires further capital for expansion;
- the share issue will provide an incentive to employees to increase productivity;
- it will prevent Parton from taking over Backyard Printers.

If the share issue proceeds, Backyard Printers' directors and "friendly" employees will control 52 per cent of the shares in the company.

Advise Backyard Printers' directors on the legality of their actions.

Would your answer be different if the company's shareholders voted in favour of the share issue?

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.
- For further corporations law links and material please refer to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.



## Chapter 16

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# Directors' conflicts of interest duties

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## Key points

- The duty to avoid conflicts of interests is breached where directors fail to disclose their material personal interests in transactions with the company. The *Corporations Act* also imposes disclosure requirements. These disclosure requirements vary depending upon whether the company is a public or proprietary company.
- At common law, directors avoid breaching their duties if full disclosure is made to the company and approval is given. This is generally taken to mean disclosure to, and approval of, the general meeting.
- Under the *Corporations Act*, disclosure of a material personal interest must be made to the other directors. A public company that gives a financial benefit to a director or other related party is required to obtain the approval of members in accordance with a specified procedure. Exceptions arise where the financial benefit is given on arm's-length terms or is reasonable remuneration.
- The fiduciary duty to avoid conflicts of interest also requires directors not to make undisclosed personal profits arising from acting as director and not to take up corporate opportunities or misuse confidential company information.
- There are corresponding statutory duties that prohibit officers or employees from making improper use of their position and improper use of information gained while acting in their position.

## Introduction

**[16.05]** Directors owe fiduciary duties to their company. All fiduciaries are under a duty to avoid conflict of interest situations. Under the general law, directors are subject to two basic fiduciary obligations:

- Directors must not allow a situation to develop where there is a conflict or real possibility of conflict between their duties to the company and their personal interests (the no-conflict rule).
- Directors must not improperly make a profit or benefit which arises out of their office (the no-profit rule).

These rules are designed to ensure that directors do not exploit their position for their personal gain. As Colvin J observed in *GFIN Pty Limited v Gooden (No 3)* [2021] FCA 227:

Directors of companies are fiduciary agents who cannot exercise their powers as directors in order to obtain a private advantage or for some purpose that is foreign to the power ... They must not promote personal interest by making a gain in circumstances where there is a real possibility that their personal interest will conflict with that of the company whose interests they as directors are bound to protect.

Directors have a duty to disclose transactions which may be in breach of the no-conflict and no-profit rules. A director who fully and frankly discloses the nature of any transaction that would otherwise breach these prohibitions and obtains the company's informed consent will not be in breach of their fiduciary duties. Such consent may be provided prior to entry into the transaction or may be provided subsequently, by ratification of the director's actions.

**[16.10]** The duty of directors to avoid a conflict of interest is strictly applied. The duty is imposed because directors who place themselves in a conflict of interest situation may be tempted to benefit themselves at the expense of the company. However, it goes further than this to prevent directors from putting themselves in a position where it appears that they may act in their own interests. In such a case, directors cannot avoid liability by claiming that they did not make a profit, that their company did not suffer any loss or that the contract was a fair one. The duty is breached whether or not the directors had fraudulent motives and whether or not they were acting with subjective dishonesty: *Re Sirrah Pty Ltd (in prov liq)* [2021] NSWSC 41.

*Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461

**[16.15]** A railway company entered into a contract with a partnership for the supply of a large quantity of iron seats. The company sought to avoid the contract on several grounds, including that at the time the contract was entered into, one of the partners was a director of the company. The House of Lords held that the company could avoid the contract even though its terms were fair.

**[16.16]** A conflict of interest occurs where a director has a personal interest of a contractual nature. It does not arise where there is a mere unenforceable expectation: *Baker v Palm Bay Island Resort Pty Ltd* [1970] Qd R 210.

The courts apply an objective test in determining whether there is a conflict or real possibility of conflict between the director's personal interests and their duties as a director: *VicBeef Holdings Pty Ltd v Chen* [2021] VSC 546. The strict fiduciary duty to avoid undisclosed conflicts of interest has been applied in various circumstances and these are categorised below. Directors will breach their fiduciary duties under the common law where they, without obtaining the company's informed consent, do any of the following:

- Have an undisclosed interest in transactions with their company: [16.20]–[16.35].
- Make undisclosed personal profits while acting in their position: [16.105]–[16.115], [16.190]–[16.205].
- Misuse company funds for an improper purpose: [16.210]–[16.220].
- Take up a corporate opportunity that they should have presented to the company: [16.230]–[16.275].
- Misuse confidential company information for their own benefit: [16.290]–[16.310].
- Compete with the company: [16.360]–[16.382].

The common feature in all cases in which a breach of the duty has been established is that the directors placed themselves in a position where they put or may have put their own interests ahead of the interests of the company. The duty to avoid conflicts of interest, however, is not confined to these defined situations. In *Phipps v Boardman* [1967] 2 AC 46, Lord Upjohn stated:

Rules of equity have to be applied to such a diversity of circumstances that they can be stated only in the most general terms and applied with particular attention to the exact circumstances of each case.

Where fiduciary duties are owed by a director, they can continue to be owed after resignation, particularly where the director resigns in order to exploit a business opportunity properly belonging to the company. The director may pursue such an opportunity and not be in breach of duty if it is a “fresh initiative” acquired after resignation but not if the resignation was prompted or influenced by the desire to obtain the opportunity: *Edmonds v Donovan* [2005] VSCA 27.

The duty to avoid conflicts of interest overlaps with several duties contained in the *Corporations Act*, especially ss 181–183. The statutory duties are in addition to the fiduciary duties at general law: s 185. Section 182 reflects the fiduciary obligation owed at common law, prohibiting officers from making improper use of their position, and s 183 prohibits the improper use of information. These are discussed at [16.120] and [16.315] respectively. Chapter 2E, discussed at [16.40]–[16.80], also regulates certain conflicts of interest transactions. Section 181 sets out another core fiduciary duty owed by directors. The duty under s 181 is breached when an officer fails to act in good faith in the best interests of the company or for a proper purpose. Section 181 is discussed at [15.235].

Directors who put themselves in a conflict of interest situation which amounts to a breach of their fiduciary or statutory duty may avoid liability for the breach if they

disclose the details of their personal interest and obtain the company's fully informed consent. Disclosure is discussed at [16.385]–[16.425].

## Self-interested transactions with the company

### Fiduciary duties

**[16.20]** Directors breach their fiduciary duty if they have undisclosed interests in transactions with their company because they are then in a position where their personal interests conflict or may conflict with the company's interests. Directors should act in the interests of the company and not be seen to put themselves in a position where they may further their own interests. A company has a variety of remedies available if directors breach their fiduciary duty by having an undisclosed interest in a transaction with their company. These remedies are discussed at [19.10]–[19.30]. Rescission of contracts is the usual remedy in such circumstances. Directors can avoid liability for breaching their fiduciary duty if they make full disclosure of their personal interest in a transaction and obtain shareholder approval. Disclosure of interests is discussed at [16.385]–[16.425]. Shareholder approval (also referred to as “ratification”) is discussed at [20.05].

The fiduciary duty regarding undisclosed self-interested transactions overlaps with both the fiduciary duty of good faith and best interests of the company (discussed at [15.05]–[15.135]) as well as the statutory duties in ss 181 (discussed at [15.235]), 182 and 183: discussed at [16.120] and [16.315] respectively.

A breach of the fiduciary duty arises whether the director's undisclosed interest in the contract is direct or indirect. A director who contracts personally with the company has a direct interest. An indirect interest in a contract arises when the director is a director or shareholder of another company that contracts with the company.

#### *Transvaal Lands Co v New Belgium (Transvaal) Land & Development Co [1914] 2 Ch 488*

**[16.25]** Samuel and Harvey were two of the directors of Transvaal Lands. Samuel was also a director of New Belgium. They both owned shares in New Belgium. Samuel's shares were held in his own right while Harvey held the New Belgium shares as trustee under a will. At the instigation of Samuel, Transvaal Land's board agreed to purchase certain shares owned by New Belgium. After the purchase was finalised, Transvaal Lands discovered Samuel and Harvey's interests in New Belgium for the first time and sought to have the contract rescinded.

The court held that Samuel's interests as both director and shareholder of New Belgium conflicted with his duty to act in the best interests of Transvaal Lands. He breached his fiduciary duty to that company even though he did not vote on the board's resolution that agreed to the contract. Harvey was also held to have conflicting interests even though his shareholding in New Belgium was only as a trustee. He was under a duty to Transvaal Lands to make the best bargain he could for it in relation to the transaction. This conflicted with his duty to make the best bargain he could for the beneficiaries of the trust.

*South Australia v Clark* (1996) 66 SASR 199

**[16.30]** The Supreme Court of South Australia held that Clark, the managing director of the State Bank of South Australia, had a conflict of interest when he arranged for the bank to enter into a contract that indirectly benefited another company in which Clark was a director and shareholder. The court also held that the circumstances surrounding the contract indicated that Clark had breached his duty of care. This aspect of the case is discussed at [17.70].

**[16.35]** A person who is a director of two companies that do business with one another may owe fiduciary duties to both companies. In *R v Byrnes* (1995) 183 CLR 501, the High Court stated:

Being a fiduciary, the director of the first company must not exercise his or her power for the benefit or gain of the second company without clearly disclosing the second company's interest to the first and obtaining the first company's consent. Nor, of course, can the director exercise those powers for the director's own benefit or gain without clearly disclosing his or her interest and obtaining the company's consent.

Directors breach their fiduciary duty only if their undisclosed self-interested transaction is a material interest. For example, a director of a proprietary company who owns a relatively small parcel of shares in a large public company does not have a material interest in any contract between the companies merely because of that shareholding.

The fiduciary duty regarding undisclosed self-interested transactions raises two important questions:

- to whom must directors disclose their material interest?
- what information must directors disclose?

These issues are discussed at [16.385]–[16.420].

## Related party transactions: Ch 2E

**[16.40]** Chapter 2E requires prior shareholder approval before a public company gives certain financial benefits to directors and related parties that endanger the interests of the company's members: s 207.

The provisions of Ch 2E are intended to protect shareholders of public companies from situations where the value of the company is reduced because a director arranged for the company to enter into a transaction which gives a benefit to the director, entities that the director controls or the people related to the director. At the same time, the legislation recognises that some transactions entered into with directors and related parties may be on arm's-length commercial terms and of benefit to the company. Where full disclosure is made, and approval given by disinterested shareholders, the transaction is permitted.

Directors are not relieved of any of their duties under the *Corporations Act* or fiduciary duties merely because shareholders authorise a transaction under Ch 2E: s 230. Uncommercial transactions that improperly benefit a director of a public company may



also involve a breach of the fiduciary duties owed by a director as they may result in a conflict of interest.

### *Prior shareholder approval needed*

**[16.45]** Section 208 is the key provision of Ch 2E and applies to public companies as well as entities controlled by public companies.

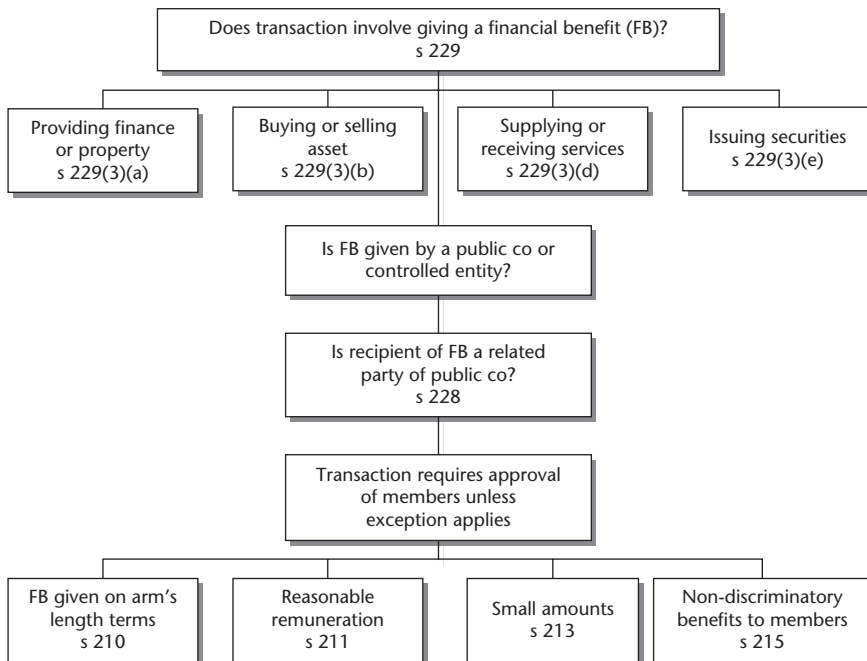
A public company cannot give a financial benefit to a related party unless it obtains the prior approval of its shareholders.

Under s 208(1)(a)(i), a public company may give a financial benefit to a related party if it obtains the approval of its shareholders in accordance with ss 217–227. Shareholder approval must be obtained no more than 15 months before the public company gives the financial benefit: s 208(1)(a)(ii). Under s 208(1), public company shareholder approval is also required where an entity controlled by a public company gives a financial benefit to a related party of the public company.

The detailed shareholder approval requirements in ss 217–227 seek to ensure that where a public company gives a financial benefit to related parties, it is agreed to by a majority vote of disinterested shareholders who are fully informed about the financial benefit and its impact on the company.

A financial benefit to a related party does not need the approval of the public company's shareholders if the financial benefit falls within an exception set out in ss 210–216: s 208(1)(b).

**Figure 16.1: Related party transactions**



## *Giving a financial benefit*

**[16.50]** The expression “giving a financial benefit” is defined in s 229. Section 229(1) requires a broad interpretation in determining whether a financial benefit has been given, even if criminal and civil penalties may be involved. The commercial substance of the transaction prevails over its legal form and any consideration is to be disregarded even if it is adequate. According to s 229(2), a financial benefit may be given indirectly through interposed entities or by informal or unenforceable agreement. It may also comprise the conferring of a financial advantage that does not involve payment of money.

Examples of giving a financial benefit are provided in s 229(3). They include:

- giving or providing finance or property (s 229(3)(a));
- buying or selling an asset (s 229(3)(b));
- leasing an asset (s 229(3)(c));
- supplying or receiving services (s 229(3)(d));
- issuing securities or granting an option (s 229(3)(e)); and
- taking up or releasing an obligation (s 229(3)(f)).

## *Related parties*

**[16.55]** Section 228 defines the term “related party”. A related party of a public company can be an individual as well as an “entity”. The word “entity” includes a company and a partnership as well as the trustee of a trust: s 9.

According to s 228, the following *people* are regarded as related parties of a public company:

- directors of the public company (s 228(2)(a));
- the spouses, de facto spouses, parents and children of public company directors (s 228(2)(d) and (3)); and
- directors of an entity that controls the public company as well as the spouses, de facto spouses, parents and children of the controlling entity’s directors (s 228(2)(b) and (3)).

The following *entities* are related parties of a public company:

- an entity that controls the public company (s 228(1));
- an entity controlled by a related party referred to in s 228(1), (2) or (3) (s 228(4));
- an entity that was a related party of the kind referred to in s 228(1), (2), (3) or (4) during the previous six months (s 228(5)); or
- an entity that acts in concert with a related party of a public company on the understanding that the related party will receive a financial benefit if the public company gives the entity a financial benefit (s 228(7)).

As noted above, an entity controlled by a related party referred to in s 228(1), (2) or (3) is regarded as a related party of a public company. Under s 50AA, “control” is the capacity of a person or entity to determine the outcome of decisions about a second entity’s financial and operating policies.

## *When shareholder approval not required*

**[16.60]** Shareholder approval for the giving of a financial benefit is not required if any one of the exceptions in ss 210–216 applies. If an exception applies, the public company's directors control whether or not to give the financial benefit to the related party.

The exceptions include:

- transactions that would be reasonable in the circumstances if the parties were dealing at arm's length or the terms were less favourable to the related party than arm's-length terms (s 210);
- reasonable remuneration as an officer or employee of the public company or an entity that controls or is controlled by the public company (s 211(1));
- repayment of expenses incurred by a related party in performing duties as an officer or employee of the public company or a controlling or controlled entity (s 211(2));
- payment of reasonable insurance premiums in respect of a liability incurred as an officer of the public company (s 212(1));
- payments in respect of legal costs incurred by an officer in defending an action involving a liability incurred as an officer of the public company (s 212(2));
- amounts of money given to a director or spouse of less than \$5,000 (s 213);
- financial benefits to or by a closely held subsidiary (s 214); and
- benefits given to the related party as a member of the public company where the benefits do not discriminate unfairly against the other members (s 215).

As noted above, a financial benefit on terms that would be reasonable if the public company and the related party were dealing at arm's length does not need shareholders' approval: s 210(a). According to *ASIC v Australian Investors Forum Pty Ltd (No 2)* [2005] NSWSC 267, the reasonableness of the terms of a financial benefit is determined on objective criteria and is to be measured against the terms of a transaction that a public company would enter into if it were:

- unrelated to the other party to the transaction in any way, financially or through ties of family, affection or dependence;
- free from any undue influence or pressure;
- through its relevant decision-makers, sufficiently knowledgeable about the circumstances of the transaction, sufficiently experienced in business and sufficiently well advised to be able to form a sound judgment as to what is in its interests; and
- concerned only to achieve the best available commercial result for itself in all of the circumstances.

In Regulatory Guide RG 76 *Related Party Transactions*, ASIC thought that public companies should at a minimum take into account the following factors when deciding whether the giving of a financial benefit to a related party came within the "arm's-length terms" exception in s 210:

- how the terms of the overall transaction compare with those of any comparable transactions between parties dealing on an arm's-length basis in similar circumstances;

- the nature and content of the bargaining process, including whether the entity followed robust protocols to ensure conflicts of interest were appropriately managed in negotiating and structuring the transaction;
- the impact of the transaction on the company (for example, the impact of dealing on those terms on the financial position and performance of the company) and non-associated members;
- any other options that may be available to the entity; and
- expert advice received by the entity (if any).

This Regulatory Guide may be viewed on the ASIC website, which is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## *Shareholder approval meeting*

**[16.65]** The public company must call a shareholders' meeting to consider a resolution to approve the giving of the financial benefit. The company must lodge with ASIC the notice convening the meeting and other accompanying documents at least 14 days before the notice is given to members: s 218(1). ASIC may approve a shorter period: s 218(2).

Explanatory statement must be given to shareholders.

To ensure members are fully informed about the proposed financial benefit, an explanatory statement must accompany the notice convening the meeting: s 221(b). The explanatory statement must set out full details of the circumstances surrounding the proposed resolution in accordance with s 219. The explanatory statement must include all the information known to the company or any of its directors that is reasonably required by members in order to decide whether or not it is in the company's interests to pass the proposed resolution to approve giving the financial benefit.

Section 219(2) provides examples of the kind of information that should be disclosed. The explanatory statement should state from an economic and commercial point of view the true potential costs and detriment of giving the financial benefits including opportunity costs, taxation consequences and benefits forgone.

Within 14 days after lodgment of the materials to be put to members, ASIC may give to the company written comments on those documents but not on whether the proposed resolution is in the company's best interests: s 220. Any comments by ASIC must be included in the documents sent to members with the notice convening the meeting: s 221(d).

In the past, ASIC conducted a number of campaigns to crack down on related party disclosure documents to ensure that shareholders received sufficient information to make a decision about whether to grant related party benefits. ASIC observed that there were a number of common defects in related party documentation supplied to shareholders. The most common defect was not adequately valuing the financial benefit. According to ASIC, an adequate valuation requires disclosure of the basis of the valuation and the principal assumptions behind it. Another common defect was the failure to explain the reason for giving the financial benefit.

## *Voting exclusions*

**[16.70]** A related party or associate to whom the proposed resolution would permit a financial benefit to be given cannot cast a vote on the resolution: s 224(1). ASIC may allow the related party to vote where it is satisfied that this would not cause unfair prejudice to the interests of any member of the company: s 224(4). A vote may be cast by a person as a proxy for someone who is not an interested related party: s 224(2). It is an offence to cast a vote in contravention of s 224(1) whether or not the resolution is passed: s 224(6). A contravention of s 224 does not generally affect the validity of a resolution: s 224(8).

A notice setting out the resolution must be lodged with ASIC within 14 days after it is passed: s 226.

## *Consequences of breach*

**[16.75]** A contravention of s 208 does not affect the validity of any contract or transaction connected with the giving of the benefit. The public company or entity that it controls is not guilty of an offence: s 209(1). However, any person involved in a contravention of s 208 by a public company contravenes s 209(2). This is a civil penalty provision: s 1317E. The civil penalty provisions are discussed at [19.120]–[19.150].

A person commits a criminal offence if their involvement in the contravention of s 208 is dishonest: s 209(3).

A proposed benefit to a related party that contravenes s 208 may be stopped by the court where an application for an injunction is brought under s 1324. Injunctions under s 1324 are discussed at [24.305]–[24.325].

### *Adler v ASIC [2003] NSWCA 131*

**[16.80]** The facts of this case are set out at [15.240]. The Court of Appeal held that the payment of \$10 million by HIHC (an entity controlled by a public company, HIH) to PEE was an interest-free unsecured loan. This amounted to HIHC giving a financial benefit to each of PEE, Adler Corporation and Adler within the meaning of s 229. PEE, Adler Corporation and Adler were all related parties of HIH. Further, the terms of the loan were unreasonable and therefore not on arm's-length terms within the meaning of s 210. As there was no shareholder approval, it followed that HIH and its controlled entity, HIHC, both contravened s 208. The court also held that both Adler and Williams were involved in the contravention. Adler was fully aware that the \$10 million loan was not on reasonable arm's-length terms, having instigated it. Williams was also involved in the contravention because he authorised the payment knowing that Adler controlled PEE. Williams also ensured that the transaction was not brought to the attention of HIH's other directors or its Investment Committee. Fodera, HIH's CFO, was also involved in the contravention because he had sufficient knowledge of the essential factual elements constituting the contravention even though he did not know every detail of it.

## Self-interested director boardroom voting

### *Public companies*

**[16.85]** Under s 195(1), a director of a public company who has a material personal interest in a matter before the board is prohibited from voting on the matter and must not be present while the matter is being considered by the board meeting.

The term “material personal interest” is not defined in the *Corporations Act*. In *Grand Enterprises Pty Ltd v Aurium Resources Ltd* [2009] FCA 513, it was held that the word “material” conveyed the idea that the interest must be of some substance or value, rather than merely a slight interest. Further, the reference to a “personal interest” in s 195(1) suggested that the section did not normally apply to a situation where the director’s conflict of interest involved being on the board of two companies that were engaged in business dealings. *Transvaal Lands Co v New Belgium (Transvaal) Land & Development Co* [1914] 2 Ch 488 discussed at [16.25] is an example of such a conflict of interests. A director has a *personal* interest in a matter if the director can derive a financial or other benefit. For example, in *McGellin v Mount King Mining NL* (1998) 144 FLR 288, a director was regarded as having a material personal interest in board discussions about whether the company should issue shares to him.

This prohibition does not apply where the disinterested directors pass a resolution stating that they are satisfied that the interest should not disqualify the interested director from voting or being present. This resolution must also identify the director, the nature and extent of the director’s interest and its relation to the affairs of the company: s 195(2). The prohibition on being present and voting does not apply where the interest does not need to be disclosed to the board under s 191: s 195(1A)(b). The s 191 disclosure requirements are discussed at [16.420].

ASIC may declare that a director of a public company may be present and/or vote despite having a material personal interest. A declaration may only be made if the number of directors entitled to be present and vote would be less than a quorum and the matter needs to be dealt with urgently or there is some other compelling reason for the matter to be dealt with at a directors’ meeting rather than by the general meeting: s 196(1). Section 195(4) provides for the general meeting to deal with matters where there are not enough directors entitled to be present and vote to form a quorum.

### *Proprietary companies*

**[16.90]** The *Corporations Act* does not prohibit an interested proprietary company director from voting at a directors’ meeting that is considering matters that relate to the interest. This is left to the company’s constitution (if any) or the proprietary company replaceable rule in s 194.

Section 194 provides that if the director makes disclosure to the board under s 191, then the director can vote, related transactions may proceed, the director may retain benefits under the transaction and the company cannot avoid the transaction merely because of the existence of the interest.

## Remuneration

**[16.95]** Remuneration is probably the most obvious situation where directors have a material self-interested transaction with the company and is a critical corporate governance issue. Remuneration packages often consist of a variety of components including fixed salaries, performance-based payments such as bonuses and equity-related remuneration in the form of shares or options issued to directors. Termination payments on retirement or resignation also give rise to potential conflicts between directors' personal interests and the interests of the company.

Because of the obvious potential for conflicts of interest in relation to remuneration of directors and other key management personnel of listed companies, there are detailed requirements for disclosure of remuneration payments contained in the *Corporations Act*. As discussed at [12.290]–[12.325], the main thrust of the *Corporations Act* requirements in relation to remuneration of listed company directors and other key management personnel is disclosure of the remuneration in the company's financial reports and in some situations the requirement for shareholder approval.

ASX Listing Rules contain additional shareholder approval requirements in relation to remuneration packages for directors and senior officers of listed companies. In addition, the *ASX Corporate Governance Principles and Recommendations* (4th ed), discussed at [14.80], set out good practice recommendations for listed companies in relation to remuneration. These focus on the internal processes for determining directors' and senior officers' remuneration packages. For example, the commentary to Recommendation 8.1 suggests that remuneration policies and practices of listed companies should be determined by a remuneration committee of the board consisting of a majority of independent directors.

## Related party disclosures in financial statements

**[16.100]** Accounting Standard AASB 124 *Related Party Disclosures* imposes various disclosure requirements in relation to benefits received by directors and other related parties. Under AASB 124, the financial statements must disclose the value of all benefits to related parties including such matters as transactions where a director or other related entity is a customer of, or supplier to, the company. Directors' transactions as shareholders must also be disclosed.

Section 300A applies to listed companies and details additional remuneration disclosure of directors and other key management personnel. Directors' remuneration is discussed at [12.290]–[12.325].

## Personal profits arising from acting as director

**[16.105]** The directors' duty to avoid undisclosed conflicts of interest applies not just to self-interested transactions with the company. Directors are also under a fiduciary duty not to make undisclosed personal profits while acting in their position. This attempts to ensure that when acting for the company, directors are not tempted by the prospect



of deriving private benefits for themselves or for others. This equitable principle applies even where the company has not suffered any loss, indeed it may even have benefited. Further, there is a breach of duty even if the transaction was fair from the company's point of view. Directors must be seen to act in good faith which includes not placing themselves in a position where it may appear that they are motivated by considerations other than what is in the best interests of the company.

*Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134

**[16.110]** Regal (Hastings) Ltd owned a cinema in Hastings. The directors wished to lease two other cinemas in the town and sell the whole business of the company as a going concern. A subsidiary company was formed for this purpose, with a capital of 5,000 £1 shares because the lessor of the two cinemas required the directors to guarantee payment of the rent unless the paid-up capital of the subsidiary was £5,000. It was originally intended that Regal (Hastings) Ltd would own all the shares in the subsidiary; however, it was only able to contribute £2,000. At board meetings of the two companies, it was decided that the balance would be allotted to the four directors, the company solicitor and persons nominated by the chairman of directors. They were allotted 500 shares each in the subsidiary. The chairman, Gulliver, held the shares as trustee for two companies and one individual. He was a director as well as minority shareholder in both of these companies.

It was decided that instead of selling the business, the purchasers would buy all the shares in both Regal (Hastings) Ltd and its subsidiary. The shareholders of the subsidiary thereby acquired a profit of nearly £3 per share. The purchasers of the shares appointed new directors of the companies and then caused Regal (Hastings) Ltd to bring an action against the former directors and the solicitor seeking to recover the profit they had made. It was found as a fact that all the transactions were honestly made; nevertheless, the House of Lords held that the four directors were liable to repay the profits they had made on the sale of the shares. Lord Russell of Killowen stated:

The rule of equity which insists on those, who by use of a fiduciary position make a profit, being liable to account for that profit, in no way depends on fraud, or absence of *bona fides*; or upon such questions or consideration as whether the profit would or should otherwise have gone to the plaintiff, or whether the profiteer was under a duty to obtain the source of the profit for the plaintiff, or whether he took a risk or acted as he did for the benefit of the plaintiff, or whether the plaintiff has in fact been damaged or benefited by his action. The liability arises from the mere fact of a profit having, in the stated circumstances, been made. The profiteer, however honest and well-intentioned, cannot escape the risk of being called upon to account ...

The House of Lords, however, considered that the positions of the chairman and solicitor were different from that of the other directors. While the solicitor had profited from the sale of the shares, he was not a director and had disclosed his profit to the appropriate organ of the company, the board of directors. Indeed,



he only acquired the shares in the first place on their request. Gulliver, Regal's chairman, was also found not to have breached his duty to the company. The court accepted that he held the shares in the subsidiary as a trustee for others and consequently he derived no personal profit from the transaction.

[16.115] *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134 illustrates the far-reaching implications of the equitable principle that directors cannot make an undisclosed personal profit arising from acting in their position as directors. The directors in that case, who personally profited, acted in good faith and the company had not been deprived of a business opportunity because it did not have the required funds. In fact, the company benefited as a result of the other shareholders taking up shares in the subsidiary. In addition, the successful action only benefited the purchasers of Regal (Hastings) Ltd who had contracted to pay an agreed price. The return of the profits to Regal (Hastings) Ltd meant that they succeeded in obtaining a reduction from the contracted purchase price. Directors in similar circumstances may now be able to avail themselves of s 1318. This section permits the court to relieve an officer from any liability for negligence, default, breach of trust or breach of duty if it appears that they acted honestly and having regard to the circumstances of the case, they ought fairly to be excused. Section 1318 is discussed in [20.30].

## Improper use of position: s 182

[16.120] Section 182 prohibits officers or employees of a corporation from improperly using their position to gain an advantage for themselves or for any other person or to cause detriment to the corporation.

Section 182 is the statutory version of the fiduciary principle applied in *Regal (Hastings) Ltd v Gulliver* that directors are under a duty not to make undisclosed personal profits arising from their position. However, s 182 is wider in that it applies to employees as well as officers. Further, s 182 is breached if officers or employees improperly use their position to gain an advantage for others. It appears that this would extend to a person in the chairman's position in *Regal (Hastings) Ltd v Gulliver* since a profit was made by him as trustee for others.

The directors' duty not to improperly use their position in s 182 overlaps with both their fiduciary duty to act in good faith in the best interests of the company as well as s 181. These obligations are discussed in Chapter 15. In *Southern Real Estate Pty Ltd v Dellow* [2003] SASC 318, DeBelle J referred to the relationship between the duty to act in the best interests of the company and s 182:

[Section 182] plainly flows from and might be regarded as one aspect of the duty to act in good faith in the best interests of the company. The duty spells out the obligations of a director not to allow personal interests to conflict with a duty to the company. That obligation stems from the fact that a director is a fiduciary.

Section 182 is a designated civil penalty provision: s 1317E. Any person who is involved in a contravention of s 182 also contravenes a civil penalty provision: s 182(2). The civil penalty provisions are discussed at [19.120]–[19.150].

## Meaning of “improper”

**[16.125]** The term “improper” means a number of things. It refers to conduct that is inconsistent with the “proper” discharge of the duties, obligations and responsibilities of an officer: *Grove v Flavel* (1986) 43 SASR 410. The courts apply an objective standard when determining what amounts to an improper use of position: *Re Colorado Products Pty Ltd (in prov liq)* (2014) 101 ACSR 233; [2014] NSWSC 789. A director may act improperly even though the director considered they were acting in the best interests of the company as a whole and did not intend to act dishonestly. Conduct is “improper” if it breaches the standard that would be expected of a reasonable person in the director’s position in the circumstances: *Doyle v ASIC* (2005) 227 CLR 18; [2005] HCA 78. The question is “whether the conduct impugned is inconsistent with the proper discharge of the duties of the office in question”: *Chew v The Queen* (1992) 173 CLR 626. Directors improperly use their position if they breach their fiduciary duties.

The courts have held that s 182 should be read in such a way that it has a purposive meaning rather than a causative meaning: the important point is that it is the purpose behind the officer’s actions, to gain an advantage or to cause detriment, that is critical, rather than the ultimate effect of that action. Section 182 requires a director not to have the prohibited purpose of gaining an advantage or causing a detriment; it is not necessary to prove that an advantage has in fact been gained or a detriment has in fact been caused to the company: *United Petroleum Australia Pty Ltd v Herbert Smith Freehills* (2018) 128 ACSR 324; [2018] VSC 347; *Chew v The Queen* (1992) 173 CLR 626.

Directors may also improperly use their position if they act without authority.

*R v Byrnes* (1995) 183 CLR 501

**[16.130]** Two directors of Magnacrete Ltd, without authority of the board, arranged for their company’s seal to be affixed to a guarantee and other documents that provided security for a loan to another company they controlled. It was held that the directors breached a predecessor of s 182 even though they reasonably but mistakenly believed that executing these documents was in the interests of Magnacrete. Brennan, Deane, Toohey and Gaudron JJ stated:

Impropriety does not depend on an alleged offender’s consciousness of impropriety. Impropriety consists in a breach of the standards of conduct that would be expected of a person in the position of the alleged offender by reasonable persons with knowledge of the duties, powers and authority of the position and the circumstances of the case. When impropriety is said to consist in an abuse of power, the state of mind of the alleged offender is important: the alleged offender’s knowledge or means of knowledge of the circumstances in which the power is exercised and their purpose or intention in exercising the power are important factors in determining the question whether the power has been abused. But impropriety is not restricted to abuse of power. It may consist in the doing of an act which a director or officer knows or ought to know that they have no authority to do.

*ASIC v Adler* [2002] NSWSC 171 (confirmed on appeal [2003] NSWCA 131)

**[16.140]** The facts are set out at [15.240]. The court decided that Adler contravened s 182 when he arranged for part of HIHC's \$10 million loan to PEE to be used to acquire HIH shares on the stock exchange. This acquisition was intended to support the HIH share price and enable Adler Corporation to sell its own HIH shares ahead of the sale of PEE's HIH shares. It was held that as a result of this transaction, Adler improperly used his position as a director of HIH, an officer of HIHC and a director of PEE to gain an advantage for Adler Corporation. The court held that Williams also breached his s 182 duty not to improperly use his position as a director of both HIH and HIHC to gain an advantage for Adler. He also improperly used his position to cause detriment to HIH and HIHC in authorising the \$10 million payment without proper safeguards and without approval from HIH's investment committee as required by HIH's investment guidelines.

The court held that Adler also improperly used his position as a director in relation to PEE's acquisition of a number of unlisted venture capital companies from Adler Corporation at their cost price and without obtaining independent valuations. These acquisitions enabled Adler to extricate himself and Adler Corporation from commercially unviable business ventures. Adler knew that each of these companies had major cash flow difficulties and that there was a significant risk that they would fail. Adler failed to disclose his personal interest in these acquisitions to HIH's board other than to Williams and Fodera.

A predecessor of s 182 has also been applied in an insolvency context.

*Jeffree v NCSC* [1990] WAR 183

**[16.155]** In this case, the facts of which are discussed at [18.65], the Supreme Court of Western Australia held that a director improperly used his position in breach of the section when he sold all the company's business to another company he controlled without obtaining payment for goodwill. This sale, which left the company as a dormant shell, was entered into to defeat the claim of a contingent creditor. The director also acted contrary to the interests of the company's future creditors.

*Brentwood Village Limited (in liq) v Terrigal Grosvenor Lodge Pty Limited (No 4)* [2016] FCA 1359

**[16.158]** Klumper, a director of Brentwood, was found to have used his position improperly when he transferred for no consideration a nursing home owned by the company to a second company controlled by family members. Markovic J found that ss 181 and 182 had been breached. He said:

There is no evidence that Mr Klumper gave any consideration to the interests of Brentwood in effecting the Veronica Nursing Home transaction. To the contrary there is evidence that supports the conclusion that he acted for a collateral

purpose. Namely, in the face of imminent or actual recovery action by the ATO of tax liabilities of tens of millions of dollars, he divested a significant asset of the company for no consideration.

#### Causing or allowing contravention.

**[16.160]** Directors improperly use their position in contravention of s 182 if they allow the company to contravene the *Corporations Act*. The duty will be breached if the contravention is likely to jeopardise the interests of the corporation, the risks to the corporation outweigh any potential countervailing benefits and there are reasonable steps that could be taken to avoid those risks: *ASIC v Maxwell* [2006] NSWSC 1052. In the *Maxwell* case, a director caused his company to contravene s 727 of the *Corporations Act*, discussed at [7.25], by offering securities to investors without a disclosure document. The director was also intimately involved in the company soliciting loans from investors causing the company to breach the advertising and publicity restrictions in s 734 of the *Corporations Act* (see [7.175]). It was held that the director improperly used his position in breach of s 182 because he arranged for the company to pay him commissions on each investor loan he introduced.

Similarly, in *ASIC v Warrenmang Ltd* [2007] FCA 973, a director caused his company to breach ss 722 and 723 of the *Corporations Act*, discussed at [7.140] and [7.145], when it failed to keep investors' subscription moneys for securities in trust until the securities were issued and to ensure the moneys were returned when the company did not achieve ASX listing as specified in its disclosure document. It was held that the director contravened ss 181 and 182 when he deliberately misappropriated a portion of investors' subscription moneys for his own personal benefit.

## To gain an advantage or to cause detriment

**[16.170]** To contravene s 182, a director, officer or employee must not only improperly use their position but must also do so "to gain an advantage for themselves or for another person or to cause detriment to the corporation".

A majority of the High Court in *Chew v The Queen* interpreted the predecessor of s 182 as being purposive. This means an officer breaches the section if improper use is made of their office in order to gain advantage or to cause detriment. In their majority judgment, Mason CJ, Brennan, Gaudron and McHugh JJ said:

it is necessary to establish not merely that the accused intended that a result should ensue, but also that the accused believed that the intended result would be an advantage for himself or herself or for some other person or a detriment to the corporation.

However, it is not necessary that an advantage or a detriment actually occurs in order for the officer to have contravened s 182.

A director may gain an advantage even where a profit has not been obtained.

*R v Donald; Ex parte Attorney-General* [1993] 2 Qd R 680

**[16.180]** Donald was managing director and owned half the shares of Ardina Pty Ltd. The company entered into contracts with two other companies that he controlled. The invoices for payment to the two companies were passed directly to Donald for payment instead of being checked by employees of Ardina Pty Ltd, as was the usual practice. Some invoices were falsely made out. Donald did not disclose his interest in the two companies and was charged with a breach of the predecessor of s 182. The Queensland Court of Appeal applied the purposive test adopted in *Chew v The Queen*. It held that the equivalent of s 182 was breached even though some payments were due under the contracts. The companies that received payment were still gaining an advantage and it was not necessary for them to gain a profit. This advantage was gained because the payments were made without the usual checking and scrutiny.

## Bribes and other undisclosed benefits

**[16.190]** An obvious example of making an undisclosed personal profit arising from acting in the position of director occurs when a director is paid a bribe or secret commission in order to procure a particular course of action by the company or to influence the director in a particular way. The receipt of the payment would also amount to a breach of the duty to act in good faith in the best interests of the company as well as ss 181 and 182.

*Boston Deep Sea Fishing & Ice Co v Ansell* (1888) 39 Ch D 339

**[16.195]** Ansell was the managing director of the company and organised the construction of fishing boats on its behalf. However, unknown to his company, he was paid a commission by the shipbuilders. The company was also unaware that Ansell was a shareholder in an ice-supplying company and a fish-carrying company. These companies paid bonuses to shareholders who employed their services. Ansell contracted with the two companies in respect of Boston's fishing business. The court held that Ansell's personal interests conflicted with his fiduciary duty to Boston in respect of both the commission received from the shipbuilders as well as the bonuses received from the two companies of which he was a shareholder.

**[16.200]** Directors who derive an undisclosed personal benefit breach their fiduciary and statutory duties irrespective of whether the company suffered loss as a result. In such cases, the director can be ordered to account to the company for the personal benefit derived. The various remedies for breach of directors' fiduciary and statutory duties are discussed in Chapter 19.

*Furs Ltd v Tomkies* (1936) 54 CLR 583

**[16.205]** Tomkies was the managing director of Furs Ltd. He had special knowledge of the company's business, including secret formulae it used, which were of considerable value. Tomkies was instructed by the Furs Ltd board to negotiate the sale of the business for the company for an initial asking price of £8,500 plus £4,500 for the formulae. Tomkies began negotiating with a potential purchaser who insisted that it would buy the business only if Tomkies agreed to work for the purchaser. Tomkies disclosed this to the chairman of Furs Ltd. The purchaser agreed to hire Tomkies under a three-year contract which included the issue of shares in the purchasing company. The purchaser also agreed to pay Tomkies an additional £5,000. Tomkies kept secret his shares in the purchasing company as well as the receipt of the £5,000. Because Tomkies promised to provide his knowledge of the secret formulae to the purchaser, it offered to pay only £8,500 for the business and nothing for the formulae. Furs Ltd accepted this reduced purchase price. After the sale of the business, Furs Ltd discovered the £5,000 payment to Tomkies and his receipt of shares in the purchasing company. Furs Ltd successfully brought an action seeking to recover from Tomkies the amount of profit he made by reason of his breach of duty.

The court held that Tomkies had a clear conflict of interests and ordered that he account to Furs Ltd for the undisclosed profits he made. As the managing director negotiating the sale of the business, Tomkies had a duty to negotiate as high a price for the business as possible. The undisclosed receipt of £5,000 and the shares in the purchasing company indicated that Tomkies preferred his personal interests.

## Misuse of company funds

**[16.210]** Directors are under a fiduciary duty to act in their company's interests with respect to the use of the company's funds which must be used for the company's legitimate business purposes. Directors are also under a duty not to mix the company's funds with their own. In some instances, this may also amount to theft or embezzlement.

A conflict of interests arises whether the company's funds are mixed with the director's personal funds or with the funds of another company in which the director has an interest.

*Totex-Adon Pty Ltd v Marco* (1982) 1 ACLC 228

**[16.215]** Marco was a director of Totex-Adon which was formed to conduct a joint venture between Totex (Aust) Pty Ltd which operated in New South Wales and Adon Pty Ltd which operated in Queensland. Marco was also a director and shareholder of Adon. Under the terms of the joint venture agreement, Totex-Adon was to purchase goods from Totex and then sell them in Queensland with the proceeds going to Totex-Adon. Marco failed to account to Totex-Adon for the proceeds

of the sale of its goods and Totex-Adon commenced proceedings against Marco under a predecessor of s 181. Marco had failed to open a separate bank account for Totex-Adon and instead used Adon's own account. The court held that Marco had breached his fiduciary duty owed to Totex-Adon when he mixed its funds with that of his other company.

**[16.220]** If directors, without proper disclosure, obtain funds from their company for their own personal use and not for any purpose of the company, it is no defence for them to later assert that the funds obtained were by way of a loan to them: *Paul A Davies (Aust) Pty Ltd v Davies* [1983] 1 NSWLR 440.

## Taking up a corporate opportunity

**[16.230]** A director breaches the duty to avoid a conflict of interests where the director, without appropriate disclosure or approval, takes up an opportunity that should have been taken up by the company. In such cases, the director may be liable to account to the company for any profit. The company may instead seek a constructive trust order, the effect of which is that the company takes the business opportunity for itself. Directors who take up a corporate opportunity in breach of their fiduciary duty will also breach their fiduciary duty to act in good faith in the best interests of the company as well as ss 181 and 182. The various remedies for breach of directors' fiduciary and statutory duties are discussed in Chapter 19.

Directors are not under an obligation to present every possible business opportunity to the company, only where there is "a sufficient temporal and causal connection between the obligation and the opportunity": *SEA Food International Pty Ltd v Lam* (1998) 16 ACLC 552. Directors do not have an obligation to seek out opportunities which lie outside the scope of the company's business: *Mudgee Dolomite & Lime Pty Ltd v Robert Francis Murdoch* [2020] NSWSC 1510.

## Diversion of contract

**[16.235]** A breach of the fiduciary duty regarding corporate opportunities occurs where a director, while negotiating a contract for the company, without appropriate disclosure and approval, arranges for the contract to be diverted from the company to the director personally or to another company in which the director is involved.

*Cook v Deeks* [1916] 1 AC 554

**[16.240]** Toronto Construction Co was formed to engage in railway construction work on contract with the Canadian Pacific Railway. Its shares were held by four contractors in nearly equal proportions. They were also the directors. The company successfully completed several contracts of considerable value. Disagreements arose between three of the directors and the fourth, Cook. The three directors,



GS Deeks, GM Deeks and Hinds, then negotiated a further contract on behalf of Toronto Construction Co. Towards the end of negotiations, Deeks, Deeks and Hinds indicated that the contract was for them and not for the company. The three directors formed a new company to carry out this contract. When Cook protested, resolutions were passed by the three as shareholders of Toronto Construction, approving the sale of part of its plant to the newly formed company, declaring that Toronto Construction Co had no interest in the new contract and authorising the directors to defend any action brought by Cook. Cook then brought a derivative action on behalf of Toronto Construction Co seeking an order that the contract and benefit of the contract belonged in equity to that company. The Privy Council held that the three directors breached their duty to Toronto Construction Co by diverting the contract to their newly formed company and consequently they held the contract as trustees for Toronto Construction Co.

**[16.242]** These types of situations where contracts belonging to a company are diverted so that a minority shareholder is excluded from the benefit of the contract raise the question whether the affected shareholder has been treated unfairly. If so, an action may be brought against the majority shareholders involving members' rights such as the oppression remedy or statutory derivative action. The rights of a member to bring a legal action in the name of a company and to seek an order under the oppression remedy are discussed at [24.15] onwards.

Directors who negotiate the diversion of a business opportunity from their company to themselves or others breach their fiduciary duty even if the negotiations have not been concluded. Directors who divert a business opportunity without obtaining their company's informed consent breach their duty even if the company was not able to take up the business opportunity.

*Omnilab Media Pty Ltd v Digital Cinema Network Pty Ltd* [2011] FCAFC 166

**[16.243]** American film studios owned equipment that converted movie projection from analogue to digital that they wanted to sell to cinema owners throughout Australia. As an incentive to purchase the expensive equipment, the film studios were prepared to pay a subsidy to purchasing cinema owners called a Virtual Print Fee (VPF). However, the film studios were not prepared to deal directly with individual cinema owners. Rather, they sought to enter into VPF agreements with a "digital integrator" who had the support of a sufficient number of cinema owners to make the project worthwhile to the studios.

Digital Cinema Network (DCN), a joint venture between two companies, MGS Group Pty Ltd and digitALL Pty Ltd, was formed for the purpose of exploiting business opportunities in the cinema industry arising from the conversion of movie projection from analogue to digital. Smith, a director of DCN and also controller of MGS, initially began negotiations with a number of Hollywood film studios with a view to them entering VPF agreements with DCN as the digital integrator. In conducting these negotiations with the film studios, Smith purported to represent DCN and told them that DCN had the support of an industry body (ICAA) that



represented cinema owners and operators in Australia and that ICAA members would purchase the equipment. Prior to the VPF agreements being finalised, ICAA made it clear that it wanted its company, Omnilab Media Pty Ltd, to be nominated as the digital integrator in the VPF agreements instead of DCN. There were negotiations between Smith and ICAA for Omnilab Media to buy DCN's business and assets. Even though the purchase did not eventuate, Smith handed over the draft VPF agreements to Omnilab Media, effectively cutting DCN out of the valuable digital integrator business opportunity with the Hollywood studios.

The court held that Smith breached his fiduciary duty as director of DCN and in doing so also contravened ss 181(1), 182(1) and 183(1) of the *Corporations Act*. Smith came across the corporate opportunity to negotiate VPF agreements with the studios in his capacity as a director of DCN. He breached his duty when he assisted Omnilab Media, DCN's rival, to take from DCN the leading role in the negotiations with the studios. He did so without making a full and true disclosure of the relevant circumstances to the other DCN shareholder; without obtaining a non-disclosure agreement from the Omnilab Parties; and without securing a binding agreement from Omnilab Media to purchase the assets of DCN. Moreover, Smith also stood to obtain benefits from Omnilab Media in the form of a board seat and monetary payments. It was no defence for Smith's breach of duty that DCN could not have profited from the opportunity itself. The court held that Omnilab Media was also liable because it had actual knowledge of Smith's breach of duty to DCN and knowingly assisted in his breach.

**[16.245]** A breach of the fiduciary duty regarding corporate opportunities also occurs where a director who is involved in a business that competes with the company arranges for the company to shut down its own business. The effect of this is that the company loses the benefit of its business.

#### *Mordecai v Mordecai* (1988) 12 NSWLR 58

**[16.250]** Three brothers, Joseph, David and Meyer, were directors of Morpack Packaging Pty Ltd. Joseph and David each held 50 per cent of the shares. Joseph separated from his wife. Later, he died, and in his will deliberately excluded his wife and left his shares to his brothers as trustees for his infant son. His brothers caused Morpack to cease business. They set up a rival company that took over all Morpack's customers. Joseph's wife, on her son's behalf, claimed damages from David and Meyer alleging that they had breached their duty both as her son's trustees and as directors by disposing of Morpack's business in such a way as to reduce the value of her late husband's estate.

The Supreme Court of New South Wales agreed that David and Meyer had breached their duties as directors. They did more than merely set up a rival business in competition with Morpack – they deliberately closed down Morpack's business purely for their own private benefit. They improperly depreciated the value of the business by asking Morpack's customers to cease to deal with it and to deal with them instead.

*CellOS Software Ltd v Huber* [2018] FCA 2069

**[16.252]** Huber, a director of CellOS Software Ltd, was responsible for raising capital for the company to fund its operations, and he was able to control the timings of formal share offerings. Huber was found to have breached his fiduciary duty regarding taking up corporate opportunities and ss 181 and 182 when he secretly purchased company shares from existing investors at a fraction of the market price and then sold those same shares to new investors for a large profit. Some of the profit gained was used by Huber for personal purposes. The court found that Huber diverted the opportunity for the company to issue new shares to the new investors by misusing his position as a director and, in doing so, improperly gained profits for himself.

## Company consent where director takes up opportunity

**[16.255]** Directors who take up a corporate opportunity avoid breaching their fiduciary duty if they make full disclosure and the company gives its approval or consent. Directors who fail to make full disclosure and obtain consent cannot defend themselves by asserting that they acted honestly and that they benefited the company by taking up the opportunity or that the company did not have the means to take up the opportunity itself. In *Regal (Hastings) Ltd v Gulliver*, the facts of which are discussed at [16.110], the House of Lords noted that it was irrelevant that the company could not take up the opportunity to acquire shares in the subsidiary. The directors were in breach of duty despite appearing to act honestly and the company not having suffered any loss.

Directors satisfy their fiduciary duty if they make full disclosure to the company's shareholders and obtain their approval or consent. Section 191 also requires directors to make full disclosure to the board. The s 191 disclosure requirements are discussed at [16.420].

In both *Furs Ltd v Tomkies* (1936) 54 CLR 583 and *Regal (Hastings) Ltd v Gulliver*, the respective courts indicated that disclosure by a director must be made to the general meeting of shareholders. However, in some circumstances, particularly in closely held companies, it may not be necessary to call a general meeting as long as shareholders are kept fully informed of the relevant circumstances and give their informed consent. This is discussed at [16.395] and [20.05].

*Queensland Mines Ltd v Hudson* (1978) 52 ALJR 399

**[16.260]** Hudson was the managing director of Queensland Mines. He took up mining exploration licences in circumstances where the company was financially unable to do so. Hudson made full disclosure of his intention to personally take up the licences and then resigned as managing director. He met all expenses and ran all risks until he proved the existence of valuable deposits. The rights were then sold to an American company with Hudson being entitled to royalties. When control of Queensland Mines changed, the company took proceedings against Hudson alleging breach of duty.

The Privy Council held that the opportunity to earn the royalties arose from the use Hudson made of his position as managing director. But he fully informed Queensland Mines shareholders as to his interest in the licence, and the company renounced its interest and assented to Hudson proceeding with the venture alone. Queensland Mines failed in its action for an account of the past and future profits from the royalties payable to Hudson.

The Privy Council also held that the disclosure by Hudson to the board of directors, who were nominees of the respective shareholders, was sufficient.

**[16.270]** Directors have the onus of proving that they provided full and frank disclosure of all material information to the shareholders. Directors breach their duty if the information they disclose is misleading or inadequate.

*Southern Cross Mine Management Pty Ltd v Ensham Resources Pty Ltd* [2005] QSC 233

**[16.275]** Ensham operated and managed an open-cut coal mine on behalf of its shareholders who were involved as joint venturers. Foots, Ensham's CEO, convinced the joint venturers that Ensham needed an additional dragline, a machine used in open-cut coal mining, for its operations. Foots advised that he had formed a company, Southern Cross Mine Management, which would buy a dragline and lease it to Ensham. Ensham's board consented to this arrangement and entered into a lease agreement with Southern Cross Mine Management which acquired the dragline from its original owner. The court found that Foots induced Ensham's consent by a number of misrepresentations. He falsely claimed that:

- the original owner of the dragline would not sell it to Ensham because it had already sold it to Southern Cross Mine Management; and
- it was significantly cheaper for Ensham to hire the dragline from Southern Cross Mine Management than to buy it outright.

Foots also failed to disclose to Ensham that Southern Cross Mine Management anticipated profits from the dragline lease would provide it with a return of more than 400 per cent on its investment.

It was held that because Foots was Ensham's CEO, he owed it a fiduciary duty in relation to dealings with the dragline. He learned of the opportunity to acquire the dragline because of his position as Ensham's CEO. It was his duty to acquire the dragline for Ensham. As Ensham's fiduciary, Foots could be relieved of this duty and acquire the dragline himself only if Ensham consented after Foots disclosed all relevant information. While Foots disclosed his interest in Southern Cross Mine Management, his misrepresentations meant that Ensham's consent was not fully informed of all relevant information. The court described Foots' conduct as "disgraceful" and that the object of the arrangement was to "swindle Ensham of the profits from the dragline". Since Southern Cross Mine Management and Foots were regarded as indistinguishable, the court held that it knowingly participated in Foots' breach of fiduciary duty. The court declared that Southern Cross Mine Management held the dragline on a constructive trust for Ensham.

A company's constructive trust remedy is discussed at [19.90]–[19.115].

## Company need not suffer loss

**[16.280]** A company need not suffer any loss to establish a breach of duty. This is illustrated in *Green v Bestobell Industries Pty Ltd* [1982] WAR 1 (discussed at [16.285]) and *Omnilab Media Pty Ltd v Digital Cinema Network Pty Ltd* [2011] FCAFC 166 (discussed at [16.243]).

*Green v Bestobell Industries Pty Ltd* [1982] WAR 1

**[16.285]** Green used information arising from his former position as Victorian manager of a company to prepare a building construction tender. His tender, which was submitted by a company he formed for the purpose, was successful. Bestobell Industries also tendered for the same project but came third. The court held that Green breached his duties and ordered an account of profits to Bestobell even though it would not have won the tender in any event.

## Misuse of confidential information

**[16.290]** Directors have a fiduciary duty not to misuse confidential company information for their own benefit without appropriate disclosure and approval. Confidential information includes trade secrets, lists of suppliers and customers, customer requirements and pricing information. The duty is restated in s 183 and often overlaps with the duty not to take up a corporate opportunity, discussed at [16.230]. The fiduciary duty regarding the misuse of confidential information is an aspect of the wider fiduciary and statutory duty to act in good faith in the best interests of the company. It also overlaps with the duty not to compete with the company, discussed at [16.360]–[16.382].

The duty not to misuse confidential information may arise when a director leaves one company to commence work for a competitor. A director or an employee, after ceasing employment, is not permitted to use confidential information obtained in the course of that employment for the purpose of competing with their former employer: *Faccenda Chicken Ltd v Fowler* [1987] 1 Ch 117.

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| What is confidential information? |
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In *Wright v Gasweld Pty Ltd* (1991) 22 NSWLR 317, Kirby P listed the following five factors to be considered in deciding whether information was confidential:

- the skill and effort expended to acquire the information;
- the degree to which the information is jealously guarded by the employer, is not readily made available to employees and could not, without considerable effort or risk, be acquired by others;
- whether it was plainly known to the employee that the material was regarded by the employer as confidential;

- the usages and practices of the industry; and
- whether the employee in question has been permitted to share the information only by reason of their seniority or high responsibility within the employer's organisation.

*Thomas Marshall (Exporters) Ltd v Guinle* [1978] 3 WLR 116

**[16.300]** Guinle was managing director of a company that carried on an importing business. Without his company's knowledge, Guinle began to trade on his own account in competition with his company. When this was discovered his company sought injunctions to restrain him from dealing with the company's customers and suppliers and to prevent him from disclosing or using the company's confidential information or trade secrets. The court granted the injunctions after deciding that Guinle had breached his fiduciary duties.

*Forkserve Pty Ltd v Jack & Aussie Forklift Repairs Pty Ltd* [2000] NSWSC 1064

**[16.310]** The Supreme Court of New South Wales held that the fiduciary duty regarding misuse of confidential information was breached when a former employee who was a de facto director set up his own business and began, prior to ceasing his employment, soliciting his former company's customers using the company's telex book containing customers' names and telephone numbers. The telex book could be classified as a customer list even though it could not be classified as confidential. Taking the telex book for use in the future to compete with the employer would, but for the employer's consent, have amounted to a breach of duty by the employee. Santow J stated:

It is long settled that during a period of employment an employee and/or a director may not solicit customers for a future time when the employment has ceased and the employee or director has established his or her own business. However, once the employment has ceased, in the absence of special stipulation, the employee may canvass the customers of the late employer and may send a circular to every customer. Further, during the course of employment an employee is not able to make or copy a list of the employer's customers but cannot be restrained from sending circulars to customers whose names the employee remembers.

## Improper use of information: s 183

**[16.315]** Section 183 supplements the fiduciary duty regarding the misuse of confidential information. It is wider than the fiduciary duty in that it also applies to employees.

Under s 183, a person who obtains information because they are or have been a director, officer or employee of a corporation must not improperly use the information to make a gain for themselves or any other person or to cause detriment to the corporation. It is clear that s 183 applies to former directors, officers and employees as well as current directors, officers and employees.

The High Court in *Chew v The Queen* suggested that the predecessor of s 183 should also be interpreted as being purposive in the same way as s 182. This means that the accrual of an advantage or suffering of a detriment need not actually occur as long as the defendant believed that an advantage or detriment would result. This is further discussed at [16.170].

## Meaning of “information”

**[16.320]** While s 183 prohibits improper use of “information”, the section does not use the word “confidential”. The cases are divided as to whether confidentiality is an element of s 183. In *Es-me Pty Ltd v Parker* [1972] WAR 52, the Supreme Court of Western Australia made it clear that for the purposes of the fiduciary duties and a predecessor of s 183, the information need not necessarily be secret but must be confidential information possessed by the company.

There is some doubt as to the correctness of the proposition in *Es-me Pty Ltd v Parker* that the information used by officers must be confidential. In *McNamara v Flavel* (1988) 6 ACLC 802, the South Australian Supreme Court held that for purposes of a predecessor of s 183, a breach depended on how the information was acquired and not whether it was confidential. If a plaintiff must prove that the information was at least confidential, breach of this duty would be more difficult to prove than the broader duty under s 181 or the fiduciary duty not to make undisclosed profits.

Young J, in *Rosetex Co Pty Ltd v Licata* (1994) 12 ACLC 269, interpreted “information” as referring to that type of information that equity would restrict the director from using to their personal profit. Section 183 also may include a situation where an employee sets up in competition and makes improper use of information after leaving the company, even though there is no restraint of trade clause in the employee’s contract with the company.

### *Armstrong World Industries (Australia) Pty Ltd v Parma* [2014] FCA 743

**[16.322]** Parma was the Chief Financial Officer of Armstrong World Industries (Australia) Pty Ltd until his employment was terminated in 2014. Following his termination, Parma copied from his company-owned laptop a large number of files containing business records of the company and then deleted them. Parma admitted that he had some business records of the company in his possession and that he intended to use those records to support a legal action he had commenced against the company arising from his dismissal. The court ordered Parma to return the business records to the company because it was satisfied that his stated purpose for using the documents would amount to a breach of s 183(1). Parma obtained the documents as an employee, he had the documents in his possession, and he had threatened to use them for his own advantage. This amounted to an improper use of that information.

**[16.323]** A director may improperly use confidential information to gain personal profits by obtaining inside information regarding the company’s affairs and then trading in the

company's shares. In such cases, the other trading party has no rights to a remedy under s 183 but may have rights under the insider trading provisions contained in ss 1042A–1043O. Insider trading is discussed at [26.235] onwards.

### *ASIC v Vizard* [2005] FCA 1037

**[16.325]** ASIC brought civil penalty proceedings against Vizard after he confessed to being involved in contraventions of the predecessors of s 183 in relation to three share transactions that were made as a result of confidential information he gained as a non-executive director of Telstra. To keep his involvement in the share trading secret, Vizard set up a share trading company, Creative Technology Investments Pty Ltd (CTI) of which his accountant was the sole director and shareholder. Vizard also controlled another company, Brigham Pty Ltd (Brigham), which was trustee of the Vizard family trust. Brigham lent money to CTI to fund its share trading activities. The loan agreement provided that CTI would pay Brigham 90 per cent of the proceeds derived from the sale of any shares.

Through his membership of Telstra's board, Vizard became aware of the following confidential information:

- In 2000, Telstra was involved in confidential merger discussions in which it was proposed that two other listed companies, Sausage Software Ltd and Solution 6 Holdings Ltd, would merge and that Telstra would acquire a substantial holding in the merged entity. Guessing that once the proposed merger became public there would be a significant increase in the share price of Sausage Software, Vizard caused CTI to buy shares in Sausage Software. Vizard's guess was correct and following the public announcement of the merger, Sausage Software's share price rose substantially giving CTI an immediate paper profit on its acquisition. CTI subsequently sold its Sausage Software shares.
- Telstra owned a substantial interest in another listed company, Computershare Ltd. Telstra's board decided that it would sell its shares in Computershare to raise funds to help pay for its interest in the Sausage-Solution 6 merger. Telstra's proposed sale was kept confidential until the sale was completed. As CTI owned shares in Computershare, Vizard correctly reasoned that the market price of shares in that company would fall after the public announcement of Telstra's sale of its holding. Vizard caused CTI to sell its shares in Computershare ahead of Telstra's sale.
- In 2000, Telstra's board secretly proposed that the company should acquire a 51 per cent interest in Keycorp Ltd, a listed company. Vizard, realising that this would mean that Keycorp's share price would rise after the announcement of Telstra's acquisition, caused CTI to buy some shares in Keycorp ahead of Telstra. CTI later sold its Keycorp shares at a profit.

It was held that as a result of the above transactions, Vizard was involved in a contravention of the predecessor of s 183. In each instance, he acquired confidential information by reason of his position as a non-executive director of Telstra. He made improper use of the information when he caused CTI to buy or sell shares. Vizard improperly used the information to gain an advantage for CTI, Brigham



and ultimately for himself personally. The court ordered Vizard to pay a pecuniary penalty and imposed a disqualification order on him. These remedies are discussed at [19.135] onwards.

## Relationship between ss 181 and 183

[16.335] The fiduciary and statutory duties regarding the misuse of information are an instance of the wider duty to act in good faith in the best interests of the company: *Southern Real Estate Pty Ltd v Dellow*. A director who contravenes s 183 may in the same circumstances also contravene s 181.

*Marson Pty Ltd v Pressbank Pty Ltd* [1989] 1 Qd R 264

[16.340] The overlapping operation of ss 181 and 183 is illustrated by this case. Pressbank was a joint venture company whose shareholders were companies controlled by Mr and Mrs Margolis on the one hand and Mr and Mrs Urban on the other. Mr and Mrs Urban were Pressbank's only directors. The company was formed to acquire land and a business. A deposit of \$50,000 was due to the vendor. Pressbank raised this amount by borrowing \$30,000 from the Urbans' company and \$20,000 from the Margolis' company, Marson Pty Ltd.

When Mr and Mrs Margolis experienced trouble raising their share of the balance of the money required to settle the purchase, it was agreed that the joint venture would be abandoned and that the Urbans would proceed with it themselves. It was accepted that Pressbank owed Marson \$20,000 and would eventually repay this debt. When the Urbans told the vendor that Pressbank was unable to settle the purchase, the contract was rescinded and the deposit forfeited to the vendor. Because the vendor was anxious to settle the sale as quickly as possible he agreed that if Urban could find a new purchaser the vendor would refund \$30,000 of the forfeited deposit.

The Urbans formed another company that settled the contract with the vendor for the same price. Mr Urban convinced the vendor to credit the new company with \$30,000 of the total deposit paid by Pressbank. The remaining \$20,000 remained forfeited to the vendor. When Margolis learned of this, he caused his company to bring an action against the Urbans arguing that they were liable to Pressbank for breach of both their statutory and fiduciary duties as directors.

The court held that the directors had breached their duties under predecessors of ss 181 and 183. The court found that it was only because of the Urbans' connection with Pressbank that they were able to negotiate what was in effect a reduction in price for their new company. Their actions indicated that they lacked honesty for purposes of an earlier version of s 181(1). This may now indicate a lack of good faith and a failure to exercise powers for a proper purpose within the meaning of s 181(1). They also made improper use of information acquired by them as directors of Pressbank to gain an advantage for themselves and their company;



the information being their awareness that the vendor would agree to a credit of \$30,000 to a purchaser connected with Pressbank.

The court noted that the Urbans would not have breached their duties if they had arranged for their own company to conclude the contract with the vendor at the same price but with the \$30,000 refund being credited to Pressbank. That would have left Pressbank with sufficient funds to repay the debt due to the Margolis' company.

## Misuse of information about a company's insolvency

**[16.345]** Directors may contravene s 183 if they make improper use of information that their companies are in financial difficulties to gain an advantage for themselves over the company's creditors.

*Grove v Flavel* (1986) 43 SASR 410

**[16.350]** The internal indebtedness within a group of companies was rearranged after a director acquired information that a company within the group was close to insolvency. A "round robin" of cheques resulted in the director, and the financially secure companies of which he was also a director, ceasing to be creditors of the company experiencing financial difficulties. Other companies of the group ceased being debtors of the troubled company and the danger of a liquidator calling up the debts was thereby removed.

It was held that the director had made improper use of information under a predecessor of s 183 acquired by virtue of his position as an officer. The information led him to believe that the company faced a risk of liquidation that was real and not remote. He acted to protect himself and other companies of which he was a director from the consequences of a liquidation. This was detrimental to the creditors of the company in financial difficulties.

**[16.355]** In *McNamara v Flavel* (1988) 6 ACLC 802, a director transferred for no consideration a valuable asset owned by his insolvent company to another company that he controlled. This was detrimental to the creditors of the first company. The extent to which directors owe duties to creditors is discussed at [18.10]–[18.95].

## Competing with the company

**[16.360]** As a general rule, fiduciaries are not permitted to enter into competition with the persons for whom they act. Trustees cannot compete with their beneficiaries and partners cannot compete with their partnerships.

Despite the similarities of the duties of directors to the duties arising in these other relationships, it is not entirely settled that directors breach their fiduciary duty merely

by being involved in a business that competes with their company. The courts draw a distinction between executive and non-executive directors.

A person who acts as a non-executive director for competing companies will not necessarily be in breach of the no-conflict rule: *Hylepin Pty Ltd v Doshay Pty Ltd* [2021] FCAFC 201. As such, non-executive directors of a company cannot be prevented from acting as a director of a competing company: *Bell v Lever Bros Ltd* [1932] AC 161. While they are permitted to compete, they cannot divulge confidential information obtained by them as director of one company to the other company or use for their own purposes information entrusted to them while acting as a director: *Markwell Bros Pty Ltd v CPN Diesels (Qld) Pty Ltd* [1983] 2 Qd R 508.

A company may provide in its constitution or in a service agreement entered into with a director that the director shall only engage in work related to the business of the company during normal office hours. Such a provision prevents the director from working for anyone else during those hours, whether or not they are engaged in a competing business.

*Hivac Ltd v Park Royal Scientific Instruments Ltd* [1946] 1 All ER 350

**[16.365]** A company had two employees who engaged in highly skilled, technical work. At least one of the employees had access to the company's manufacturing data. In their spare time, they were employed by a rival company doing similar work and they persuaded other employees to work for the rival company in their spare time. There was no evidence that the employees had revealed any confidential information to the rival company. It was held by the Court of Appeal, that an employee owes a duty of fidelity (good faith and no undisclosed conflicts) to the employer. However, an employee may work for another employer in their spare time. This is so in the case of a manual worker: what is done in their spare time is a private concern. However, a contract of employment may contain an express or implied term that an employee will not work for a competitor.

**[16.370]** *Hivac Ltd v Park Royal Scientific Instruments Ltd* [1946] 1 All ER 350 appears to suggest that an executive director employed under a service agreement at least owes an employees' duty of fidelity. This prevents the employee competing with the employer, the company.

While directors may sit on the boards of rival companies, they are not permitted to use or disclose the confidential information of one company to the rival company.

*Riteway Express Pty Ltd v Clayton* (1987) 10 NSWLR 238

**[16.375]** The Supreme Court of New South Wales noted that the law permits former employees of a company to compete with their company and use or disclose certain categories of information gained in the course of their employment. Former employees may, after leaving the company, legitimately use or disclose information

that they have memorised. They can also use all their skills and experience acquired in the course of their previous employment.

Ex-employees, however, are not permitted to use or disclose trade secrets of their former employer. The court decided that the information in the present case fell into the permitted use category so that had Clayton merely been in the position of a former employee of the company he would have been permitted to use and disclose it. The court held, however, that because Clayton was still a non-executive director of Riteway Express he was not permitted to use the information. The court granted the injunction but made it subject to certain conditions. It would be lifted if either a general meeting of the company consented to Clayton carrying on a competing business or he ceased to be a director.

Soliciting customers.

**[16.380]** A director who forms an undisclosed intention to resign and set up a competing business is not permitted to actively solicit the company's customers for the competing business prior to the resignation or for a reasonable period of time thereafter: *Southern Real Estate Pty Ltd v Dellow*. Directors are also not allowed to compete with their company where this involves them closing down the company's business and operating it for themselves: *Mordecai v Mordecai* (1988) 12 NSWLR 58.

*Holyoake Industries (Vic) Pty Ltd v V-Flow Pty Ltd* [2011] FCA 1154

**[16.382]** While employed by Holyoake Industries, its managing director and two other senior managers set up their own company, V-Flow Pty Ltd, and without disclosure or approval from their employers arranged for that company to purchase the business of one of Holyoake Industries' competitors. The three employees resigned from Holyoake Industries and proceeded to compete with their former employer. It was held that they breached their contractual and fiduciary duties to Holyoake Industries. They also contravened ss 182(1) and 183(1) of the *Corporations Act*. The court further held that the managing director also contravened s 181(1).

The three officers breached their implied contractual duties of loyalty and fidelity as well as their fiduciary duties as officers of Holyoake Industries in several respects. While still employed by Holyoake, and without the knowledge of the management of Holyoake, the three officers set about obtaining customers for their proposed new business, which was to compete with Holyoake. They also set up the trust structures that they proposed to use to conduct the purchased business at a time while they were still employed by Holyoake. In negotiating the purchase of the business, they used confidential information in Holyoake's records relating to the nature of the business they purchased. By acting in those ways, the three officers placed themselves in a position in which their interests conflicted materially with

those of their former employer. The court held that V-Flow was also liable because it knowingly participated in the breaches of fiduciary duty.

Given the circumstances of their breaches of contractual and fiduciary duties described above, the court also held that the three officers improperly used their positions to gain an advantage for themselves and their company, V-Flow, in contravention of s 182(1). Their use of confidential Holyoake information relating to the business they purchased also meant they improperly used information in contravention of s 183(1).

The managing director breached his fiduciary duty and s 181(1) duty to act in the best interests of Holyoake and for a proper purpose in several respects. As well as the conflicts of interest described above, when the managing director came across the information that the competing business was for sale, he failed to pass on this information to Holyoake. When negotiating the employment contracts with the other two senior managers prior to purchasing the competing business, the managing director deliberately ensured that those employment contracts omitted Holyoake's usual clauses that prohibited employees having conflicts of interest; 12-month restraint on employees soliciting Holyoake's customers; and restrictions on the disclosure of confidential information and intellectual property.

## Disclosure of interests

**[16.385]** Directors who enter into a self-interested transaction with the company or otherwise put themselves in a conflict of interest situation which amounts to a breach of their fiduciary duty must disclose the details of their personal interest and obtain the company's fully informed consent if they are to avoid liability for the breach. Examples of such conflict of interest situations include where a director:

- makes a personal profit that arises from their position;
- diverts an opportunity from their company; or
- misuses confidential company information.

In some situations disclosure will not be sufficient to avoid liability. Where a director has "a position of power and influence" over the board, they may be under a duty to take positive action to protect the interests of the company – for example, by using their influence to prevent the transaction proceeding: *ASIC v Adler* [2002] NSWSC 171; (2002) 168 FLR 253.

To whom must directors disclose their interests?

A key issue in relation to disclosure of interests is to whom directors must disclose their interests. As a general rule, directors' fiduciary obligations require them to make full disclosure of their potential conflicts of interest to the company's shareholders at a general meeting and obtain their consent (also referred to as "ratification"). However, as discussed at [16.390], a company's constitution may relax the obligation to disclose

conflicts of interest to shareholders and allow disclosure to be made to the board. The *Corporations Act* also imposes disclosure and approval requirements. For example, as discussed at [16.45], s 208 requires prior shareholder approval if a public company provides a financial benefit to a related party. In addition, under s 191 directors who have a material interest in a matter that relates to the affairs of the company have a duty to disclose that to the other directors. Section 191 is discussed at [16.420].

## Under constitution and replaceable rules

**[16.390]** A company's constitution may require a director's material interest in a transaction to be disclosed to and approved by the company's directors instead of the general meeting of shareholders: *Woolworths Ltd v Kelly* (1991) 22 NSWLR 189. The effect of such a provision in a company's constitution is to relax the strict fiduciary obligation to disclose conflicts of interest to shareholders. Even though such provisions are relatively common, companies recognise the possibility of the potential for conflicts of interest and their constitutions often provide that directors must disclose their personal interests and refrain from voting on the matter at directors' meetings. This is the case with the replaceable rule in s 194.

The proprietary company replaceable rule in s 194 permits directors of proprietary companies to have an interest in contracts with the company provided certain conditions are satisfied. The director must disclose the nature and extent of the interest at a directors' meeting. The rule also permits proprietary company directors to vote on whether the company enters into the contract if the director discloses the nature and extent of the interest at a directors' meeting: s 194(c).

While a company's constitution may prohibit an interested director from voting, such prohibitions only apply to voting at directors' meetings. A director who is also a shareholder is generally not disqualified from voting at a general meeting of members on matters affecting their personal interests as a shareholder: *North-West Transportation Co v Beatty* (1887) 12 App Cas 589. In some cases though, members may seek a remedy. This is discussed in Chapter 24.

## At common law

**[16.395]** Directors' fiduciary obligations require them to make full disclosure of their potential conflicts of interest to the company's shareholders at a general meeting and obtain their consent (also referred to as "ratification"). Ratification by the general meeting of acts that constitute breach of directors' fiduciary duties is further discussed at [20.05].

As a general rule, the appropriate organ of the company to whom disclosure must be made is the general meeting of shareholders.

*Furs Ltd v Tomkies* (1936) 54 CLR 583

**[16.400]** The facts of this case are set out at [16.205]. The director defended his actions on the basis that he had disclosed his interest in a contract to his company's

chairman of directors. The High Court rejected this defence on the basis that neither the chairman of directors nor the whole board had the power to authorise him to disregard the interests of the company in pursuing his own interests.

*Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134

**[16.405]** The facts of this case are set out at [16.110]. The House of Lords took a similar view when it held that the directors could have protected themselves by making full disclosure to, and having their actions ratified by, the general meeting. This would have been a mere formality because the directors controlled the voting of the general meeting.

*Queensland Mines Ltd v Hudson* (1978) 52 ALJR 399

**[16.410]** A more lenient approach was taken by the Privy Council in this case, the facts of which are outlined at [16.260]. The company, after a change in control, brought an action claiming that Hudson had breached his duty as its managing director by taking up a corporate opportunity and making a profit for himself and that his profits should be accounted to the company. This argument was rejected by the Privy Council on the ground that Hudson had kept the boards of two companies, which originally controlled Queensland Mines Ltd, fully informed of his dealings. They permitted him to take up a mining licence himself, because the company had insufficient funds to utilise the opportunity itself. The two companies had very few shareholders and the respective boards were their nominees so that board approval was effectively the same as shareholder approval. Hudson was thus not in breach of his duty even though no formal disclosure had been made to the company's general meeting and it had not ratified his actions.

*Southern Cross Mine Management Pty Ltd v Ensham Resources Pty Ltd* [2005] QSC 233

**[16.415]** The facts of this case are discussed at [16.275]. It was held that the CEO had breached his fiduciary duty even though he had the company's shareholders' consent to his taking a corporate opportunity. As he had misrepresented important information, he had not satisfied his fiduciary obligation to make full disclosure. His misrepresentations meant that the shareholders' consent was not fully informed and was therefore invalid.

## Under the Corporations Act

### *Disclosure to other directors*

**[16.420]** Section 191(1) requires a director who has a material personal interest in a matter that relates to the affairs of the company to give notice of the interest to the other directors.

Directors must make disclosure to both the shareholders and to the board as s 191 has effect in addition to and not in derogation of any general law rule about conflicts of interest and any applicable provision in the company's constitution: s 193. The meaning of the expression "material personal interest" is discussed at [16.85] in the context of the s 195 restrictions.

Directors of proprietary companies who have a material personal interest in a matter relating to the affairs of the company are subject to the replaceable rule set out in s 194. It provides that if a director gives notice in accordance with s 191, the company cannot avoid the transaction merely because of the existence of the interest. The director may retain benefits under the transaction and can vote on matters that relate to the interest.

The notice required by s 191(1) must give details of the nature and extent of the interest and the relation of the interest to the affairs of the company: s 191(3)(a). It must be given at a directors' meeting as soon as practicable after the director becomes aware of their interest in the matter: s 191(3)(b).

The requirement to give notice under s 191(1) does not apply in the circumstances specified in s 191(2). For example, a director does not have to give notice of an interest if it is part of the director's remuneration or it relates to a proposed contract of the company that is subject to member approval and does not impose any obligation on the company if member approval is not obtained: s 191(2)(ii) and (iii).

Section 191 also does not apply to a proprietary company that has only one director: s 191(5).

A director may give standing notice to the other directors of the nature and extent of the director's interest in a matter: s 192(1). The details required to be disclosed correspond to the disclosure requirements set out in s 191 and it must also be recorded in the minutes. The standing notice ceases to have effect when a new director is appointed until notice is given to the new director: s 192(5). It also ceases to have effect if the nature or extent of the interest materially increases above that disclosed in the notice: s 192(6). Standing notice is often given by directors who are on the boards of companies that may have frequent dealings with each other.

A contravention of ss 191 or 192 does not affect the validity of any act or transaction: ss 191(4) and 192(7). However, a breach constitutes an offence.

## Disclosure to the ASX

**[16.425]** Under s 205G, directors of listed companies must notify the ASX of relevant interests they hold in securities of the company or a related body corporate. They must also disclose any rights or options. Any changes in these holdings must be notified within 14 days. ASX Listing Rule 3.19A requires disclosure by a listed company of this information within five business days of a director acquiring a security holding or changing an existing holding. The information required to be given to the ASX includes details of relevant interests in securities which are indirectly held through interposed entities.

## Tutorial questions

*Further multi-issue directors' duty questions are located at the end of Chapter 13.*

1. The main business of Presto Pty Ltd was real estate development. Presto Pty Ltd had five directors. Jessica was Presto Pty Ltd's managing director. At a board meeting of Presto Pty Ltd a year ago, Jessica presented the following proposal for the board's consideration:
  - Presto Pty Ltd should purchase a beachfront property in Noosa for purposes of developing a multi-storey apartment building.
  - Jessica knew that Noteworthy Ltd, a competitor of Presto Pty Ltd, was also interested in buying the Noosa property. Noteworthy Ltd offered her an all-expenses-paid trip to Paris and \$250,000 if she made sure that Presto Pty Ltd made an unrealistically low offer for the Noosa property.

Jessica convinced the directors of Presto Pty Ltd to make an unrealistically low offer for the Noosa property. This offer was rejected and the Noosa property was ultimately acquired by Noteworthy Ltd.

Has Jessica contravened any of the directors' duties?

2. Lindsay is a director and shareholder in Seloc Ltd, a large public company in the retail sector. Recently, the board of Seloc Ltd was considering whether to hire a specialist transport company. Lindsay told the board that his private company, Wolf Pty Ltd, would like the job. Seloc Ltd's board agreed and a contract for transport services was signed.
  - (a) Explain what steps should be taken to ensure that there is no contravention of the *Corporations Act*.
  - (b) To what extent would your answer to (a) be different if Seloc were a proprietary company.
3. Recently, while on company business, Sam, a director of Internet Publishing Ltd became aware of a potentially very lucrative software publishing product. Disassociating himself from Internet Publishing Ltd, saying, "It's an amateur operation and going down the gurgler fast", Sam signed up the software developers to a contract with Yuppie Software Pty Ltd, Sam's family company. The contract gave Yuppie Software Pty Ltd full copyright in the software publishing product and it is anticipated that it will earn a profit of \$750,000 in the first year alone.



The other directors of Internet Publishing Ltd have now discovered what Sam has done. Advise them of the rights Internet Publishing Ltd have against Sam.

4. At a recent board meeting of Welstar Ltd, Victor, one of the company's directors, became aware that Welstar was about to buy a large parcel of shares in Flexizin Ltd, a listed company. After buying the Flexizin shares Welstar intended to make a takeover bid for the rest of Flexizin's shares. Victor thought that when Welstar Ltd's initial purchase became public knowledge it would signal Welstar's takeover intentions and that Flexizin's share price would increase significantly. He therefore arranged for his wife's company, Spousal Investments Pty Ltd, to buy shares in Flexizin Ltd ahead of Welstar's purchase. Spousal Investments Pty Ltd later sold the Flexizin Ltd shares after Welstar's takeover bid was publicly announced and made a large profit.

Advise ASIC whether there has been a breach of the *Corporations Act* in the above circumstances.

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.
- For further corporations law links and material please refer to the Understanding Company Law website at <http://www.uclaw.com.au>.

## Chapter 17

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# Directors' duties of care, skill and diligence

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### Key points

- Directors and officers are under both common law and statutory duties to exercise their powers and discharge their duties with the degree of care, skill and diligence that a reasonable person would exercise if they were a director in the corporation's circumstances, held the same office and had the same responsibilities as the directors. In considering whether a director or officer has breached the duty of care, the standard which must be met is variable as it takes into account the position occupied by the director. This involves considering whether the director is an executive or non-executive director, senior executive or has further responsibilities such as being the chair. Breach of this duty gives rise to civil but not criminal liability.
- Directors are now expected to meet higher standards of care and diligence than was previously required. Directors are expected to make inquiries and be properly informed about the company's financial position and they are

expected to safeguard the company's interests and prevent the company contravening the law.

- The statutory duty of care imposes an objective standard of a reasonable director in the corporation's circumstances and in the director's position. Breach of this duty gives rise to civil but not criminal liability.
- The business judgment rule was introduced as a defence for directors against claims arising from breaches of the duty of care. To gain the protection of this rule, directors must show their business judgment was made in good faith and for a proper purpose, they had no material personal interest, they were informed and they rationally believed their business judgment was in the company's best interests.
- Directors may rely upon information or advice provided by others. Directors may also delegate their powers to others provided they are properly informed and the reliance or delegation is reasonable in the circumstances.

## Introduction

**[17.05]** Directors and other officers are under a duty to exercise a reasonable degree of care, skill and diligence. These duties are imposed by s 180(1) as well as the common law tort of negligence and the equitable duty of care. The substance of these duties is the same: *Vines v ASIC* [2007] NSWCA 75.

Directors' duty to exercise a reasonable degree of care, skill and diligence is imposed by s 180(1), the common law tort of negligence and the equitable duty of care.

Directors and other officers who breach their duties of care, skill and diligence will be liable to pay damages to the company if it is proved that:

- they breached their standard of care, skill and diligence (in other words they were not careful enough in the circumstances);
- their carelessness caused the company's loss or damage; and
- the kind or type of loss suffered by the company was reasonably foreseeable.

The court may impose civil penalty orders on directors or officers who contravene the statutory duty of care and diligence in s 180(1).

Directors and other officers avoid liability for breaching their duties of care, skill and diligence if they satisfy the business judgment rule defence in s 180(2), discussed at [17.160].

Most of the cases dealing with breaches of the duties of care, skill and diligence focused on whether the applicable standard has been met. The law recognises that directors must make decisions and exercise their management functions in a risky environment and shareholders are taken to accept that directors will take calculated risks. Just because the directors have pursued a failed activity, which causes loss to the company, does not of itself establish a contravention of s 180(1).

The standard of care that directors and officers must exercise varies and depends on the degree of care and diligence that a reasonable person would exercise if they were a director or officer of a company in the company's circumstances and occupied the office and had the same responsibilities as the director or officer in question. The standard of care expected of directors has changed over time: see [17.10]. The current standards of care, skill and diligence are discussed at [17.15]–[17.155].

There are also a number of other provisions that are allied to the duty of care and diligence:

- s 189 explains when directors are entitled to rely on information or advice; and
- s 190 deals with directors' responsibility for the actions of their delegates.

## Changing attitudes and expectations

**[17.10]** In the past, the courts adopted a very lenient approach in determining the standards expected of directors. The rules governing directors' standards of care, skill

and diligence were established in a series of English cases in the late 19th and early 20th centuries, the effect of which was that directors would only be regarded as having breached their duty of care if they were grossly negligent. Directors were not required to possess minimum levels of skill as was expected of other professions. Standards of skill were measured subjectively by reference to the particular director's knowledge and experience. In *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407, it was held that a director need not exhibit a greater degree of skill than may reasonably be expected from someone of their knowledge and experience. The implications of this were that the less knowledge and experience possessed by a director, the lower the applicable standard of care. Conversely, a director with considerable business experience and knowledge was required to exercise a higher degree of care and skill. The courts were generally reluctant to override matters involving directors' business judgments because they recognised that conducting business involved the taking of risks and sometimes decisions turned out badly. The risk lay with shareholders as they expected that directors would take risks and not be excessively risk averse. If it turned out that shareholders had elected incompetent directors they had only themselves to blame.

In the past, the courts also took a very lenient view of directors' duty of diligence. In *Re City Equitable Fire Insurance Co Ltd*, Romer J stated that a director:

is not bound to give continuous attention to the affairs of the company. His duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happens to be placed. He is not, however, bound to attend all such meetings, though he ought to attend whenever, in the circumstances, he is reasonably able to do so.

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| Community attitudes and expectations have changed. |
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In more recent times, there has been a change in community attitudes and expectations concerning directors' standards of care, skill and diligence. Directors, especially those of listed public companies, are now seen as professionals and in common with other professions, should meet objective standards of care based upon how a reasonable person of that profession would have acted in the given circumstances. Shareholders are entitled to expect that directors will meet certain minimum standards in carrying out their respective roles.

Changing community attitudes towards climate change provide an illustration of how contemporary expectations may impact the standard of care and diligence expected of company directors. In 2016, barristers Noel Hutley and Sebastian Davis issued a legal opinion on "Climate Change and Directors' Duties" which advised that climate-related risks were foreseeable risks of harm to Australian companies. In order to comply with the duty of care and diligence, company directors were under an obligation to inform themselves of relevant climate risks, disclose those risks and take appropriate steps to mitigate those risks, having regard to the probability of risks eventuating, the gravity of any possible harm, and the cost and practicality of mitigating steps. In their opinion, directors who fail to respond to climate change risks could breach their duty of care and diligence. In a supplementary opinion issued in 2019, Hutley and Davis considered that there had been "a profound and accelerating shift in the way that Australian regulators, firms and the public perceive climate risk" since their initial opinion.

## Current standards of care, skill and diligence

[17.15] Directors' and other officers' duties of care, skill and diligence are imposed by s 180(1) as well as the common law tort of negligence and the equitable duty of care. The present standards of care, skill and diligence that directors and other officers must exercise are expressed in s 180(1) which reflects contemporary expectations and is consistent with modern case law on the common law duty of care.

Section 180(1) provides that a director or other officer of a corporation must exercise their power and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:

- were a director or officer of a corporation in the corporation's circumstances; and
- occupied the office held by, and had the same responsibilities within the corporation as, the director or officer.

An objective "reasonable person" standard applies.

The limbs of s 180(1) make clear that the content of the duty is dependent on the circumstances of the corporation and the position occupied by the officer. However, even though the standard of care is variable, the leading cases such as *Daniels v Anderson* (1995) 37 NSWLR 438, discussed at [17.40], make it clear that the duty is objective, and the law imposes minimum standards of care, skill and diligence on directors.

The test for determining whether a director failed to exercise reasonable care and diligence and so breached the duty of care is "what an ordinary person, with the director's knowledge and experience, might be expected to have done in the circumstances": *Re Colorado Products Pty Ltd (in prov liq)* [2014] NSWSC 789. The test involves balancing the foreseeable risk of harm to the interests of the company against the benefits that could reasonably have been expected to flow to the company from the conduct in question: *Cassimatis v ASIC* [2020] FCAFC 52.

For the purposes of the duty of care and diligence, the interests of the company are broader than those of the shareholders. In *Cassimatis v ASIC* [2020] FCAFC 52, Greenwood J described the s 180(1) duty as "normative", meaning it sets an objective standard of the degree of care and diligence directors must attain in exercising a power or discharging a duty. The duty is a matter of public concern that goes beyond the interests of the company's shareholders and is not just a matter of private rights. Therefore, shareholders cannot approve their own conduct as directors, which is in breach of s 180. This limitation on the power of shareholders to exonerate directors who breach their statutory duties is discussed at [20.05]. The company's interests include its reputation, its ability to continue operating its business, compliance with the law, and potential exposure to civil penalties or other liability: *Cassimatis v ASIC* [2020] FCAFC 52.

General negligence tort principles apply in determining how careful a reasonable director or officer should be when making decisions that involve a risk of harm: *ASIC v Vines* [2005] NSWSC 738. According to those principles, the standard of care that would be exercised by a reasonable person when making business decisions that involve risk is determined by weighing up the following factors:

- the magnitude of the risk of harm and the probability of it occurring;
- the seriousness of the loss that would result if the harm occurs; and
- the expense, difficulty and inconvenience of taking alleviating action.

## Corporation's circumstances

[17.20] Section 180(1)(a) recognises that a corporation's circumstances are one of the factors to be taken into account when deciding the degree of care and diligence which a reasonable person would exercise in a particular case. The reference to the "corporation's circumstances" includes factors such as the type of company, its size, whether it is a listed company, the nature of its business, the relationship between its board and other officers, the state of the company's financial position and the urgency of dealing with particular problems: *ASIC v Rich* [2009] NSWSC 1229.

In *Cassimatis v ASIC* [2020] FCAFC 52, the majority of the Full Federal Court held that the investment model deployed by Storm Financial Pty Ltd, which involved advising vulnerable investors to incur high levels of debt, was relevant in determining the content of the duty of care and diligence owed by the directors of Storm.

## Director's office and responsibilities

[17.30] Section 180(1)(b) makes it clear that the office held by a director or officer and their responsibilities in the corporation are relevant factors in deciding the degree of care and diligence that a reasonable person would exercise in the corporation's circumstances. This requirement recognises that the standard of care, skill and diligence that a reasonable person would exercise may vary from company to company depending on the type of office a particular director occupies and their responsibilities.

For example, as discussed at [12.30], one of the directors will be appointed to the position of the chair of the board with the special responsibilities attaching to that position. The boards of many companies consist of both executive directors, such as the managing director and chief financial officer (CFO), and non-executive directors. In some companies, directors may be on a board committee and be given particular committee responsibilities or may be appointed to the board because they have particular skills or experience.

In *ASIC v Rich* [2009] NSWSC 1229, it was held that the word "responsibilities" in s 180(1)(b) refers to the factual arrangements operating within the company and affecting the director in question and is not limited to the person's position title or to legal duties. The "responsibilities" of a director refers not only to the specific tasks which have been delegated but also include the acquisition of responsibilities through the way in which work is actually distributed within the company as well as the particular director's experience and skills. Austin J stated:

The "responsibilities" of a director or officer include arrangements flowing from the experience and skills that he or she bring to the office and also any arrangements within the board or between the person and executive management affecting the work that the person is expected to carry out.



Sometimes a director or officer may simultaneously occupy more than one position in a company. For example, in *Shafron v ASIC* [2012] HCA 18, Shafron came within the s 9 definition of “officer” by virtue of his position as both the general legal counsel of James Hardie Industries Ltd (JHIL) as well as its company secretary. The High Court held that it was inappropriate to consider the responsibilities associated with an officer’s various positions separately. The “responsibilities” referred to in s 180(1)(b) were not confined to Shafron’s statutory responsibilities as company secretary; they included *whatever* responsibilities he had within the company, regardless of how or why those responsibilities came to be imposed on him.

While all directors and senior executives are expected to meet a minimum standard, there are various types of directors and positions held by senior officers that are relevant factors in determining the standard of care, diligence and skill expected to be met by a particular director or officer. These are discussed in the following.

### *Non-executive directors*

**[17.35]** The boards of large, listed companies usually consist of both non-executive and executive directors. The ASX Corporate Governance Council’s *Corporate Governance Principles and Recommendations* (4th ed) suggests that the boards of listed companies should consist of a majority of independent non-executive directors. This is further discussed at [14.40].

Non-executive directors are not directly involved in the daily management of the company’s business. Of necessity, non-executive directors of large companies must rely on management, led by the company’s managing director or chief executive officer, for information to properly carry out their roles as directors.

The standard of care of non-executive directors recognises that their duties are of an intermittent nature to be performed at periodic board meetings and at meetings of any committee of the board to which the director has been appointed: *AWA Ltd v Daniels* (1992) 7 ACSR 759. While non-executive directors do not expect to be informed of the minute details of how the company is managed, they expect to be informed of anything untoward or anything appropriate for consideration by the board.

Even though the law does not require non-executive directors to have any particular educational qualifications or business experience, reflecting changing community attitudes and expectations of the modern director’s duty of care, cases such as *Daniels v Anderson* set out minimum standards of care and diligence applicable to non-executive directors of listed public companies.

#### *Daniels v Anderson* (1995) 37 NSWLR 438

**[17.40]** AWA, a listed company, incurred large losses from foreign exchange transactions carried out by one of its middle-level managers. The foreign exchange dealings were not adequately supervised by senior AWA executives who did not put in place adequate internal controls to monitor foreign exchange activities. Nor did they ensure that there were adequate records kept of the numerous foreign currency dealings.

For a time, the foreign exchange manager concealed these losses from senior executives when he arranged unauthorised foreign currency borrowings from a number of banks. AWA's auditor failed to detect the unauthorised foreign currency borrowings. However, he warned AWA senior executives of the inadequacies of the company's internal controls. The auditor failed to inform AWA's board of the full extent of the inadequacies even though he knew that the senior executives had not acted on his warnings. The auditor wrote to the company's chief executive officer (who was also chairman) suggesting improvements to the company's internal audit procedures but did not specifically mention the problems with the foreign exchange operations or stress the urgency of the matter. The board later became aware of the full extent of the unsupervised foreign exchange deals and the unauthorised loans.

AWA sued its auditors for negligence, who then alleged contributory negligence on the part of AWA and instituted a cross-claim against all the AWA directors seeking contribution. In the cross-claim, the auditors argued that AWA's directors had breached their duty of care. The NSW Court of Appeal held that the auditors were negligent but that AWA's contributory negligence reduced the audit firm's liability. AWA's contributory negligence arose because both its senior executives and chief executive officer were held to have been negligent and this was attributed to AWA.

The Court of Appeal held that directors of listed companies are required to take reasonable steps to place themselves in a position to guide and monitor the management of a company. In particular:

- directors must become familiar with the company's business when they join the board;
- while directors need not have equal knowledge and experience of every aspect of the company's activities, they are under a continuing obligation to make inquiries and keep themselves informed about all aspects of the company's business operations. "A director is not an ornament, but an essential component of corporate governance. Consequently, a director cannot protect himself behind a paper shield bearing the motto dummy director: *Francis v United Jersey Bank* 432 A 2d 814 (1981)";
- directors must also be familiar with their company's financial position by regularly reviewing its financial statements as they will be unable to avoid liability for insolvent trading by claiming that they do not know how to read financial statements (*Commonwealth Bank of Australia v Friedrich* (1991) 9 ACLC 946);
- directors who are appointed because they have special skills or experience in an aspect of the company's business must also pay attention to other aspects of the company's business which might reasonably be expected to attract inquiry even if this is outside their area of expertise. They must ensure that the board has the means to monitor management so as to satisfy themselves that the company is being properly run;
- directors are allowed to make business judgments and take commercial risks. However, they cannot safely proceed on the basis that ignorance and a failure to inquire are protection against liability for negligence; and

- directors cannot shut their eyes to corporate misconduct and then claim that they did not see the misconduct and did not have a duty to look. "The sentinel asleep at his post contributes nothing to the enterprise he is charged to protect."

It was held that AWA's non-executive directors did not breach their standard of care because on the facts of the case they had made inquiries and requested information about the foreign exchange dealings from senior management and the auditor but the full details were concealed from them.

**[17.45]** A non-executive director who has special skills or experience in the company's business has a duty to give the company the benefit of that skill or experience. Such a director cannot avoid liability for negligence simply by asserting that they relied on the company's executive directors and officers.

*Gold Ribbon (Accountants) Pty Ltd v Sheers* [2006] QCA 335

**[17.50]** Dunn was a non-executive director of Gold Ribbon and was the only director on the five-man board with extensive lending experience. Together with the other directors, Dunn assisted the company in setting up a scheme that involved Gold Ribbon lending money to practising accountants or their associated service companies. The loans were at high interest rates and unsecured. Gold Ribbon's directors delegated the administration of the scheme to another company, Austide Holdings Pty Ltd, which was required to make "due diligence" inquiries about prospective borrowers' professional fees and their capacity to service their loans. Gold Ribbon's lending scheme effectively ceased when its bank, which had funded its lending activities, terminated its loan facility and demanded that Gold Ribbon repay its bank loan. Gold Ribbon in turn called up the loans it had made to borrowing accountants, however, five of the accountant borrowers defaulted under their respective loan agreements leaving Gold Ribbon with bad debts of over \$3 million. Gold Ribbon went into liquidation and its liquidator commenced legal proceedings against Dunn and the other directors. In relation to Dunn, it was alleged that he had breached his duty of care in relation to both the setting up of the lending scheme and the scheme's operation.

The court at first instance held that Dunn breached his duty of care in a number of respects. By its nature, Gold Ribbon's business was a high risk venture that was only likely to attract accountants who had had difficulties in borrowing money from other sources. Being the only person on Gold Ribbon's board with extensive lending experience, Dunn failed to ensure that the scheme was set up to comply with "accepted lending practice" to minimise the risk of borrowers' defaults. A reasonable director with Dunn's background and experience would have ensured that the company had appropriate procedures for making due diligence inquiries to ensure loan applicants had the financial capacity to service and repay their loans. Dunn breached his duty of care by failing to monitor Austide's administration of the scheme in circumstances where a director with his lending experience would have identified obvious deficiencies. Dunn also breached his duty of care because he

failed to ensure that Austide's managers had the capacity to administer the scheme properly. He also failed to advise the other directors that Austide should be replaced as scheme administrator when it became apparent that it was incompetent.

On appeal, the court held that even though Dunn failed to ensure that his company's lending business was adequately administered and complied with accepted lending practice, his failure did not cause the company's losses in relation to the five "bad" loans. Dunn was therefore not personally liable. The Queensland Court of Appeal found that on the evidence the company would have approved these "bad" loans even though they would not have satisfied due diligence inquiries because, in each case, other Gold Ribbon directors had business interests with the borrowers and stood to personally benefit from the loans. There was no evidence that proper supervision by Dunn would have made any difference.

## Chair

[17.55] The chair of a listed company has special responsibilities and therefore is subject to a different standard of care and diligence than is applicable to non-executive directors discussed at [17.35]. The *Corporations Act* does not refer to the roles or functions of a chair and until recently there has been little relevant case law. The *ASX Corporate Governance Principles and Recommendations* (4th ed) provides some general guidance suggesting that the chair is responsible for leading the board, facilitating the effective contribution of all directors and promoting constructive and respectful relations between directors and between the board and management. The chair is also responsible for setting the board's agenda and ensuring adequate time is available for discussion of all important agenda items, especially strategic and risk management issues.

### *ASIC v Rich* [2003] NSWSC 85

[17.60] ASIC brought civil penalty proceedings against Greaves, the chairman of One.Tel, alleging that he contravened s 180(1). The court did not make a decision on whether Greaves breached s 180(1) but dealt only with the preliminary issue of whether Greaves' position as chairman and his skills and experience came within the meaning of "responsibilities" for the purposes of s 180(1)(b).

The court held that the factual responsibilities of chairman of a listed company were more than "ceremonial or procedural matters" relating to chairing board meetings or shareholders' meetings and were assessed by reference to contemporary community expectations. The court accepted the analysis of Rogers J in *AWA Ltd v Daniels* who asserted that a chair has the primary responsibility of selecting matters and documents to be brought to the board's attention, in formulating the policy of the board and in promoting the position of the company. ASIC provided expert opinion evidence of responsibilities ordinarily undertaken by chairmen of listed public companies in Australia. These included the following:

- the general performance of the board;
- the flow of financial information to the board (including information about cash reserves, actual segment performance and key transactions);

- the establishment and maintenance of systems for information flow to the board;
- the employment of a finance director;
- the public announcement of information;
- the maintenance of cash reserves and group solvency; and
- making recommendations to the board as to prudent management of the One. Tel group.

### *ASIC v Mitchell (No 2) [2020] FCA 1098*

**[17.62]** The board of Tennis Australia approved a lucrative broadcast rights contract with a television station. ASIC alleged that Healy, the chair of Tennis Australia, failed to exercise the degree of care and diligence that a reasonable person in his position would exercise because he had failed to present certain documents and information concerning possible rival bids to the board. The court held that Healy had not breached his duty of care and diligence as it was reasonable for him to rely on the CEO's view as to what documents should be presented to the board. Beach J went on to consider the role and responsibilities of the chair and made the following propositions:

- the chair is not a “directorial overlord” but has authority to manage board meetings and so may have greater responsibility for the performance of the board;
- the chair has responsibility to set the agenda and ensure the board has sufficient information and time to properly deliberate and make decisions on the agenda items;
- the chair is responsible for ensuring workable and harmonious relations between directors and between the board and executives including dealing with disruptive board members;
- the chair may have greater responsibility for ensuring appropriate corporate culture and corporate governance within the organisation;
- the chair may assist in identifying new directors, dealing with induction and continuing education and development;
- the chair must ensure appropriate communication with members and that their interests and concerns are taken into account; and
- the chair has a public relations role in representing the board to outside parties.

Where the chair has particular experience or skills, these may be relevant in raising expectations to a higher standard than the base level expected of a reasonable director.

### *Executive directors and officers*

**[17.65]** Executive directors not only occupy a position on the board, they are also full-time employees of the company to whom the board has delegated particular managerial

responsibilities. Their involvement in management means that executive directors have special responsibilities commensurate with their positions and have a greater knowledge of the daily operations of the company. They are therefore subject to more stringent standards of care and diligence than non-executive directors.

Executive directors appointed to positions requiring skill are subject to an objective standard of skill.

Officers (defined in s 9) below board level are in a similar position in relation to their duty of care as executive directors.

Executive directors and other officers who are appointed to positions requiring the exercise of skill are also subject to objective standards of skill even though s 180(1) does not use the word “skill”: *ASIC v Vines* [2003] NSWSC 1116.

Standard of care of managing directors.

Because chief executive officers and managing directors have the overall responsibility for the day-to-day management of the company's business, they will breach their standard of care if they do not ensure that the company has appropriate management systems in place and that those systems are functioning properly.

### *South Australia v Clark* (1996) 66 SASR 199

**[17.70]** The South Australian Supreme Court held that Clark, the managing director of the State Bank of South Australia, breached his duty of care to the bank. He arranged for the bank to acquire a subsidiary of APA Holdings Ltd for considerably more than its true value in the knowledge that APA would use the proceeds to repay a loan due to Equiticorp Holdings Ltd. Clark did not disclose to the other directors that he indirectly benefited from the transaction because he was also a director of Equiticorp Holdings Ltd and his family owned a large parcel of its shares. Further, notwithstanding this was an unusually large transaction for the bank, Clark did not ensure that the bank carried out the usual due diligence inquiries and did not obtain an independent valuation of the subsidiary.

Perry J commented on the degree of skill expected of Clark as the chief executive officer and managing director of a bank:

As the chief executive officer and managing director of a large bank, he was obliged to bring to bear an appropriate level of skill having regard to the responsibilities which that office entailed. No doubt, as is the case with all large corporations, it was necessary for him to delegate responsibility for the operation of different functions of the bank, in the circumstances where no further oversight could be expected. But he must unquestionably be regarded as responsible for the overall control of the operations of the bank, both in a day to day sense and in giving effect to the broader policies spelt out in the *State Bank of South Australia Act* and by the board of directors.

Furthermore, it is clear that the board of directors looked to him and relied upon him not only to provide the board full and accurate information as to all of the matters which it was proper for the board to consider, but to see to it that any specific decisions of the board were implemented in a way which did not expose the bank to unnecessary risk.

The *South Australia v Clark* case also involved a breach of duty to avoid conflicts of interest. This is discussed at [16.30].

**[17.75]** Managing directors may breach their duty of care if they fail to monitor management effectively.

*Daniels v Anderson* (1995) 37 NSWLR 438

**[17.80]** The facts of this case are outlined at [17.40]. The court held the AWA's chief executive officer breached his duty to act with reasonable care because he failed to make inquiries of the company's senior executives that would have led to a better appreciation of the risks and dangers of the foreign exchange dealings which resulted in heavy losses for the company. As the company's chief executive officer, he was under a continuing obligation to supervise management and seek satisfactory explanations regarding the deficiencies of the foreign exchange trading system and procedures.

#### Standard of care of CFOs.

**[17.85]** A person occupying the position of the CFO of a listed company has special responsibilities regarding preparation of the company's financial statements and profit forecasts. Persons appointed to such executive positions must exercise the level of skill of a reasonably competent CFO: *Vines v ASIC*. CFOs may breach their standard of care if they fail to inquire and obtain information in circumstances where a reasonable officer occupying a similar position would have done so.

*Vines v ASIC* [2007] NSWCA 75

**[17.90]** ASIC brought civil penalty proceedings against Vines, Fox and Robertson, officers of GIO Australia Holdings Ltd, alleging that they breached their respective statutory duties of care and diligence under the predecessor of s 180(1) in relation to their involvement in preparing a profit forecast for their company. In 2000, AMP made a takeover offer for GIO, another listed insurance company. GIO's directors were of the opinion that AMP's takeover bid was inadequate and took vigorous defensive measures to defeat it. As required by the takeover provisions, GIO's directors responded to AMP's takeover bid by giving a target's statement (then called a "Part B statement") to their shareholders. A target's statement must



include all the information that shareholders would reasonably require to make an informed assessment whether to accept the takeover offer: s 638(1). GIO's Part B statement included a profit forecast which indicated that GIO was "well on track to achieve a significant profit". The forecasted profit did not eventuate because it did not take into account material underwriting losses arising from a hurricane that occurred shortly before the forecast was finalised.

Vines, while not a director, was GIO's CFO and in addition to his CFO's role he had a prominent role in relation to GIO's Part B profit forecast and provided the GIO board's due diligence committee an unqualified assurance of its reliability. Fox and Robertson, who worked under Vines' supervision, were also officers of GIO in relation to its reinsurance business which was directly affected by the hurricane. Their particular responsibilities included formulating and supervising the preparation of the profit projections for the reinsurance business for inclusion in GIO's profit forecast. Both Fox and Robertson also expressed unqualified satisfaction with the reliability of the reinsurance division's profit forecast.

The NSW Supreme Court at first instance held that Vines, Fox and Robertson all breached their standard of care in a number of respects. In relation to Fox and Robertson, the court at first instance held that they breached their standard of care because they failed to obtain up-to-date information about the level of hurricane claims being made in circumstances when they should have done so. Despite the fact that they were aware that the level of claims would make the profit forecast improbable, they did not inform Vines and other senior GIO managers of this.

Vines appealed the first instance decision that he was negligent. The NSW Court of Appeal held that Vines breached his standard of care when he signed off on GIO's profit forecast without taking positive steps to advise the board's due diligence committee of the basis of the assumptions underlying the forecast. His supervisory and operational responsibilities required him to be proactive and to take steps to ensure that the monitoring process about the hurricane claims was continuing and was up to date. He could not simply rely on Fox to provide him with up-to-date information about the extent of GIO's hurricane claims when there were warning signals that would have led a reasonable person in Vines' position to take steps to verify Fox's advice that the reinsurance division's profit forecast was accurate. GIO's external auditors warned Vines on a number of occasions prior to the preparation of the forecast that attention had to be given to the extent of potential liability for the losses caused by the hurricane.

While Fox and Robertson were regarded as officers of GIO, the *Corporations Act* definition of officer changed in 2004. Under the current s 9 definition, Fox and Robertson would not be regarded as officers because they were only middle managers of GIO. Consequently, they would not now have been prosecuted for contravening s 180(1). As discussed at [13.20], a person below board level is classified as an officer if they are involved in making decisions that affect the whole or a substantial part of a company's business.



**[17.95]** Company secretaries come within the s 9 definition of officer of a corporation. The office of company secretary carries with it certain statutory responsibilities as well as other responsibilities delegated to that person by the board. The statutory responsibilities of a company secretary under s 188(1) are discussed at [12.360].

Standard of care of company secretaries and other officers.

Part of a listed company secretary's responsibilities includes a responsibility for lodging the company's continuous disclosure announcements with the ASX as well as ensuring the accuracy of those announcements: *Morley v ASIC* [2009] NSWSC 287. The continuous disclosure requirements of ASX listed companies are discussed at [22.140].

Apart from the s 188 responsibilities, the board may give the company secretary additional responsibilities. It is quite common for company secretaries to occupy more than one position in a company. For example, a company may appoint a person as its secretary and in addition give that person responsibility as its chief legal officer, CFO or chief human resources officer. In determining whether a person in such a situation has exercised the required degree of care, it is inappropriate to separate the person's responsibilities as a secretary from their responsibilities in another capacity. The "responsibilities" referred to in s 180(1)(b) include *whatever* responsibilities a person has within the company, regardless of how or why those responsibilities came to be imposed on them.

Officers below board level who are appointed to their positions because of their particular skills and responsibilities are required to exercise that degree of skill that a reasonable person would exercise with that level of skill and responsibility in the company's circumstances.

*Shafron v ASIC* [2012] HCA 18

**[17.97]** Shafron, a qualified lawyer, was the general legal counsel of James Hardie Industries Ltd (JHIL) when the company was involved in a complex restructure to separate itself from subsidiaries that were exposed to present and future liabilities of tort claimants who were harmed by the subsidiaries' asbestos manufacture. Another part of the restructure involved JHIL setting up a compensation fund for asbestos victims. JHIL made misleading announcements to the ASX and in media releases alleging that the asbestos fund was sufficient to cover all asbestos-related claims. The case is discussed further at [17.145].

As general counsel and company secretary, Shafron was one of a group of three senior JHIL executives responsible for developing and implementing the restructure and for providing advice, including legal advice, about the company's disclosure requirements associated with the restructure. He was also delegated the task of providing the board with cash flow modelling concerning the ability of the asbestos compensation fund to cover asbestos-related claims.

It was held that Shafron contravened s 180(1) in a number of respects. He failed to advise JHIL's board or its chief executive officer that the ASX announcements about the sufficiency of the compensation fund were based on inappropriate cash flow modelling assumptions and failed to draw their attention to the deficiencies in actuarial reports. He also failed to advise the board or its managing director of the need to disclose to the ASX *all* material aspects of the company's restructuring arrangements. These matters were all within Shafron's responsibilities as general counsel and secretary of JHIL. The "responsibilities" referred to in s 180(1) are not limited to just statutory responsibilities but also encompass whatever responsibilities the director has within the corporation, regardless of how or why these responsibilities came about. As discussed at [17.145], the High Court in *ASIC v Hellicar* [2012] HCA 12 held that the directors of JHIL also breached s 180(1).

## Familiarity with and understanding of the company's financial affairs

[17.100] All directors, whether they are executive directors or non-executive directors, have a continuing obligation to familiarise themselves with the company's financial position by regular review and understanding of its financial statements: *Daniels v Anderson*. Directors may breach their duty of care and diligence if they are unaware of their company's financial position.

*Sheahan v Verco* [2001] SASC 91

[17.105] In this case, two investors became non-executive directors of an established company after they invested in a share issue. Their investment, together with a secured bank loan, enabled the company to expand its business. On becoming directors, they told the company's managing director and major shareholder that they did not want to be involved in managing the company's business and expected to be treated as "sleeping partners".

The managing director misled the non-executive directors as to the company's financial position, falsely representing that it was profitable when in fact it owed a large amount to its bank as a consequence of previous unsuccessful business ventures. Eventually, the bank appointed a receiver because of non-payment of interest and instalments of principal. The company was subsequently placed in liquidation and the liquidator sued the non-executive directors alleging that they were negligent and responsible for the losses incurred by the company from the time of their appointment until the bank's receiver was appointed.

The court held that the non-executive directors breached their common law and statutory duties of care because they did not ask to see even the basic financial statements for previous years which would have revealed the company's substantial bank debt. Neither of them sought any information as to how the business

expansion had been financed or its capacity to meet any such financial obligations. They did not become familiar with the business and how it was conducted so that they could form a sound judgment about whether it was being properly run. They did not take reasonable steps to place themselves in a position to monitor and guide the company but were content to leave the management of the company entirely to the company's managing director. Even though the non-executive directors breached their common law and statutory duties of care, they were not liable for damages as their breach did not cause the company's losses. The losses stemmed from its continuing inability to meet the interest payments on bank loans which were taken out before the non-executive directors joined the company.

**[17.110]** Directors have a key role in relation to their company's financial reports. As discussed at [22.65], a directors' declaration, which forms part of the company's financial report, must include a statement of the directors' opinion whether the financial statements are in accordance with applicable accounting standards and present a true and fair view of the company's financial position and performance: s 295(4)(d). In order to form such an opinion directors must have the ability to read and understand the company's financial statements.

Directors must have the ability to read and understand the company's financial statements.

Even though directors are entitled to delegate the task of preparing the financial statements to others, delegation does not absolve them of the responsibility to ensure the information contained in the financial statements is consistent with the directors' knowledge of the company's affairs and that the financial statements do not omit material information known to them or that ought to be known to them. Where the financial statements contain material omissions that would have been apparent on a careful and diligent review, directors breach their duty of care and diligence if they fail to make further inquiries where inquiries are called for.

#### *ASIC v Healey* [2011] FCA 717

**[17.115]** In this case, it was held that the directors of the ASX listed entities in the Centro Properties Group and the Centro Retail Group contravened s 180(1) by approving the 2007 financial reports of the two groups. The consolidated balance sheet of the Centro Properties Group failed to disclose \$1.5 billion of short-term liabilities by classifying them as non-current liabilities. In addition, the notes to the financial statements failed to disclose post-balance date guarantees of short-term liabilities of an associated company of about US\$1.75 billion. The consolidated balance sheet of the Centro Retail Group also misclassified \$500 million of short-term liabilities as non-current. The court held that the directors also contravened s 344 which requires directors to take reasonable steps to comply with the financial reporting provisions of the *Corporations Act*. This aspect of the case is discussed at [22.200].

The Centro directors delegated the task of preparing the 2007 financial reports to the group's accounting staff, headed by the group's CFO and the CEO, both of whom signed off on the reports. There was no dispute that the financial reports contained the material omissions described above. However, the directors argued that they relied on appropriately qualified accounting staff and the company's external auditor who failed to detect the misclassifications and did not alert the directors to the deficiencies in the financial reports.

The court held that even though directors were entitled to delegate to others the preparation of the books and accounts, this did not absolve them of the responsibility to read and understand the content of the financial statements and make further inquiries if necessary. Had they done so, the omissions in the financial statements would have been readily apparent.

The directors should have queried the level of current and non-current liabilities reported in the financial statements because they were aware of the volatile market conditions caused by the onset of the global financial crisis. There had been extensive boardroom discussions about the need to convert billions of dollars of short-term debt to longer-term borrowings. For this reason, the errors in the financial statements should have been obvious to any reader of them who had the requisite financial literacy and the knowledge that the Centro directors had of the affairs and debts of the company.

Middleton J explained the minimum degree of financial literacy required of directors to satisfy their duty of care and diligence:

In my view, the objective duty of competence requires that directors have the ability to read and understand 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. ... 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.

Middleton J's reasoning has been applied more broadly to a director's ability to read and understand prospectus documents before they are approved: *Re Sino Australia Oil and Gas Limited (in liq)* [2016] FCA 934.

*Re Sino Australia Oil and Gas Limited (in liq)* [2016] FCA 934

**[17.117]** In this case, the court found that Sino Australia contravened s 728(1)(a) of the *Corporations Act* by offering shares under a replacement prospectus that

contained misleading or deceptive statements. Misleading and deceptive statements in prospectuses are discussed at [7.185].

The court applied Middleton J's reasoning in *ASIC v Healey* and held that Shao, the managing director, chairman and chief executive officer of Sino Australia breached his duty of care in s 180 because he signed and authorised the release of prospectus documents when he admitted that he did not understand the English language contained in them and did not obtain a Chinese translation of them. It was held that Shao's duty of care required him to inform himself fully and comprehensively about the content of the prospectus documents to ensure that the information contained in those prospectus documents was accurate.

## Duty to safeguard the company's interests

**[17.120]** A director may breach the duty of care by causing the company to enter into transactions that exposes it to risks without the prospect of producing any benefit for the company.

*ASIC v Adler* [2002] NSWSC 171

**[17.125]** The facts of this case are set out at [15.240]. It was held that Adler, a non-executive director, breached s 180(1) because a reasonably careful and diligent director of HIH and HIHC in Adler's position would not have caused or procured the \$10 million payment by HIHC to PEE, a company controlled by Adler, part of which was applied in purchasing HIH shares. Further, Adler's failure to ensure that HIH and HIHC followed authorised investment practices which he was familiar with and his failure to safeguard HIH and HIHC's interests also fell well short of the standard of a reasonably competent person in his category of appointment. Williams, the managing director of both HIH and HIHC, was also held to have breached s 180(1) because he failed to make sure that there were proper safeguards in place before HIHC lent the money to PEE. Williams failed to ensure that there was an independent appraisal of the proposed investment and failed to ensure that there were appropriate safeguards to avoid investments being made in breach of the *Corporations Act*. The court also held that Fodera (HIH's finance director) breached s 180 because he failed to submit the proposal to lend PEE \$10 million to HIH's Investment Committee or board for approval.

*Circle Petroleum (Qld) Pty Ltd v Greenslade* (1998) 16 ACLC 1577

**[17.130]** It was held that a highly experienced managing director of a petroleum supplier breached his duty to exercise a reasonable degree of care under a predecessor of s 180(1) when he allowed a customer to exceed its credit limits in a substantial departure from normal industry practice and in defiance of a resolution of the

board. The managing director knew that the customer had been a difficult trade debtor and was not in a position to meet its obligations.

*Permanent Building Society v Wheeler* (1994) 11 WAR 187

[17.135] A managing director was held to have breached his duty of care when he failed to make inquiries into an unusual transaction that was capable of causing harm to the company. The managing director had a responsibility to ensure that the other directors were made aware of the potential harm and so breached his duty even though he declared a conflict of interest and did not vote on the board resolution in relation to the transaction.

## Directors who permit the company to contravene the law

[17.140] Directors may breach their duty of care if they permit the company to contravene the law (including the *Corporations Act*) which may result in the company being exposed to criminal penalties or civil liability. For example in *ASIC v Sydney Investment House Equities Pty Ltd* [2008] NSWSC 1224, it was held that a director contravened ss 180 and 181 when he permitted his companies to conduct an unregistered managed investment scheme, an unregistered financial services business and to engage in misleading and deceptive conduct in contravention of various provisions of the *Corporations Act*. Hamilton J said:

The duties imposed by ss 180 and 181 of the *Corporations Act* are owed to the company itself. They are not directly concerned with the obligation of directors to conduct the affairs of the company in accordance with the law. But it has been recognised that causing a company to engage in a course of conduct that breaches the law may involve on the part of directors a failure to exercise reasonable care and skill ...

There have been several cases where directors were liable for breach of their duty of care and diligence in circumstances where they have caused or permitted the company to contravene the *Corporations Act* or other law. Some examples of such cases are discussed at [17.143]–[17.150]. There has been some criticism directed at this line of cases suggesting that they impose “stepping stone” liability on directors as accessories to contraventions by their companies where such liability is not clearly expressed in the particular statutory provision contravened by the company. As a result, it has been argued that the duty of care and diligence in s 180 has been expanded by a backdoor method to make directors liable for civil penalties and disqualification for contraventions by their companies of provisions that may not provide for the imposition of civil penalties. This line of argument was rejected by the majority of the Full Federal Court in *Cassimatis v ASIC* [2020] FCAFC 52 where it was held that the directors failed to act with due care and diligence and these failures were “primary direct failures” on their parts to discharge their duties under s 180(1). Their contraventions of s 180(1) did not depend on “some sort of dystopian accessorial liability” but because the contraventions by the company, deriving

from the conduct of its directors, contained within it a foreseeable risk of serious harm to the company which reasonable directors should have guarded against. *Cassimatis v ASIC* is discussed at [17.150].

A breach of s 180(1) will occur where a director fails to exercise reasonable care and diligence, and this failure causes or allows the company to contravene the *Corporations Act*, and it was reasonably foreseeable that such a contravention might harm the company's interests: *ASIC v GetSwift Limited* [2021] FCA 1384; *ASIC v Vocation Limited (in liq)* [2019] FCA 807.

**[17.143]** The question whether directors breach their duty of care when they expose their company to the risk of criminal or civil liability was considered by the High Court in the context of ASIC's litigation against the directors and officers of James Hardie Industries for various breaches of s 180.

#### *ASIC v Hellicar* [2012] HCA 12

**[17.145]** In 2001, James Hardie Industries (JHIL) underwent complex restructure arrangements involving a series of transactions in an effort to quarantine itself from the present and future asbestos liabilities of its subsidiaries. One aspect of the restructure involved the establishment of a company, Medical Research & Compensation Foundation Ltd (MRCF), with a board independent of JHIL, to act as trustee of a trust fund established to compensate the asbestos victims.

Another aspect of the restructure involved the group's move to The Netherlands. A new Dutch company, James Hardie Industries NV (JHINV), was formed and under a scheme of arrangement, JHINV became the holding company of the James Hardie Group and JHIL became a wholly owned subsidiary of the Dutch company.

JHIL made a continuous disclosure announcement to the ASX that caused the company to contravene s 674(2). The continuous disclosure rules are discussed at [22.135]–[22.144]. The decision to issue the announcement in the form approved by the board was a collective one and not made by any particular individual. The issued subsequent press releases about the restructure that gave the false and misleading impression that an effect of the restructure was that MRCF would have access to sufficient funds to meet current and future asbestos-related claims. In about 2004, it became apparent that the compensation foundation was substantially underfunded and would soon run out of money to meet future claims.

In *ASIC v Macdonald (No 11)* [2009] NSWSC 287, the NSW Supreme Court held that JHIL and JHINV both contravened the predecessor of s 1041H by making misleading or deceptive statements that the compensation foundation was "fully funded". These two companies also contravened their continuous disclosure obligations under the *ASX Listing Rules* and s 674.

This case resulted in appeals to the NSW Court of Appeal and the High Court. The ultimate finding in the case was that JHIL's managing director, Macdonald, its CFO, Morley, its company secretary and general counsel, Shafron, and all seven non-executive directors failed to take reasonable care when they approved the ASX announcement.



In relation to Macdonald, the court noted that as the board gave him ultimate responsibility for planning the restructure proposal and the public statements in relation to them, he bore a high standard of care in relation to those matters. He breached s 180 in a number of respects including that he failed to advise the board that the draft ASX announcement was expressed in too emphatic terms concerning the adequacy of compensation funding. He negligently approved the final ASX announcement that contained the misleading or deceptive statements. He also failed to advise the board of the limited nature of the external consultants' reviews of the financial modelling for future asbestos claims.

Morley contravened his statutory duty of care and skill. He was closely involved in the restructuring proposals and cash flow modelling on which he gave a presentation to the board, and these matters were consequently part of his responsibilities. The contravention occurred because he failed to advise the board that the external consultants' reviews of the cash flow model were limited in nature and did not involve reviews of the key assumptions underlying the cash flow modelling. This erroneously gave the impression that an unlimited review had been conducted.

The liability of Shafron, the company secretary and general counsel is discussed at [17.97].

The non-executive directors were held to have contravened s 180(1). They all knew or ought to have known that if JHIL's announcement about the sufficiency of compensation funding was misleading there was a danger that JHIL would face legal action, its reputation would suffer and there would be an adverse market reaction to its share price. They were intelligent people with considerable business skills who were well aware of the importance of the issue of the sufficiency of compensation funding and its communication to stakeholders. They approved the draft ASX announcement even though they must have been aware it contained misleading statements. A reasonable person who occupied the office of a non-executive director of a company in JHIL's circumstances, would not have voted in favour of, or authorised the execution of the misleading ASX announcement.

### *Cassimatis v ASIC* [2020] FCAFC 52

**[17.150]** The liability of directors for breach of their duty of care when they expose their company to the risk of civil liability was also considered in this case which was part of the long-running litigation concerning the collapsed financial advice firm Storm Financial Pty Ltd (Storm).

Mr and Mrs Cassimatis were the founders and sole directors and shareholders of Storm. In advising its clients, Storm used an investment model that involved clients investing borrowed sums of money secured by mortgages against their homes and margin loans. Storm promoted this investment model to all its clients, regardless of their financial and other circumstances. Many clients were retired or near retirement with limited income and few assets. The company collapsed in 2009 when it had 14,000 clients, many of whom suffered severe losses of retirement



savings. The Full Court of the Federal Court unanimously held that Storm and Mr and Mrs Cassimatis breached s 945A(1)(b) and (c) of the *Corporations Act* which was an investor-protection provision that required financial advice providers to ensure their advice was appropriate to their clients' personal circumstances. This section has since been repealed and replaced with new provisions contained in ss 961B, 961G, 961H and 961J. These are discussed at [26.105].

The majority also held that Mr and Mrs Cassimatis breached their duty of care and diligence under s 180(1) by exercising their powers as directors to permit or fail to prevent Storm contravening the Act. The majority stated that just because there was a contravention of s 945A did not necessarily also result in a breach of s 180(1). However, in this case, the contraventions by Storm were derived from the conduct of its directors and it was reasonably foreseeable that the contraventions constituted a risk of serious harm to Storm. A reasonable director with Mr and Mrs Cassimatis' responsibilities and in Storm's circumstances would have realised that inappropriate advice was given that would be likely to contravene the *Corporations Act*. Discovery of these contraventions would have threatened the continuation of Storm's Australian Financial Services Licence and its very existence. In failing to guard against this foreseeable harm, the directors breached s 180(1).

## Examples of breaches of the duty to exercise a reasonable degree of care and diligence

**[17.151]** In *Re Sirrah Pty Ltd (in prov liq)* [2021] NSWSC 413, a director caused his company to pay management fees to a related entity which were above market rates and enter into an agreement which bound the company to pay for services even if they were not provided. The company loaned substantial sums to a company with no specified interest rate or repayment date, no loan agreement and no identified events of default. The court held that the director breached his duty of care and diligence under common law and s 180 of the *Corporations Act* by causing or permitting the company to enter into these transactions.

A director who procured his company to enter into an agreement which conferred no direct benefit on the company, but which exposed the company to the potential for substantial detriment, constituted a breach of his duty of care and diligence: *VicBeef Holdings Pty Ltd v Chen* [2021] VSC 546; also *OLI 1 Pty Ltd (in liq) v OLG 1 Pty Ltd (No 2)* [2022] NSWSC 1199.

*ASIC v GetSwift Limited* [2021] FCA 1384 concerned a company which adopted a "public relations driven approach to corporate disclosure" intended to promote the company and dramatically increase its share price. The company made a series of announcements to the market concerning its entry into agreements with national and multinational clients. These announcements omitted key information about the true status of the relevant agreements, in breach of its continuous disclosure and other obligations under the *Corporations Act*, and which were likely to mislead investors. The court held that three directors of the company, by causing or failing to prevent the company from making these announcements, breached their duty of care and diligence.

In *DSHE Holdings Ltd v Potts* [2022] NSWCA 165, it was alleged that the directors of a company, Dick Smith Holdings Ltd, breached their duty of care and diligence by resolving to pay a dividend to its shareholders when its financial position did not meet the requirements for payment of a dividend set out in s 254T(1). The court held that, on the information available to the non-executive directors and the managing director, it was not unreasonable for them to approve the payment of the dividend. However, the CFO did breach his duty of care and diligence by voting in favour of the dividend. On the information available to him, it was not apparent how the company would pay its creditors at the time for payment of the dividend, and the dividend payment was likely to reduce the amount available to pay creditors in breach of s 254T.

## Frequency of board meetings and attendance

[17.155] Judicial attitudes regarding directors' attendance at board meetings and the frequency of such meetings have changed over the years. The old cases took an extremely lenient view. Non-executive directors were not required to give continuous attention to the affairs of their company. According to *Re City Equitable Fire Insurance Co Ltd*, non-executive directors' duties were regarded as of an intermittent nature to be performed at periodical board meetings. Directors were not, however, bound to attend all such meetings.

An extreme example of non-attendance occurred in *Re Cardiff Bank; Marquis of Bute's Case* [1892] 2 Ch 100. In that case, the Marquis of Bute was appointed president of a bank at the age of six months. Over time losses arose from irregularities in the bank's operations but the Marquis was not held liable despite having attended only one board meeting in 38 years.

The modern cases take a more demanding approach.

The obligation to attend board meetings is an aspect of a director's duty of care. Unless directors regularly attend board meetings they will be unable to participate in the governance of the company and therefore fulfil one of their prime responsibilities: *Gold Ribbon (Accountants) Pty Ltd v Sheers* [2005] QSC 198. The *Corporations Act* does not prescribe how many board meetings a company should have. This is generally left to the board itself to decide. Directors should meet as often as is necessary in order to fulfil their obligation to monitor management: *Daniels v Anderson*. Directors are expected to attend all board meetings unless exceptional circumstances, such as illness or absence from the State, prevent them doing so: *Vrisakis v ASC* (1993) 9 WAR 395.

To assist shareholders to know the extent of directors' attendance at board meetings, s 300(10) requires a public company's directors' report to include details of the number of board meetings (including committee meetings) held in the financial year and each director's attendance at the meetings.

## The business judgment rule

[17.160] Section 180(2) sets out a defence (called the business judgment rule) for directors and officers who make a business judgment that would otherwise contravene their

statutory, common law or equitable duties of care and diligence. The section provides that a director or other officer who makes a business judgment is taken to meet the requirements of s 180(1) and their equivalent duties at common law and in equity, in respect of the judgment if they:

- make the judgment in good faith for a proper purpose (s 180(2)(a));
- do not have a material personal interest in the subject matter of the judgment (s 180(2)(b));
- inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate (s 180(2)(c)); and
- rationally believe that the judgment is in the best interests of the corporation (s 180(2)(d)). The director 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.

Directors and officers who are alleged to have breached their duty of care have the onus of proving the four elements in s 180(2): *ASIC v Mitchell (No 2)* [2020] FCA 1098. If they are able to establish that they fulfil each one of these elements, they have an explicit "safe harbour" and are shielded from personal liability for any breach of their duty of care and diligence.

**[17.165]** The business judgment rule defence applies only in respect of a "business judgment" made by a director or officer.

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|-------------------------------|
| Meaning of business judgment. |
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"Business judgment" is defined to mean any decision to take or not take action in respect of a matter relevant to the business operations of the corporation: s 180(3). In *ASIC v Rich* [2009] NSWSC 1229, it was held that "matters relevant to business operations of the corporation" included matters of planning, budgeting and forecasting. Consequently, the definition of "business judgment" encompassed the setting of policy goals, the apportionment of responsibilities between the board and senior management relating to corporate personnel and the termination of litigation provided these matters involve a "decision to take or not to take action". In *ASIC v Mitchell (No 2)* [2020] FCA 1098, it was suggested that a chair's decision to include or not include information to be provided to the board may not have been a business judgment under s 180(3).

In order to be a business judgment, a director or officer must make a conscious decision to take or refrain from taking action. This means that a director who "simply neglected to deal with proper safeguards, with no evidence that he even turned his mind to a judgment of what safeguards there should be" has not made a business judgment: *ASIC v Adler* [2002] NSWSC 171. Consequently, the business judgment rule cannot operate to protect a director where the breach of the duty of care consists of a failure to monitor the company's affairs or a failure to maintain familiarity with the company's financial position. In *ASIC v Rich*, Austin J stated:

I agree with ASIC that the discharge by directors of their oversight duties, including their duties to monitor the company's affairs and policies and to maintain familiarity of the company's financial position, is not protected by

the business judgment rule, because the discharge or failure to discharge those duties does not involve any business judgment as defined. ... Monitoring the company's affairs and maintaining familiarity with its financial position are not in themselves matters that involve a "decision to take or not to take action" in respect of a matter relevant to the company's business operations.

A decision to undertake a particular kind of business activity promoted in a prospectus is an example of a business judgment that would come within the scope of s 180(2). However, the rule would not apply to a failure to comply with the fundraising provisions. This is subject to its own liability regime with its own specific defences.

The business judgment rule protects directors and officers against liability for breaches of the duty of care in s 180(1) and its common law and fiduciary equivalents. It does not operate in relation to breaches of other duties such as the s 181(1) duty to act in good faith and for a proper purpose or the s 588G duty to prevent insolvent trading.

**[17.170]** Because the onus is on directors and officers to produce evidence that they satisfy each of the elements of s 180(2) they will not be able to gain the protection of the business judgment rule defence if the circumstances surrounding their breach of duty indicates that they did not make a business judgment in good faith and for a proper purpose as required by s 180(2)(a).

Good faith and proper purposes.

For example, in *ASIC v Adler* (the facts of which are outlined at [15.240]), it was held that Adler, a non-executive director of HIH, could not rely on the business judgment rule because the evidence regarding his contravention of s 181 disclosed his lack of good faith. It was also held that Williams, the HIH CEO, could not rely on the business judgment rule defence because his failure to ensure that proper safeguards were adopted in relation to HIH's \$10 million loan to Adler Corporation Ltd was not a business judgment and even if it was, he failed to present evidence that his judgment was made in good faith and for a proper purpose as is required by s 180(2)(a).

Section 180(2)(b) requires a director or officer to prove that they did not have any material personal interest in the subject matter of the judgment.

No material personal interest.

In *ASIC v Adler*, Adler was held to have had a clear conflict of interest in relation to the decision to invest HIHC's \$10 million in PEE and therefore could not rely on s 180(2)(b). As Williams was a major shareholder of HIH, he also had a material personal interest that prevented him from relying on s 180(2)(b).

Appropriately informed judgment.

Under s 180(2)(c), a director or officer must inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate. In *ASIC v Rich*, Austin J stated:

The statutory language [of s 180(2)(c)] relates to the decision-making occasion, rather than the general state of knowledge of the director. It requires the director to become informed about the subject matter of the decision prior to making it, since the business judgment rule should not protect decisions taken in disregard of material information readily available. The qualifying words, “to the extent they reasonably believe to be appropriate”, convey the idea that protection may be available even if the director was not aware of available information material to the decision, if he reasonably believed he had taken appropriate steps on the decision-making occasion to inform himself about the subject matter.

Rational belief judgment in best interests of corporation.

The final element of the business judgment rule is that the director or officer rationally believes that the judgment is in the best interests of the corporation: s 180(2)(d). The director 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. The two aspects of s 180(2)(d) appear, at first sight, to suggest that a “rational” belief that a judgment is in the best interests of the corporation is determined by whether or not it is a “reasonable” belief. This is an incorrect interpretation of the subparagraph. In *ASIC v Rich*, it was held that:

the director's or officer's belief would be a rational one if it was based on reason or reasoning (whether or not the reasoning was convincing to the judge and therefore “reasonable” in an objective sense), but it would not be a rational belief if there was no arguable reasoning process to support it. ... The director or officer's belief about the best interests of the corporation is to be formed, and its rationality assessed, on the basis of the information obtained through compliance with [s 180(2)(c)].

## Reliance on others: s 189

**[17.175]** The question often arises as to when are directors entitled to rely on others, to what extent are directors obliged to keep themselves separately informed so they can assess the information or advice they receive and what steps should directors take to assess the competence and reliability of the person being relied upon. The case law was unclear and particular instances were determined on a case by case basis.

In *AWA Ltd v Daniels* (1992) 10 ACLC 933, Rogers J was of the opinion that directors were entitled to rely without verification on the judgment, information and advice of senior management. The right of reliance would be removed only where a director was aware of circumstances that were so obvious that no person with any degree of prudence would have relied on the particular judgment, information and advice.

Directors have a positive obligation to be informed and satisfy themselves that the person they are relying upon is competent and reliable.

On appeal in *Daniels v Anderson* (1995) 37 NSWLR 438, the majority of the NSW Court of Appeal disagreed with the observations of Rogers J in relation to reliance.

They thought that directors are under a positive obligation to keep informed about corporate activities and satisfy themselves that the person they are relying upon is competent and reliable.

While directors are entitled to rely on others for matters such as the preparation of the company's financial statements, directors still retain the responsibility to read, understand and focus on the contents of the financial statements: *ASIC v Healey* [2011] FCA 717.

**[17.185]** Section 189 attempts to clarify when directors may rely on others and provides directors with greater scope to rely upon information or advice provided by an employee, professional adviser or expert or another director or officer. Section 189 provides that a director may rely upon information or advice provided by:

- an employee whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned (s 189(a)(i)); or
- 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 (s 189(a)(ii)); or
- another director or officer in relation to matters within the director's or officer's authority (s 189(a)(iii)); or
- a committee of directors on which the director did not serve in relation to matters within the committee's authority (s 189(a)(iv)).

Under s 189(b), the reliance must be made in good faith and after making an independent assessment of the information or advice, having regard to the director's knowledge of the corporation and the complexity of its structure and operations.

The reasonableness of the director's reliance on the information or advice arises in proceedings to determine whether a director has breached duties under Pt 2D of the *Corporations Act* or an equivalent general law duty: s 189(c). For purposes of s 189, a director's reliance on information or advice is taken to be reasonable unless the contrary is proved. This means that the onus of proof rests upon the person asserting that the director's reliance was not reasonable.

## Responsibility for actions of delegates: s 190

**[17.200]** Section 190 complements s 189, the reliance provision, and makes it clear when directors are permitted to delegate tasks to others. That section also explains directors' responsibilities for the actions of their delegates. Section 190(1) states the general rule that if directors delegate a power under s 198D, they are responsible for the exercise of power by the delegate as if the power had been exercised by the directors themselves.

Section 198D authorises the directors of a company to delegate any of their powers to:

- a committee of directors;
- a director;
- an employee of the company; or
- any other person.

The delegation must be recorded in the company's minute book in accordance with s 251A. This power is subject to contrary provision in the company's constitution. The exercise of the power by the delegate is as effective as if the directors had exercised it themselves: s 198D(3).

Under s 190(2), a director avoids responsibility if the director believed on reasonable grounds that the delegate would exercise the power in conformity with the duties imposed on directors by the *Corporations Act* and the company's constitution, in good faith, after making proper inquiry if the circumstances indicated the need for inquiry and the delegate was reliable and competent in relation to the power delegated and would exercise the power in conformity with the duties imposed on the directors by the *Corporations Act*.

If the s 190(2) requirements are satisfied, a director will not be responsible for the acts of a delegate if the delegate acts fraudulently, negligently or outside the scope of their delegation.

Relevant factors in deciding whether delegation and reliance was reasonable.

In *ASIC v Adler*, Santow J summarised the various factors that should be taken into account in deciding whether a director's decision to rely on a delegate was reasonable for purposes of either ss 189(c) or 190(2):

- the function that has been delegated is such that "it may properly be left to such officers" (*Re City Equitable Fire Insurance Co Ltd*);
- the extent to which the director is put on inquiry, or given the facts of a case, should have been put on inquiry (*Re Property Force Consultants Pty Ltd* [1997] 1 Qd R 300);
- the relationship between the director and delegate must be such that the director honestly holds the belief that the delegate is trustworthy, competent and someone on whom reliance can be placed. Knowledge that the delegate is dishonest or incompetent will make reliance unreasonable (*Dempster v Mallina Holdings Ltd* (1994) 15 ACSR 1);
- the risk involved in the transaction and the nature of the transaction (*Permanent Building Society v Wheeler* (1994) 11 WAR 187);
- the extent of steps taken by the director, for example, inquiries made or other circumstances engendering "trust"; and
- whether the position of the director is executive or non-executive.

## Consequences of contravention

**[17.205]** While the content of common law and statutory duties of care are essentially the same, different consequences result if there is a breach. Since the common law duty of



care is owed to the company it can sue a director or officer for damages if their breach of the common law standard of care causes loss. Shareholders may bring proceedings in the name of the company under s 236 if they obtain prior leave of the court. This is discussed further at [24.285]–[24.300].

Section 180(1) is a designated civil penalty provision under s 1317E. As discussed at [19.140]–[19.150], a person who contravenes a civil penalty provision may be:

- ordered to pay a pecuniary penalty of the greater of \$1.05 million or, if the court is able to calculate it, three times the benefit gained or loss avoided under s 1317G;
- made subject to a relinquishment order requiring payment of an amount equal to the benefit derived and detriment avoided because of a contravention of a civil penalty provision under s 1317GAB(1);
- ordered to pay compensation to the corporation for damage suffered by it under s 1317H; and/or
- disqualified from management under s 206C.

Contravention of s 180(1) is not a criminal offence as criminal liability requires the existence of dishonesty – an active awareness of wrongdoing. Since the concepts of negligence and failure to exercise sufficient care and diligence do not involve dishonesty, contravention of s 180(1) is deliberately excluded from s 184, which provides for criminal offences where other directors' duties are breached dishonestly.

## Tutorial questions

*Further multi-issue directors' duty questions are located at the end of Chapter 13.*

1. Do-Care Ltd, a small ASX listed company, owned and operated a large number of nursing homes. Ackland was the company's chief executive officer and managing director. Prior to this he had many years' experience as chief administrator of a large public hospital in Melbourne. Hoadley, a director and the company's CFO, has postgraduate degrees in business and accounting as well as a PhD in finance. Do-Care Ltd's other directors, Barnes, Campbell and Davis, are non-executive directors and merely attend the monthly board and audit committee meetings. Barnes and Campbell are both doctors and have been appointed to the board to provide expert medical advice. Davis is a partner in a large firm of chartered accountants and is the chair of the board's audit committee. Barnes and Campbell are the other members of the audit committee.

At a recent board meeting attended by all the directors, a long-term multi-million dollar contract with Hartwell Pty Ltd to supply necessary nursing home equipment to Do-Care Ltd was discussed. At the time Campbell and Davis were unaware that Hartwell Pty Ltd's prices were extremely high. While Campbell was also unaware that Ackland's family company owned 35 per cent of Hartwell Pty Ltd's shares, Barnes suspected (but was not certain) that Ackland had a financial interest in Hartwell Pty Ltd but did not mention his suspicions to the other directors. At this meeting Hoadley reported to the board on the level of the company's current liabilities. He informed the board that Do-Care had significant short-term loans that needed to be either repaid within the year or refinanced.



A decision about the long-term multi-million dollar contract was deferred to the next board meeting and Hoadley was asked to prepare a report on the financial impact of the contract for the company. A number of matters were considered at this subsequent board meeting. First, Hoadley's inadequate but favourable report on the financial impact of the contract was accepted without discussion and the board resolved that Do-Care should enter into the contract. Secondly, the board considered the company's draft annual financial statements prepared by the company's accounting staff under Hoadley's supervision. After the board's audit committee recommended the adoption of the draft financial statements, the directors, without further discussion, formally resolved pursuant to s 295(4)(c) that the financial statements complied with applicable accounting standards and presented a true and fair view of the company's financial position. None of the directors noticed that the financial statements incorrectly classified \$500 million in debt as non-current liabilities. The financial statements with the incorrectly classified non-current liabilities were then submitted to the ASX in accordance with Do-Care's s 674(2) continuous disclosure obligations.

Consider the position of each of the Do-Care directors and explain whether they breached their duty of care in the above circumstances. Can the directors rely on the business judgment rule?

2. The Solar Panel Group is a corporate group established in 2019 consisting of three companies which together carry on a business of importing and installing solar panels on residential properties.

Solar Panel (Importations) Pty Ltd (SP Importations) imports the solar panels and Solar Panel (Installations) Pty Ltd (SP Installations) sells and installs the solar panels. SP Importations and SP Installations are both wholly owned subsidiaries of Solar Panel Holdings Pty Ltd (SPH).

Frodo and his wife Arwen are the directors and only shareholders of SPH. Frodo holds the position of managing director of SPH and Arwen is a director and CFO of SPH. Frodo exercises firm control over every aspect of the SPH group of companies. Aragorn, an experienced lawyer with expertise in corporate governance, is the corporate counsel and company secretary of SPH. The directors of both SP Importations and SP Installations are Arwen (who is a director and CFO) and Aragorn (who is corporate counsel and company secretary).

SP Installations employs a team of sales agents to sell solar panels to property owners; the sales agents are paid a base salary of \$20,000 per annum and receive a commission of 50 per cent of the price of any solar panels sold. Their marketing strategy is based on promising home owners savings on electricity costs which are calculated according to a pre-determined formula. SP Installations lends part of the purchase price to the customer to fund the installation.

In 2019, the directors of SPH wished to employ a suitably qualified person to give technical advice to the SPH group on matters relating to solar electricity. They advertised the position of Senior Technical Consultant on Seek and LinkedIn. Ten candidates applied for the position, including Sparkee Bell, whose CV said that he had a PhD in renewable energy from the Yale School of Electrical Science. Impressed, they employed him to the position. However, no such institution exists. After his appointment, Frodo and Bell developed the formula which is used by SPH sales agents to calculate predicted savings on electricity costs.

By early 2022, a string of complaints had been received from customers of SP Installations that the promised savings had not materialised, with customers typically receiving only 40–50 per cent of the savings promised. Over 500 negative reviews have been left on SPH's social media accounts.

The Australian Competition and Consumer Commission (ACCC) launched an investigation and determined that SP Installations engaged in misleading and deceptive conduct in breach of the *Australian Consumer Law*. The ACCC then commenced proceedings in the Federal Court against SP Installations, seeking a determination of breach and penalties. The Federal Court proceedings and the negative social media reviews cause a sudden downturn in the business of the SPH group.

Concerned about potential liability, Frodo and Arwen pass a shareholders' resolution exonerating the directors of SPH from any liability, and SPH passes a shareholders' resolution exonerating the directors of SP Importations and SP Installations from any liability. Frodo and Arwen then pass a directors' resolution putting the SPH group of companies into voluntary administration.

Consider the position of each of the officers and explain whether they breached their duty of care in the above circumstances. Are any defences available?

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.
- For further corporations law links and material please refer to the Understanding Company Law website at <http://www.uclaw.com.au>.

## Chapter 18

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# Directors of insolvent companies

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## Key points

- Directors owe a duty to their company not to prejudice the interests of the company's creditors. The obligation to take creditors' interests into account arises where the company is insolvent or in financial difficulties.
- Directors improperly disregard the interests of creditors where they use "phoenix" companies. These are insolvent companies whose assets have been deliberately stripped, leaving the insolvent company with insufficient funds to meet the claims of creditors. A new company with the same or similar directors and shareholders acquires the business of the insolvent company at undervalue and, like the mythical phoenix, the new company arises from the ashes of the insolvent company.
- The *Corporations Act* imposes a duty on directors to avoid insolvent trading. This requires directors to prevent their company incurring debts when there are reasonable grounds to suspect that the company is insolvent.
- An insolvent trading action is usually brought by the liquidator seeking compensation from the directors. Amounts recovered from directors are primarily available to meet the claims of unsecured creditors. In limited situations, a creditor of a company in liquidation can initiate an insolvent trading action against directors and if successful, the compensation goes to that creditor.

## Introduction

**[18.05]** Creditors, especially unsecured creditors such as employees and suppliers of goods and services, take a risk when they are owed money by a limited liability company. Shareholders are not personally liable for their company's debts. Consequently, if the company becomes insolvent, its unsecured creditors will be unable to fully recover their debts because it will not have sufficient funds to repay its outstanding debts in full, especially as secured creditors are paid their debts first. When an insolvent company is wound up, a liquidator is appointed, sells its property and divides the proceeds among unsecured creditors according to the rules dealing with priorities on distributions to unsecured creditors discussed at [32.670]–[32.675].

Directors of an insolvent company prejudice the interests of the company's creditors if they permit the company to give away its property or otherwise dispose of its assets at less than commercial values. Such actions prejudice the interests of the existing creditors of an insolvent company because the pool of assets available to pay the company's outstanding debts is diminished or assets are put out of the reach of the company's liquidator and cannot therefore be distributed to its creditors.

Directors of companies in financial difficulties are subject to a fiduciary duty to their company not to engage in activities that prejudice creditors' interests.

The law regards arrangements that have the effect of putting valuable property out of the reach of an insolvent company's creditors as improper behaviour by directors. For this reason, directors of companies in financial difficulties breach their fiduciary duties to act in good faith in the best interests of the company, as well as to exercise their powers for proper purposes, by engaging in activities that prejudice the creditors' interests: *Westpac Banking Corporation v Bell Group Ltd (in liq) (No 3)* [2012] WASCA 157. This is discussed at [15.10] where the company is solvent, directors must exercise their powers in the long-term interests of its shareholders. However, where the company is in financial difficulties, shareholders cease to be the primary stakeholders, as creditors rank ahead of shareholders, and the directors' fiduciary duties are aimed at ensuring that the interests of the company's creditors are not prejudiced.

Directors who prejudice creditors' interests may also breach their statutory duties.

Directors who prejudice creditors' interests may also breach their statutory duties in ss 180 (duty of care and diligence), 181 (best interests of the company and proper purposes), 182 (improper use of position) and 183 (improper use of information).

As discussed in Chapter 32, the following provisions supplement directors' fiduciary and statutory duties not to prejudice creditors' interests:

- the provisions in s 588FE(5) which deal with company transactions that have the purpose of defeating the rights of creditors on a winding-up (see [32.560]);

- the uncommercial transaction provisions in s 588FB which allow a liquidator to recover company gifts and other uncommercial transactions from the other party to the transaction (see [32.520]); and
- the unreasonable director-related provisions in s 588FDA which allow a liquidator to recover payments from, or avoid transactions with, directors or their close associates, that are of no commercial benefit to the company (see [32.550]).

Directors also adversely affect the interests of creditors if they fail to prevent their company incurring debts when there are reasonable grounds to suspect that the company is insolvent. This is because the continuation of trading after the onset of insolvency often increases the extent of the insolvency and so reduces the amount available to creditors in the liquidation. As discussed at [18.100] onwards, directors contravene s 588G if they fail to prevent their company incurring debts when there are reasonable grounds to suspect that it is insolvent. This is referred to as “insolvent trading”.

## Interests of creditors

### Duty not to prejudice creditors’ interests

**[18.10]** We noted in Chapter 15 (see [15.05] and [15.145]) that directors are under fiduciary obligations to exercise their powers in good faith in the best interests of the company and for a proper purpose. Directors owe similar duties under s 181.

When the company is solvent, the company’s interests broadly correspond with the interests of its shareholders. Different considerations apply when a company is insolvent or near-insolvent. The interests of the company become primarily the interests of its creditors so that the directors must act in the interests of the company’s creditors.

Directors prejudice creditors’ interests if they cause their company to enter into arrangements that reduce the pool of company assets that would otherwise be available to be shared among creditors when the company is wound up. This may arise where directors cause their company to lend money at a rate lower than the market rates or refinance debts of the company so as to confer security over its assets and thereby enable an unsecured creditor to gain priority over other unsecured creditors: *Ring v Sutton* (1979) 5 ACLR 546.

*Walker v Wimborne* (1976) 137 CLR 1

**[18.15]** The liquidator of an insolvent company, which was one of a group of associated companies, brought an action against its directors under a predecessor of s 598 (discussed at [32.460]) to recover money disposed of by the company prior to its winding-up. The directors caused the company to make loans to other companies in the group in circumstances where there was no prospect of repayment. They used the company’s funds to pay wages of the employees of associated companies and to pay the associated companies for work that they had not in fact carried out. The High Court held that the directors were liable. Mason J stated:



The directors of a company in discharging their duty to the company must take account of the interests of its shareholders and its creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them. The creditor of a company ... must look to that company for payment. His interests may be prejudiced by the movement of funds between companies in the event that the companies become insolvent.

*Westpac Banking Corporation v Bell Group Ltd (in liq) (No 3) [2012] WASCA 157*

**[18.25]** The Bell group of companies had unsecured loan facilities with six Australian banks and various other lending institutions. When it became apparent that the Bell group could not repay the loans, the directors arranged for the group to enter into refinancing transactions with the banks. As a result of those transactions, the banks took security over all the assets of the Bell group of companies, giving the banks priority over the other creditors, including the Australian Taxation Office.

The Bell group became insolvent and went into liquidation. The banks sought to enforce their securities, however the liquidators claimed that the assets seized by the banks under the securities should be returned to the Bell group of companies for the benefit of all of the creditors. The liquidators were able to establish that the banks knew that the transactions that resulted in the banks receiving security over the group's assets arose from a breach of the directors' fiduciary duties. Under the rule in *Barnes v Addy* (1874) LR 9 Ch App 244, the banks were ordered to return property to the Bell group under a constructive trust. This rule is discussed at [19.90]–[19.115].

The Western Australia Court of Appeal held that the directors of the Bell group of companies breached their duty to act in the interests of the companies, by causing various companies to act so as to prejudice the interests of creditors other than the banks. Lee AJA thought that the directors also acted for an improper purpose by charging or delivering to the banks, security interests in assets of the Bell group in circumstances where it was known or anticipated that the Bell group of companies was insolvent. These transactions materially prejudiced the interests of the other creditors of those companies and the banks knowingly assisted the directors in their breaches of duty.

Drummond AJA thought that the directors only breached their duty to exercise powers for proper purposes. He asserted that the duty to exercise powers for proper purposes was objective in nature, and will not ordinarily be satisfied by directors who consider the impact that entry into a particular transaction by the company will have on its creditors but proceed with the transaction even though it causes significant prejudice to those creditors. By doing that, the directors will usually be in breach of their fiduciary duty to the company to exercise their powers for proper purposes and the transaction will be voidable at the election of the company liquidator.

## Corporate groups.

**[18.30]** The directors' duty not to prejudice creditors' interests also arises in the context of corporate groups, particularly where the companies in a group are under financial pressure to pay a particular creditor and enter into transactions with one another. For example, one company in a group may lend money to another company in the same group as occurred in *Walker v Wimborne*. If the lending company is in financial difficulties, its directors prejudice the interests of the lending company's creditors especially if the borrowing company is, or becomes, insolvent and cannot repay.

It is common commercial practice for companies in a group to enter into cross-guarantees to secure borrowings by other group companies. For example, a wholly owned subsidiary may be asked by a bank to guarantee the bank's loan to its holding company. Directors of the wholly owned subsidiary who allow the subsidiary to guarantee the loan are taken to have acted in its best interests if doing so is in the best interests of the holding company – provided the subsidiary is solvent: s 187. However, if the subsidiary is in financial difficulties, s 187 does not apply and its directors may breach their duty if they enter into the guarantee as that would prejudice the interests of the subsidiary and its creditors.

*ANZ Executors & Trustee Co Ltd v Qintex Australia Ltd* [1991] 2 Qd R 360

**[18.35]** Qintex raised \$185 million by an unsecured debenture issue and executed a deed with ANZ acting as the trustee for the debenture-holders. To secure the borrowings, the deed provided that Qintex would arrange for its wholly owned subsidiaries to guarantee its indebtedness. The subsidiaries were not parties to the deed. When Qintex defaulted, ANZ sought an order for specific performance requiring the subsidiaries to execute guarantees. At the time of the hearing, the subsidiaries were insolvent.

It was held that the effect of such an order would be that the subsidiaries would be making a gift of their assets to the detriment of their creditors and for no benefit to them. To make such a gift is not to use powers for their corporate purposes but to do so for a non-corporate purpose.

**[18.40]** We noted in Chapter 17 that directors are under a duty to exercise a reasonable degree of care and diligence. The statutory duty of care is contained in s 180. The duty of care may be breached where directors act contrary to the interests of creditors.

*Hilton International Ltd v Hilton* (1988) 4 NZCLC 96-265

**[18.45]** Mr and Mrs Hilton, the directors and shareholders of Hilton International Ltd, owed the company a considerable amount of money. The company was experiencing financial difficulties and its bank insisted that the directors' loans be repaid. To this end, the company's factory was sold on a sale and lease-back basis and a dividend was declared and paid from capital profits. This dividend was used to repay the Hiltons' loans. When the company was placed in liquidation,

the liquidator sought to recover the dividend arguing that it was paid contrary to law. Alternatively, he asserted that the Hiltons as directors acted carelessly in recommending the dividend and were liable to make good the loss.

The court upheld both of the liquidator's assertions. Tipping J held that directors breach their duty of care if, when recommending a dividend, they fail to have before them a proper set of accounts.

## When are creditors' interests paramount?

**[18.50]** The courts have been deliberately vague as to precisely when creditors' interests become paramount. It seems to be when there is a real and not remote risk that creditors will be prejudiced by the dealing in question: *Kalls Enterprises Pty Ltd v Baloglow* [2007] NSWCA 191.

Directors must take creditors' interests into account if the company is insolvent or of doubtful solvency.

This issue was examined by the New Zealand Court of Appeal in *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 172 (*Permakraft*). Cooke J said that directors must take creditors' interests into account:

if the company is insolvent, or of doubtful solvency, or if a contemplated payment or other course of action would jeopardise its solvency ...

In my opinion, a payment made to the prejudice of current and continuing creditors when a likelihood of loss to them ought to have been made known is capable of constituting misfeasance by the directors; and hence they may be made liable for it.

## Phoenix companies

### Meaning of the term

**[18.55]** The term "phoenix company" is not a legal term but describes a company that operates a business and incurs debts, including unpaid employee wages and unpaid tax liabilities. When creditors threaten to liquidate the company because of its insolvency, the directors form a new company with the same directors and shareholders as the old, and transfer to it the old company's business and its most valuable assets for little or no consideration.

Phoenix companies rise from the ashes of a failed company.

The old company is left as an assetless shell and may be wound up by its creditors who receive very little if anything in the liquidation. The new company, like the mythical phoenix, rises from the ashes of the failed company and continues in business while avoiding paying the old company's creditors. Phoenix company arrangements that are aimed at avoiding payment of creditors' claims are regarded as an abuse of the corporate form and the privilege of limited liability.

Phoenix activities have a significant adverse impact on government revenues. Under the taxation legislation, a company that employs staff is obliged to withhold from employees tax attributable to their salaries and wages and periodically remit the withheld amounts to the Australian Taxation Office (ATO) under the pay as you go (PAYG(W)) system. Phoenix companies typically fail to remit the withheld amounts. According to a 2017 consultation paper, *Combatting Illegal Phoenixing*, the cost of phoenix activity was estimated to be in the range of \$1.8 to \$3.2 billion per year. This Report is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## Regulatory issues

[18.56] Liquidators of phoenix companies face a major practical problem in prosecuting the directors for breach of duty. Because a phoenix company is usually stripped of its assets, its liquidator rarely has enough funds to launch legal proceedings against its directors. This inevitably means that ASIC prosecutions of directors for breach of their statutory duties may be the only avenue for dealing with such improper behaviour. In 2006, the Assetless Administration Fund was established to finance preliminary investigations and reports by liquidators into the failure of companies with few or no assets. This Fund is administered by ASIC and provides grants to liquidators where it appears that enforcement action may arise from an investigation or report. A major priority of this Fund is to curb phoenix activity. However, the ability of the fund to curb phoenix activity is somewhat limited because prior to being able to seek funding, liquidators are required to make substantial inquiries and gather sufficient evidence to indicate that enforcement action may arise from the investigation, should it be funded. The fact that liquidators must undertake these preliminary inquiries at their own expense with no guarantee of receiving funding will likely reduce the number of applications for grants made by liquidators.

Occasionally, directors of a phoenix company purport to deregister it or simply abandon the company so as to avoid their possible misconduct being investigated. Deregistration is discussed in Chapter 32 at [32.770] onwards. ASIC has the power to appoint a liquidator to take over the conduct of a company's affairs where the company is deregistered, deregisterable or otherwise abandoned by its directors: s 489EC. Appointment of a liquidator enables that person to investigate and report on directors' alleged misconduct and is a potential additional mechanism for addressing phoenix company activity.

## Recent reforms

[18.57] A reform package was introduced in 2020 aimed at reducing and deterring illegal phoenix activity. The *Treasury Laws Amendment (Registries Modernisation and Other Measures) Act 2020* (Cth) introduced a requirement that anyone seeking to be registered as a director must obtain a director identification number (DIN): s 1272C(1). A DIN is a unique identification number that will be issued to individuals after they have satisfied an identity check. The DIN allows the regulator to trace each individual director's identity and to link individuals to the companies of which they are a director. DINs aim to reduce the use of fictitious identities, allow for better tracking of directors of failed companies and assist regulators and external administrators to investigate a director's involvement in suspected unlawful activity.

The *Treasury Laws Amendment (Combating Illegal Phoenixing) Act 2020* was a response to the perceived increased use of phoenix companies to defeat the claims of creditors. It provides for new criminal offences and civil penalties where officers engage in conduct that results in a company making a prohibited “creditor-defeating disposition” of company property. A creditor-defeating disposition is defined in s 588FDB(1) as a disposition where:

- (a) the consideration payable to the company for the disposition was less than the market value of the property or the best price that was reasonably obtainable for the property, having regard to the circumstances existing at that time; and
- (b) the disposition has the effect of preventing the property from becoming available for the benefit of the company’s creditors in the winding-up of the company; or hindering, or significantly delaying, the process of making the property available for the benefit of the company’s creditors in the winding-up of the company.

A creditor-defeating disposition is voidable if made by an insolvent company or, because of the disposition, the company immediately becomes insolvent or enters external administration: s 588FE(6B). This is discussed at [32.567]. Transactions that involve a creditor-defeating disposition may also be voidable as uncommercial transactions. See [32.520]–[32.545]. Voidable transactions generally are discussed at [32.590]–[32.595].

Officers who fail to prevent the company from making creditor-defeating dispositions, and others who facilitate making the disposition, commit a criminal offence in circumstances where: (a) the company is insolvent; or (b) the company becomes insolvent because of the disposition or a number of dispositions; or (c) less than 12 months after the disposition, the company enters external administration as a direct or indirect result of the disposition; or (d) less than 12 months after the disposition, the company ceases to carry on business altogether as a direct or indirect result of the disposition: s 588GAB(1). The central mental element of the criminal offence is recklessness.

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| Civil penalty. |
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A civil penalty provision applies a negligence standard to officers who engage in conduct that results in a company making a disposition of property where a reasonable person would have known the disposition was a prohibited creditor-defeating disposition in circumstances where: (i) the company is insolvent; or (ii) the company becomes insolvent because of the disposition or a number of dispositions; or (iii) less than 12 months after the disposition, the company enters external administration as a direct or indirect result of the disposition; or (iv) less than 12 months after the disposition, the company ceases to carry on business altogether as a direct or indirect result of the disposition: s 588GAB(2).

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|----------------------|
| Compensation rights. |
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Liquidators, and in some cases creditors, may recover compensation from a person who breaches the creditor-defeating disposition prohibition. This right to compensation is similar to the compensation rights in relation to insolvent trading. These are discussed at [18.225]–[18.235]. Compensation may be sought against a person who has contravened

a civil penalty provision or committed an offence in relation to a creditor-defeating disposition. Compensation may be sought for damage suffered by the company's creditors and may be awarded in the same proceedings that determined the offence or civil penalty: ss 588J(1A) and 588K(2). Creditors can bring an action for compensation under s 588M(1A). Creditors generally require the consent of the liquidator before bringing their own compensation proceedings: s 588R. They cannot bring proceedings where the liquidator has already taken certain action or ASIC has issued an order: s 588U(1).

#### Criminal liability.

It is a criminal offence for a person to procure, incite, induce or encourage a company to make a prohibited creditor-defeating disposition: s 588GAC. The central mental element of the criminal offence is recklessness. A person is reckless if they are aware of a substantial risk and having regard to the circumstances known to them, it is unjustifiable to take the risk: s 588GAB(1) and *Criminal Code* (Cth), s 5.6. A civil penalty provision applies to a person that procures, incites, induces or encourages a company to enter into a disposition where a reasonable person would have known the disposition was a prohibited creditor-defeating disposition: s 588GAC(2).

These offences are subject to several exemptions so that they do not apply to situations where the disposition was made by a liquidator, administrator, restructuring practitioner or under a compromise or arrangement approved by the court: s 588GAC(3). The prohibitions against procuring creditor-defeating dispositions contained in s 588GAC(1) and (2) also do not apply under the “safe harbour” defence if the disposition was connected with a course of action likely to lead to a better outcome for the company: s 588GA(1). The “safe harbour” defence is discussed at [18.216].

## Case examples of phoenix-type arrangements

**[18.60]** The following cases provide examples of phoenix-type arrangements and how directors may breach their duty to take into account creditors' interests.

### *Jeffree v NCSC* [1990] WAR 183

**[18.65]** Jeffree was a director of a company that operated a business as trustee for a family trust. When a dispute between the company and one of its customers was referred to arbitration, Jeffree, fearing an adverse award that the company could not meet, formed a new trustee company which bought all the tangible assets of the old company and took over the business but did not pay anything for goodwill. Only part of the purchase price was paid to the old company. This was used to pay the debts due to the old company's existing creditors. When the customer won the arbitration, the old company was a “dormant shell” and its only asset was the debt due from Jeffree's new company. This could have been recovered if the old company was wound up, however, the customer was unwilling to spend further amounts to apply for its liquidation. The NCSC, a predecessor of ASIC, sought to make Jeffree criminally liable for breach of a predecessor of s 182, alleging that Jeffree had made improper use of his position as a director.

The Western Australian Supreme Court held that directors owe duties to their company's creditors, present and future, to ensure that corporate assets are not dissipated or exploited to their prejudice. Jeffree's action in transferring the assets to his new company was improper because he not only failed to take into account the interests of the customer, a contingent creditor, he acted positively against them. Full value for the transfer of assets had not been provided by the new company. There was no amount included for goodwill and part of the purchase price was never paid. It was no defence for Jeffree to assert that the balance of the purchase price could have been recovered had the customer taken the expensive step of placing the company in liquidation.

*Grove v Flavel* (1986) 43 SASR 410

**[18.70]** The South Australian Supreme Court applied the predecessor of s 183 to a director of a financially troubled company who acted improperly when he made improper use of information that the company faced a real risk of liquidation. The court held that the director acted improperly for the purposes of a predecessor of s 183 as the company's most valuable assets were debts due by associated companies and the director arranged for these debts to be transferred to himself and other companies in the group. This adversely affected creditors' interests because it decreased the amount that otherwise would have been available to them on liquidation.

*McNamara v Flavel* (1988) 6 ACLC 802

**[18.75]** A director of an insolvent company arranged for it to cease trading and allowed its business name to be used by another company he controlled without payment for goodwill attaching to the name. The South Australian Supreme Court held that the director breached the equivalent of s 184(3) and was guilty of a criminal offence. The director made improper use of information that the company was in financial difficulties when he transferred the business name to the advantage of his other company. It was no defence for the director to assert that this information was not confidential to the company. The company's creditors suffered detriment. The director's actions deprived them of any value attaching to the goodwill associated with the company's name.

*Brentwood Village Limited (in liq) v Terrigal Grosvenor Lodge Pty Limited (No 4)* [2016] FCA 1359

**[18.83]** Klumper, a director of Brentwood was found to have breached ss 181 and 182 of the *Corporations Act* when he transferred for no consideration a nursing home owned by the company to a second company controlled by family members. The court found that there was evidence that the transaction was effected so that



the first company could avoid the payment of tax liabilities of tens of millions of dollars to the ATO.

## Shareholders cannot ratify breach of duty

**[18.85]** Shareholders cannot ratify a directors' breach of duty that involves prejudicing the interests of creditors.

*Kinsela v Russell Kinsela Pty Ltd* (1986) 4 NSWLR 722

**[18.90]** The directors of a family company in financial difficulties arranged for the company to transfer its business and lease its building to themselves on advantageous terms. This meant that when the company went into liquidation the directors could continue to carry on the family business and the company could not easily sell the property. The court held that the liquidator could invalidate the lease because the directors had breached their duty and the company's shareholders had no power to ratify the directors' breach of duty where it involved a failure to take account of the creditors' interests.

## Right to bring legal action

**[18.95]** As discussed at [18.10], directors who fail to take into account the interests of their insolvent company's creditors may breach both their fiduciary and the statutory duties in Ch 2D of the *Corporations Act*. Nevertheless, creditors cannot themselves bring a civil action against the directors to recover their losses: *Spies v The Queen* [2000] HCA 43. Creditors only have indirect rights. The fiduciary duties are owed to the company and consequently, it is only the company that has the right to sue directors who act in breach of their duties. However, when the company is wound up, its liquidator can take action against directors in breach of duty and any amount recovered from them is available for distribution to creditors. In *Re New World Alliance Pty Ltd* (1994) 122 ALR 531, Gummow J described the duty not to prejudice creditors' interests as "a duty of imperfect obligation owed to creditors, one which creditors cannot enforce save to the extent that the company acts on its own motion or through a liquidator".

Breach of the statutory duties in Ch 2D attracts the civil penalty provisions of Pt 9.4B. Under these provisions, ASIC may apply for a civil penalty order including an order for compensation. The civil penalty provisions also enable the company to apply for a compensation order whether or not ASIC has applied for a civil penalty order: s 1317J(2). The civil penalty provisions are discussed at [19.120]–[19.150].

## Duty to prevent insolvent trading

**[18.100]** A director is under a duty to prevent the company incurring debts if there are reasonable grounds for suspecting that it is insolvent: s 588G. This is referred to as



“insolvent trading”. Subject to four alternative defences set out in s 588H, contravening directors are liable to pay compensation to the company of an amount equal to the loss or damage suffered by unsecured creditors in relation to the debts so incurred because of the company’s insolvency: ss 588J, 588K and 588M. In addition, contravention of s 588G may result in directors being liable for a civil penalty order pursuant to Pt 9.4B or a criminal offence under s 588G(3).

In *Hawkins v Bank of China* (1992) 26 NSWLR 562, Kirby P explained the legislative purpose of insolvent trading legislation in the following terms:

The whole purpose or object of [a predecessor of s 588G] was to discourage officers of corporations from improvidently committing the corporation to obligations to pay money as a debt when they have reasonable grounds for supposing that their corporation is (or will, upon incurring the debt in question) become insolvent.

Section 588G aims to encourage directors to carry out their duties properly if the company is at or approaching insolvency, and provides a sanction if they fail to do so: *Edwards v ASIC* [2009] NSWCA 424.

## Section 588G

### *Who is liable?*

**[18.105]** The duty to prevent insolvent trading applies to a person who is a director at the time when the company incurs the relevant debt: s 588G(1)(a). The duty is imposed only on directors because they control overall management of the company and have the ultimate power to prevent debts being incurred. Imposing the duty on directors is also consistent with s 295(4)(c) which obliges directors, in a declaration attached to the company’s financial statements, to declare whether or not there are reasonable grounds to believe that the company will be able to pay its debts as and when they become due and payable.

Persons not formally appointed as directors but who act as either “de facto” or “shadow” directors are also subject to the duty because they come within the extended definition of “director” in s 9 which includes those who “act in the position of a director”. “De facto” and “shadow” directors are discussed at [12.15] and [12.20]. This may include a disqualified director who was the only director: *Owen v Davey* [2021] FCA 200. In that case a disqualified director continued to act in the position of director because he continued to transact contracts and communicate on behalf of the company and held himself out to be the managing director.

Where a notification of resignation of a director is received by ASIC more than 28 days after the resignation was purported to have occurred, the resignation will take effect from the date it is reported to ASIC: s 203AA(1). This provision makes it harder for directors to avoid liability for insolvent trading for debts that were incurred in the past because they will not be able to backdate the date of their resignation for more than 28 days.

A registered director who claims that he or she resigned as a director, prior to the debt being incurred, will be considered to be a director of the company at the time of the incurring of that debt if they are not able to produce evidence of their resignation: *Re KMS Imports (Aust) Pty Ltd (in liq)* [2016] FCA 1571.

## Incurring a debt

**[18.110]** An essential element in establishing a contravention of s 588G is the requirement that a company incurs a debt. According to ordinary usage, a debt is an obligation by one person to pay a sum of money to another: *Powell v Fryer* [2001] SASC 59. A debt is incurred when a company “so acts to expose itself contractually to an obligation to make a future payment of a sum of money as a debt”: *Hawkins v Bank of China*.

Most reported insolvent trading cases involve a company contracting with a supplier to buy goods or services on credit terms. The debt is the obligation to pay the purchase price at the agreed time for payment. A debt is also incurred if a company:

- borrows money from a bank or other lender (*Commonwealth Bank of Australia v Friedrich* (1991) 9 ACLC 946); or
- leases business premises from a landlord (*Russell Halpern Nominees Pty Ltd v Martin* [1987] WAR 150).

In *Hawkins v Bank of China*, the NSW Court of Appeal noted that the expression “incurs a debt” was capable of a number of meanings and the appropriate meaning depended on the context and the statutory purposes of the legislation. It was held that the word “debt” included a contingent debt such as a guarantee and the word “incurs” included “the undertaking of an engagement to pay a sum of money at a future time, even if the engagement is conditional and the amount involved is uncertain”. These interpretations best advanced the purpose of the legislation.

The expression “incurs a debt” also covers situations that do not necessarily involve contracts under which a company exposes itself to an obligation to make a future payment of a sum of money as a debt. For example, in *Powell v Fryer*, it was held that debts included statutory obligations to pay taxes, assessed penalties for non-payment of taxes, statutory levies for workers’ compensation insurance and assessed penalties for non-payment of such levies.

In *Jelin Pty Ltd v Johnson* (1987) 5 ACLC 463, it was held that a “debt” was a claim for an ascertained amount but did not include unliquidated claims for damages for fraudulent misrepresentation. However, in *Hawkins v Bank of China*, Gleeson CJ left open the possibility that incurring a debt included incurring a liability for damages.

Section 588G(1A) gives an expanded meaning to the expression “incurs a debt”. That section contains a table (see Table 18.1), which indicates that if a company takes any of the seven actions set out in column 2, it incurs a debt at the time set out in column 3. For example, under s 588G(1A), a company incurs a debt if it pays a dividend, buys back its shares or enters into an uncommercial transaction as defined in s 588FB.

**Table 18.1: When debts are incurred**

|   | Action of a company | When debt is incurred                                                                                                                     |
|---|---------------------|-------------------------------------------------------------------------------------------------------------------------------------------|
| 1 | paying a dividend   | when dividend is paid or, if the company has a constitution that provides for the declaration of dividends, when the dividend is declared |

|   | Action of a company                                                                                                                                                             | When debt is incurred                                                                                                      |
|---|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------|
| 2 | making a reduction of share capital to which Div 1 of Pt 2J.1 applies (other than a reduction that consists only of the cancellation of a share or shares for no consideration) | when the reduction takes effect                                                                                            |
| 3 | buying back shares (even if the consideration is not a sum certain in money)                                                                                                    | when the buy-back agreement is entered into                                                                                |
| 4 | redeeming redeemable preference shares that are redeemable at its option                                                                                                        | when the company exercises the option                                                                                      |
| 5 | issuing redeemable preference shares that are redeemable otherwise than at its option                                                                                           | when the shares are issued                                                                                                 |
| 6 | financially assisting a person to acquire shares (or units of shares) in itself or a holding company                                                                            | when the agreement to provide the assistance is entered into or, if there is no agreement, when the assistance is provided |
| 7 | entering into an uncommercial transaction (within the meaning of s 588FB) other than one that a court orders or a prescribed agency directs, the company to enter into          | when the transaction is entered into                                                                                       |

### *When is a debt incurred?*

**[18.115]** It is important to ascertain the time when a debt is incurred because s 588G(1)(b) requires proof that the company was insolvent at the time the debt was incurred or became insolvent by incurring that debt.

The time when a debt is incurred depends on the terms of the agreement between the parties and when, in “substance and commercial reality”, the company is exposed to the unavoidable liability to pay the debt for which it otherwise would not have been liable: *Leigh-Mardon Pty Ltd v Wawn* (1995) 17 ACSR 741. This is usually at the time the contract is entered into but this may not always be the case.

#### *Hawkins v Bank of China* (1992) 26 NSWLR 562

**[18.120]** It was held that a debt is incurred when, by its conduct or operations, a company has necessarily subjected itself to a conditional, but unavoidable, obligation to pay a sum of money at a future time. In that case, a company guaranteed the pre-existing debts that two other companies in the same group owed to the Bank of China. At the time of the guarantee, the borrowing companies were unable to repay their loans because they were insolvent. It was held that the guarantor company incurred a debt to the bank when the guarantee was executed because after that date the company's obligation to the bank under the guarantee was unavoidable by any action of its own.

**[18.125]** In *ASIC v Plymin* [2003] VSC 123, it was held that a debt can be incurred when the contract giving rise to the debt is entered into, even if contingencies affect the debt or the debt is a future debt. In the case of a future debt, it may be incurred at the time of

entering the contract if it is then an ascertained or ascertainable amount. For example, in *Russell Halpern Nominees Pty Ltd v Martin*, it was held that a debt for rent was incurred when the tenant executed the agreement to lease and not on the days when rent was due but not paid. On those days, the tenant company merely accrued a liability for an amount. Similarly, in *John Graham Reprographics Pty Ltd v Steffens* (1987) 5 ACLC 904, a debt for interest under a loan agreement was incurred on the date of execution of the agreement, not on the days interest became due and payable. In other cases, a debt can be incurred after the contract giving rise to the debt is entered into.

### *ASIC v Plymin* [2003] VSC 123

**[18.130]** In some situations, a company may incur a debt in “substance and commercial reality” after the contract giving rise to it is entered into. In this case, the company contracted to buy raw materials for its business from a large number of suppliers. The contract with one of the suppliers provided that the company could place orders for the raw materials from time to time and payment was to be made 30 days after delivery. The court held that the debt for a particular order was incurred, in “substance and commercial reality”, when the company made the delivery order. A contract with another supplier related to the sale of a quantity of wheat, which was to be stored by the supplier and delivered to the company as required. In this case, it was held that the debt was incurred when the contract was made and not when the deliveries were ordered. The company also had a contract for the supply of electricity. It was held that as a matter of substance and commercial reality, the debt for the supply of electricity was incurred when the electricity was used and not on the date of the contract with the electricity supplier.

**[18.135]** In *Playspace Playground Pty Ltd v Osborn* [2009] FCA 1486, the court was required to determine when a debt for the supply of component parts for 15 children’s playgrounds was incurred. The playground equipment was delivered in separate batches over a period of months, commencing two months after it was ordered. Reeves J said that once the supplier dispatched these goods, they were unlikely to have been of any real commercial value to anyone else. The debt was incurred when the purchaser became obliged to pay for the goods and this obligation arose once the dispatch date on the order form passed without the purchaser cancelling the order.

## Insolvency

**[18.140]** Section 588G(1)(b) requires proof that the company was insolvent at the time the debt was incurred or became insolvent by incurring that debt.

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|---------------------------|
| Definition of insolvency. |
|---------------------------|

The s 95A definition of insolvency has regard to the company’s inability to pay its debts as and when they become due and payable. A person is solvent if, and only if, the person is able to pay all their debts, as and when they become due and payable: s 95A(1). A person who is not solvent is regarded as being insolvent: s 95A(2). The test of insolvency under

s 95A involves a cash flow test and is not determined simply on the basis of a surplus of assets over liabilities. However, a deficiency of assets over liabilities can be a non-conclusive indicator of insolvency: *Quin v Vlahos* [2021] VSCA 205.

Whether or not a company is able to pay its debts when they become due is based on the commercial realities of the company's financial position and a temporary lack of liquidity of itself may not establish insolvency. Insolvency is an inability to pay one's debts as they fall due. But a company's funds are not limited to its cash resources immediately available; they include funds which it can procure by realisation by sale or mortgage or pledge of its assets within a relatively short time: *Sandell v Porter* (1966) 115 CLR 666. It is relevant to consider not just the company's cash resources but also the money it could realistically raise from sources such as the sale of its assets or borrowing on security of its assets: *Powell v Fryer* [2001] SASC 59.

The s 95A definition does not necessarily require payment of the company's debts from its own money, as the company may obtain funds in the form of financial support from a director, shareholder or other associated person. The capacity to raise funds from external sources must be judged in a practical and businesslike way. Mere possibility is not enough, there must be a genuine and realistic availability of funds as a matter of commercial reality: *Barboutis v The Kart Centre Pty Ltd (No 2)* [2020] WASCA 41. The Queensland Court of Appeal held in *Chan v First Strategic Development Corporation Ltd (in liq)* [2015] QCA 28:

[i]n cases where the financial support is from a source which cannot be compelled by legal arrangement, ... there [must] be a degree of assuredness that the financial support will be forthcoming and at such a level that one could say the company was *able* to pay its debts as and when they fall due, rather than being *possibly able* to do so.

In *International Cat Manufacturing (in liq) v Rodrick* [2013] QCA 372, the Queensland Court of Appeal found that a company was not insolvent because at the relevant time it was being provided with loans by a de facto director of the company. The court was satisfied on the evidence that the loans were likely to continue and that they provided sufficient working capital for the company to meet its debts as and when they fell due. However, in *Chan v First Strategic Development Corporation Limited (in liq)* [2015] QCA 28, the Queensland Court of Appeal held that a company was insolvent when debts were incurred despite the fact that one of the directors had offered to pay the company's debts. This offer was not enough to support a finding of solvency because it was qualified such that the director would only pay the company's debts if certain circumstances existed.

|                           |
|---------------------------|
| Indicators of insolvency. |
|---------------------------|

In *ASIC v Plymin* [2003] VSC 123, the Victorian Supreme Court thought that the following 14 indicators were common features in insolvency situations:

1. continuing losses;
2. liquidity ratios below one;
3. overdue Commonwealth and State taxes;

4. poor relationship with present Bank, including inability to borrow further funds;
5. no access to alternative finance;
6. inability to raise further equity capital;
7. suppliers placing (company) on COD, or otherwise demanding special payments before resuming supply;
8. creditors unpaid outside trading terms;
9. issuing of post-dated cheques;
10. dishonoured cheques;
11. special arrangements with selected creditors;
12. solicitors' letters, summons(es), judgments or warrants issued against the company;
13. payments to creditors of rounded sums which are not reconcilable to specific invoices; and
14. inability to produce timely and accurate financial information to display the company's trading performance and financial position, and make reliable forecasts.

The meaning of "insolvency" is further discussed at [32.60].

### *Presumptions of insolvency*

**[18.145]** Two presumptions of insolvency are available under s 588E to assist in proving that a company was insolvent at the relevant time. The presumptions do not apply in connection with criminal proceedings for contravention of s 588G. The presumptions may be rebutted by evidence to the contrary: s 588E(9).

|                        |
|------------------------|
| Continuing insolvency. |
|------------------------|

Under s 588E(3), there is a presumption of continuing insolvency.

If it can be proved that a company was insolvent at a particular time during the 12 months ending on the "relation-back day", it is presumed that the company remained insolvent thereafter. The relation-back day in the case of a compulsory winding-up is the date that the application to wind up the company was filed: s 9. Consequently, where a company incurs several debts at different times within the 12-month period prior to the relation-back day, this presumption obviates the need to prove that it was insolvent on each occasion.

|                                                       |
|-------------------------------------------------------|
| Failing to keep or retain adequate financial records. |
|-------------------------------------------------------|

Under s 588E(4), there is also a presumption of insolvency where the company has for a time contravened either s 286(1) or (2) by failing to keep, or retain for seven years financial records that were sufficient to enable the company to correctly record and explain the company's transactions, financial position and performance and which would enable true and fair financial statements to be prepared and audited: *Fisher v Divine Homes Pty Ltd* [2016] NSWSC 1724.

Companies must not simply retain for seven years the financial statements that were prepared from the financial records. They must retain the underlying financial records from which the financial statements are prepared: *Re Substance Technologies Pty Ltd* [2019] NSWSC 612. Where such records are not kept and retained, it must be presumed that the company is insolvent during the period of contravention. This presumption seeks to overcome difficulties of proving insolvency in the absence of proper accounting records. It does not apply to a minor or technical contravention of s 286: s 588E(5). Nor does it apply if the s 286 contravention is due solely to someone other than the director destroying, concealing or removing the company's accounting records: s 588E(6).

In *Kenna & Brown Pty Ltd v Kenna* [1999] NSWSC 533, a company was presumed to be insolvent under s 588E(4) because its financial records had been falsified in contravention of the predecessor of s 286.

### *Reasonable grounds for suspecting*

**[18.150]** Directors do not contravene s 588G merely because the company is insolvent at the time a debt is incurred. Section 588G(1)(c) requires that there must be reasonable grounds for suspecting that the company was insolvent at the time the debt was incurred. This section involves two separate issues. What is meant by the word “reasonable” and what are suspicions of insolvency?

In *ASIC v Plymin* [2003] VSC 123, it was held that the word “reasonable” imported the standard of reasonableness appropriate to non-executive directors of reasonable competence and diligence, seeking to perform their duties as imposed by law and capable of reaching a reasonably informed opinion as to the company's financial capacity. Reasonable grounds for suspecting insolvency arise when a reasonably competent and diligent director would have had grounds for suspecting insolvency in the circumstances. It is not necessary for a plaintiff to prove that the director actually suspected insolvency. This case considered a number of aspects of the insolvent trading provisions. The first instance decision in *ASIC v Plymin* was affirmed by the Victorian Court of Appeal in *Elliott v ASIC* [2004] VSCA 54.

#### *Williams v Scholz* [2007] QSC 266

**[18.155]** The directors of an insolvent company argued that they had not engaged in insolvent trading because there were no reasonable grounds for suspecting insolvency. Chesterman J, in finding the directors liable for insolvent trading, stated that there were reasonable grounds for suspecting that the company was insolvent during the relevant period because:

- the company traded unprofitably and accumulated losses continuously;
- the company had no substantial assets and no working capital;
- the company regularly defaulted in making payments which were owing;
- the company's overdraft facility was frequently exceeded and the directors negotiated with the bank to increase the limit on three occasions;
- the company's bank sent monthly bank statements to the directors indicating that the company was exceeding its overdraft limit;



- a bank officer regularly telephoned the directors when the account exceeded its approved limit and when cheques were dishonoured; and
- eventually the bank advised the directors that no further increase to the overdraft facility would be approved.

The court held that given the existence of these factors it was obvious that there were reasonable grounds for suspecting the Company's insolvency.

### *Failure to prevent incurring of debt*

[18.165] Section 588G(2) requires proof that a director failed to prevent the company incurring the debt. According to *ASIC v Plymin*, the expression “failing to prevent” covers inactivity or the failure to attempt to prevent the company from incurring the debt. A director fails to prevent the company incurring a debt if the director acquiesced in the company continuing to incur all such debts as it would incur in the ordinary course of business. It is not necessary for a plaintiff to prove that a director had the power to prevent the company incurring debts or continuing to trade. Nor is it necessary to prove that an individual director failed in their duty to take a particular step which would have been effective to prevent the company incurring the debt: *Elliott v ASIC* [2004] VSCA 54.

The Victorian Court of Appeal noted in *Quin v Vlahos* [2021] VSCA 205 that s 588G(2) sets out two pathways to establish a contravention of s 588G:

- a subjective pathway, where the director was aware that grounds existed for suspecting that the company was insolvent; and
- an objective pathway, where a reasonable person in those circumstances would have been aware of such grounds.

A director contravenes s 588G by failing to prevent the company incurring the debt if the director is aware that at the time the debt is incurred there are reasonable grounds for suspecting the company's insolvency: s 588G(2)(a). In *ASIC v Plymin*, it was held that this requires proof that the director is aware that there are reasonable grounds for suspecting the company's insolvency. It is not necessary to prove that the director had an actual suspicion that the company was insolvent. It is sufficient if the director was aware of facts which would cause a reasonably competent non-executive director to suspect that the company was insolvent at the time it incurred a debt.

A director also contravenes s 588G by failing to prevent the company incurring the debt if a reasonable person in a like position in a company in the company's circumstances would be aware of reasonable grounds for suspecting insolvency: s 588G(2)(b). This corresponds to the duty of care and diligence under s 180(1) and covers situations where a director was unaware of the facts or circumstances constituting reasonable grounds for suspecting insolvency because the director failed to ascertain them, but a reasonable person in a like position in a company in the company's circumstances would or ought to have ascertained those facts and circumstances: *Powell v Fryer* [2001] SASC 59.

## **Defences**

[18.170] Section 588H sets out four alternative defences (reasonable grounds to expect solvency, delegation and reliance on others, absence from management and reasonable



steps to prevent debt being incurred) available to directors who otherwise contravene s 588G(2). In addition, directors may be able to rely on the honesty defences in ss 1317S and 1318 to excuse themselves from liability for a contravention of s 588G: *McLellan v Carroll* [2009] FCA 1415. Sections 1317S and 1318 are discussed at [20.30]. According to the Explanatory Memorandum to the legislation that introduced ss 588G and 588H:

The s 588H defences are designed to assist a director who has acted diligently and has actively participated in management, but has nevertheless been unable to prevent the incurring of the crucial debt.

### *Reasonable grounds to expect solvency*

**[18.175]** Under s 588H(2), it is a defence if the director proves that, at the time when the debt was incurred, the director 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.

The s 588H(2) defence refers to reasonable grounds to expect the company's solvency whereas contravention of s 588G requires proof of reasonable grounds to suspect insolvency. According to the Federal Court in *Metropolitan Fire Systems Pty Ltd v Miller* (1997) 23 ACSR 699:

to “suspect” something requires a lower threshold of knowledge or awareness than to “expect” it. It implies a measure of confidence that the company is solvent. The directors must have reasonable grounds for regarding it as likely that the company would at the relevant date have been able to pay its debts as and when they fall due.

In that case, the court held that the company's three directors could not prove the s 588H(2) defence. Their expectations of solvency were based on optimism regarding the company's future. These expectations were based on hope and were not objectively reasonable expectations.

As noted at [18.140], a company that experiences a temporary lack of liquidity is not regarded as being insolvent. Directors may seek to rely on expectations of additional external financial support from the company's bank or major creditors to demonstrate that they had reasonable grounds to expect that the company was solvent for purposes of the s 588H(2) defence. However, a director's expectations of additional financial support must be objectively reasonable in the circumstances.

#### *Hall v Poolman* [2007] NSWSC 1330

**[18.177]** The court provided some guidance for determining when a director would be justified in expecting solvency for purposes of the s 588H(2) defence. In that case, the director knew his company could not pay a disputed tax debt and was not paying debts owed to its trade creditors as and when they fell due. On being sued for contravening s 588G, the director relied on the s 588H(2) defence and argued that he believed on reasonable grounds that the tax dispute would soon be resolved in the company's favour and that in the meantime there was no obligation to sell substantial assets as the company's creditors were not pressing for payment.

Palmer J stated:

Where a company has assets which, if realised, will pay outstanding debts and will enable debts incurred during the period of realisation to be paid as they fall due, the critical question for solvency is: how soon will the proceeds of realisation be available. Bearing in mind the commercial reality that creditors will usually prefer to wait a reasonable time to have their debts paid in full rather than insist on putting the company into insolvency if it fails to pay strictly on time, I think it can be said, as a very broad general rule, that a director would be justified in “expecting solvency” if an asset could be realised to pay accrued and future creditors in full within about ninety days.

The position becomes murkier the less certain are the outcomes. The market value of the asset may not be ascertainable until the market is tested, so that it is not certain that the realisation will pay in full both existing debts and those to be accrued during the realisation period. The time at which the proceeds of realisation become available may depend upon the state of the market and the complexity of the transaction.

There comes a point where the reasonable director must inform himself or herself as fully as possible of all relevant facts and then ask himself or herself and the other directors: “How sure are we that this asset can be turned into cash to pay all our debts, present and to be incurred, within three months? Is that outcome certain, probable, more likely than not, possible, possible with a bit of luck, possible with a lot of luck, remote, or is there is no real way of knowing?”

If the honest and reasonable answer is “certain” or “probable”, the director can have a reasonable expectation of solvency.

If the honest and reasonable answer is anywhere from “possible” to “no way of knowing”, the director can have no reasonable expectation of solvency.

**[18.178]** The s 588H(2) defence cannot be used by a sleeping director or a director who failed to take reasonable steps to acquire information about the company’s financial position and who was completely unaware of the company’s financial position. The defence requires an actual expectation that the company was and would continue to be solvent, and that the grounds for so expecting were reasonable. A director cannot hide behind ignorance of the company’s affairs which is of their own making or has been contributed to by their own failure to make further necessary inquiries: *Tourprint International Pty Ltd v Bott* [1999] NSWSC 581.

### *Delegation and reliance on others*

**[18.185]** The s 588H(3) defence applies to a director who has delegated the monitoring of the company’s financial position to others upon whom the director relies. This defence is based on a recommendation in the Harmer Report which explained that such a defence was necessary for directors of larger companies.

For such companies, it could not be expected that directors have control over every action taken in the conduct of the company's business. In addition, it thought that a defence of this nature could encourage a proper system of financial management.

A director must establish a number of matters before being able to rely on the defence in s 588H(3). First, the director must prove that at the time when the debt was incurred, the director had reasonable grounds to believe, and did believe, that a competent and reliable person was responsible for providing the director with adequate information about whether the company was solvent and that the other person was fulfilling that responsibility: s 588H(3)(a).

### *ASIC v Plymin* [2003] VSC 123

**[18.190]** It was held that Elliott, a non-executive director, could not rely on this defence. Elliott argued that he relied on information about the company's financial position provided to him by its managing director, Plymin, and the company's management. The court was not satisfied that Elliott believed that Plymin and the management were competent and reliable persons who were fulfilling the responsibility to provide him with adequate information about whether the company was solvent.

The court held that a reasonable person would not have regarded that Plymin and the management were competent and reliable persons who were fulfilling their responsibilities, including that of providing adequate information about the company's solvency. The evidence disclosed that Plymin did not comply with board requirements for financial information. The court was not satisfied that Elliott, an experienced businessman and an astute intelligent individual, did not know that he could and should have obtained from management regular lists of debtors and creditors by age and amount, regular profit and loss and cash flow statements and reports on negotiation with creditors whose debts were outside trading terms. The court thought that Elliott turned a blind eye to the details of the company's liquidity crisis in the hope that "something would turn up".

**[18.195]** In order to make out the s 588H(3) defence, the director must also prove that the director expected, on the basis of information provided to the director by the other person, that the company was solvent and would remain solvent even if it incurred that debt and any other debts that it incurred at that time. A director cannot be said to have expected that the company was solvent under s 588H(3)(b) if the director did not obtain any information about the company's solvency from a competent and reliable person. Directors are under an obligation to take an interest in and demand information on the financial state of their company. They will not be able to rely on s 588H(3) if they fail to demand information when suspicions about the company's financial viability and survival was or should have been aroused: *Metropolitan Fire Systems Pty Ltd v Miller* (1997) 23 ACSR 699.

### *Absence from management*

**[18.205]** Section 588H(4) provides a defence for a director who was absent from management because of illness or for some other good reason at the time when the company incurs the debt in question.

A director may have a good reason for being absent from management at the time a debt was incurred if the director did not take part in the board decision on the matter because the director had a material personal interest. There may be other situations where a director may have a good reason for being absent from management. In *ACCC v ASIC* [2000] NSWSC 316, the ACCC applied to the court to reinstate a deregistered company so that the ACCC could join the company as a defendant in other court proceedings alleging various breaches of the predecessor of the *Competition and Consumer Act 2010* (Cth). In granting the ACCC's application, the court noted that on reinstatement the company's directors would resume office. However, they would have no power to manage its affairs and so would have a s 588H(4) defence to any liability for insolvent trading.

At first sight, s 588H(4) appears to provide a complete defence for a passive director who fails to be involved in the company's management. This is not how the courts have interpreted s 588H(4). In *Tourprint International Pty Ltd v Bott* [1999] NSWSC 581, it was held that a director does not have a "good reason" for being absent from management merely by not participating in managing the company's business. The policy underlying the insolvent trading provisions requires directors to have a "necessary commitment to an involvement with the management of a company in financial difficulties".

*Deputy Commissioner of Taxation v Clark* [2003] NSWCA 91

**[18.210]** The NSW Court of Appeal held that a woman, who was a director of a family company run by her husband, could not rely on the absence from management defence where she had taken no part in the management of the company because she had deferred to her husband, the managing director. The court held that the legislative policy underpinning s 588G was that a person should not become a director unless they were prepared to assume the obligations and duties of such an office.

### *All reasonable steps to prevent debt being incurred*

**[18.215]** Under s 588H(5), it is a defence if the director proves that they took all reasonable steps to prevent the company from incurring the debt. The Explanatory Paper accompanying the Bill that inserted that defence indicated that s 588H(5) requires directors to take "unequivocal action".

To take advantage of s 588H(5), a court might require unequivocal action on the part of those directors seeking to rely on the defence to exercise what powers and functions they possess, either to prevent the incurring of the debt directly or to bring the matter to the attention, either of an officer with the necessary authority to prevent the incurring of the debt or to the board of directors where that is required.

In *Byron v Southern Star Group Pty Ltd* (1997) 136 FLR 267, the NSW Court of Appeal held that an executive director could not avoid personal liability under a predecessor of s 588G simply by telling the company's managing director that he had reservations and did not agree with the company incurring further debts. If a director cannot prevent the debt being incurred, Ormiston J in *Statewide Tobacco Services Ltd v Morley* [1993] 1 VR 423 indicated that the director should seek to have the company wound up or resign.

Section 588H(6) encourages directors to make prompt use of the voluntary administration or restructuring provisions which are discussed in Chapter 31. In determining whether a defence under s 588H(5) has been proved, s 588H(6) directs the court to have regard to matters including any action the director took with a view to appointing an administrator of the company or a restructuring practitioner, when that action was taken and the results of that action.

### *Safe harbour for insolvent trading*

**[18.216]** Section 588GA contains a “safe harbour” for directors from civil liability for insolvent trading. The safe harbour is intended to protect directors from personal liability for insolvent trading if the company is undertaking a restructure outside formal insolvency. The defence aims to encourage company directors to keep control of their company, engage early with possible insolvency and take reasonable risks to facilitate the company’s recovery instead of simply placing the company prematurely into voluntary administration or liquidation.

Section 588GA(1) provides that s 588G(2) does not apply to a person and a debt if:

- at a particular time after the person starts to suspect the company may become or be insolvent, the person starts taking one or more courses of action that are reasonably likely to lead to a better outcome for the company; and
- the debt is incurred directly or indirectly in connection with any such course of action during the period starting at that time, and ending at the earliest of any of the following times:
  - if the person fails to take any such course of action within a reasonable period after that time – the end of that reasonable period;
  - then the person ceases to take any such course of action;
  - when any such course of action ceases to be reasonably likely to lead to a better outcome for the company; or
  - the appointment of an administrator, or liquidator, of the company.

According to s 588GA(2) in working out whether a course of action is reasonably likely to lead to a better outcome for the company, regard may be had to whether the person:

- is properly informing himself or herself of the company’s financial position;
- is taking appropriate steps to prevent any misconduct by officers or employees of the company that could adversely affect the company’s ability to pay all its debts;
- is taking appropriate steps to ensure the company is keeping appropriate financial records consistent with the size and nature of the company;
- is obtaining advice from an appropriately qualified entity who was given sufficient information to give appropriate advice; or
- is developing or implementing a plan for restructuring the company to improve its financial position.

The term “better outcome” for the company means an outcome that is better for the company than the immediate appointment of an administrator, or liquidator, of the company.

According to s 588GA(4), the safe harbour for insolvent trading does not apply if:

- when the debt is incurred, the company is failing to do one or more of the following matters:
  - pay employee entitlements by the time they fall due;
  - give returns, notices, statements, applications or other documents as required by taxation laws; and
- that failure:
  - amounts to less than substantial compliance with the matter concerned; or
  - is one of two or more failures by the company to do any or all those matters during the 12-month period ending when the debt is incurred.

Section 588HA provides for an independent review of the impact of the availability of the safe harbour contained in s 588GA(1) to directors of companies on the conduct of directors and the interests of creditors and employees of those companies.

A similar safe harbour protection applies in several other situations:

- where an officer fails to prevent a creditor-defeating disposition under s 588GAB(1) and (2). Creditor-defeating dispositions are discussed at [18.57];
- where a person procures a creditor-defeating disposition under s 588GAC(1) and (2);
- where a holding company assumes liability for debts incurred by its insolvent subsidiary under s 588V. A holding company's liability for insolvent trading of a subsidiary is discussed at [2.195]; and
- where directors of a company incur a debt during restructuring, if the debt was incurred in the ordinary course of the company's business or with the consent of the restructuring practitioner: s 588GAAB. The restructuring process is discussed at [31.390] onwards.

## Consequences of contravention

**[18.220]** Several consequences may flow from a contravention of s 588G.

The court may order the director to pay compensation. In addition, since s 588G is a civil penalty provision, a contravention may also result in the imposition of a pecuniary penalty order under s 1317G or disqualification from managing corporations under s 206C. Further, under s 588G(3) a contravention is a criminal offence, punishable by a fine or imprisonment (or both) if a director's failure to prevent the company incurring the debt in breach of s 588G was dishonest.

### *Compensation*

**[18.225]** The court can make a compensation order against a director who contravenes s 588G in a number of circumstances. Compensation orders can be made in the context of an application for civil penalty orders and as part of proceedings for the criminal offence: ss 588J and 588K.

Compensation orders can be made whether or not the court imposes a civil penalty order or a criminal penalty. Compensation orders under either s 588J or 588K may be made whether or not the company is in liquidation.

If the company that incurred the debt has been placed in liquidation, s 588M gives the liquidator the ability to seek compensation from a director who contravenes s 588G. Liquidators are permitted to mount compensation recovery proceedings whether or not ASIC has commenced an application for a civil penalty order or criminal proceedings: s 588M(1)(e) and (f). For liquidators, the advantage of the compensation procedures in ss 588J and 588K is that ASIC initiates the proceedings and bears the legal costs in mounting actions for contravention of s 588G as part of the application for a civil penalty order or criminal proceedings.

Unsecured creditors are also given a limited right to initiate their own compensation claims against directors: s 588M(3). They may only do this if the company's liquidator fails to launch an action or the liquidator consents to the creditor's action. Where creditors initiate their own action, they must prove the director has contravened s 588G.

Sections 588R–588U set out a regime for creditor-initiated compensation recovery actions. These provisions ensure that liquidators have sufficient time to consider whether to mount their own compensation claims. They require unsecured creditors to wait at least six months after the beginning of winding-up and then apply for the liquidator's consent to the individual creditor's action. The creditor's application must be initiated in the period during which the company "is being wound up". The company is no longer "being wound up" once the liquidator lodges a s 509(3) return with ASIC. The s 509(3) return is required to be lodged following a meeting of the creditors at which the liquidator provides an account of how the affairs of the company have been wound up. Creditors are not able to initiate a claim for compensation after its lodgment: *International Greetings UK Ltd v Stansfield* [2010] NSWSC 1357.

Section 588S sets out the procedure for gaining a liquidator's consent. It requires the creditor to give the company's liquidator written notice of the creditor's intention to bring proceedings under s 588M. The notice can be given only after the end of six months from the beginning of winding-up. In the notice the creditor must ask the liquidator to give consent to the creditor beginning the proceedings or to state the reasons why those proceedings should not be initiated. The liquidator has three months to respond to the notice. If the liquidator consents, a creditor may begin proceedings under s 588M in relation to the incurring by the company of an unsecured debt that is owed to the creditor: s 588R(1). Where, however, the liquidator has not consented to the creditor's action by the end of the three-month notice period, the creditor must apply for leave of the court to begin the proceedings: s 588T(2)(b).

Section 588U(1) ensures that in some circumstances creditors are not permitted to begin direct proceedings against a director. Creditors cannot begin their own proceedings if the liquidator has:

- applied under the antecedent transactions provisions of s 588FF (discussed at [32.480] onwards) in relation to the debt, or in relation to a transaction under which the debt was incurred;



- begun proceedings under s 588M in relation to the incurring of the debt; or
- intervened in an application for a civil penalty order against the director in relation to a contravention of s 588G in relation to the incurring of the debt.

### *Amount of compensation*

**[18.230]** Under ss 588J, 588K and 588M, directors are liable to pay compensation equal to the amount of loss or damage suffered by all unsecured creditors whose debts were incurred in contravention of s 588G because of the company's insolvency. However, in the case of creditor-initiated actions, under s 588M(3), the amount recoverable is the amount of loss or damage suffered by the individual creditor.

As a general rule, the amount of "loss or damage suffered" by a creditor is the amount of the unpaid debt: *Powell v Fryer* [2001] SASC 59. However, in *ASIC v Plymin* [2003] VSC 123, the court accepted that the amount of loss or damage recoverable from directors could be reduced by the amount of actual or expected dividends distributed to creditors. Where a deed of company arrangement is entered into by creditors and an administrator, the loss or damage suffered by creditors for the purposes of s 588J is the amount representing the shortfall between what was received under the deed and the amount of the debt. This is despite the fact that the remaining debt may have been extinguished under the terms of the deed: *Elliott v ASIC* [2004] VSCA 54. Deeds of company arrangement are discussed at [31.235]–[31.365].

The amount recoverable from directors is restricted to the loss or damage suffered by creditors in relation to debts that are wholly or partly unsecured: ss 588J(1)(b), 588K(b)(i) and 588M(1)(c). In *Metropolitan Fire Systems Pty Ltd v Miller* (1997) 23 ACSR 699, the Federal Court held that a creditor whose debt was secured by a retention of title clause was still an unsecured creditor. In this case, the creditor had made no claim under the retention of title clause. If, however, a secured creditor proves for the debt as an unsecured creditor, s 588D regards the debt as unsecured.

### *Who receives the benefit of compensation?*

**[18.235]** An amount recovered from directors pursuant to an application for a civil penalty order, a criminal proceeding or a liquidator-initiated proceeding is payable to the company and is available for distribution to all unsecured creditors including those creditors whose debts were incurred before reasonable suspicions of insolvency arose. In the case of creditor-initiated actions, however, the amount recovered is payable to the unsecured creditor who initiated the action.

Amounts recovered are not available to pay a secured debt of the company unless all the company's unsecured debts have been paid in full: s 588Y(1). Section 588Y stems from an ALRC recommendation that amounts recovered from directors should only be available for unsecured creditors because insolvent trading has a major impact on them.

Further, under s 588Y(2), the court has power to order that compensation recovered is not available to pay the debt of a creditor who, at the time the debt was incurred, knew that the company was insolvent, unless all the company's other unsecured debts have been paid in full. This may mean that a director who is an unsecured creditor of the company is unable to share in the proceeds of the compensation. The power to exclude creditors from participating in the amount recovered does not, by virtue of s 588Y(3), apply in relation to creditor-initiated proceedings.



Under certain circumstances, the court may relieve a person, either wholly or partly, from liability for contravention of s 588G.

### *Court relief*

**[18.240]** Pursuant to s 1317S(2), the court may relieve a person, either wholly or partly, from a liability for contravention of s 588G if it appears that the person has acted honestly and having regard to all the circumstances of the case ought fairly be excused. Section 1317S(3) reiterates s 588H(6) when it explains that in determining whether a person ought fairly be excused, the matters to which regard is to be had include any action the person took, with a view to appointing an administrator of the company, when that action was taken and the results of that action. Section 1317S is discussed at [20.30]–[20.47].

## **Liability for unremitted taxation**

**[18.250]** Income tax legislation requires employer companies to deduct employees' taxation contributions from their wages and salaries. These amounts of tax must be remitted to the Commissioner of Taxation. There are similar requirements for companies that collect Goods and Services Tax (GST) from sales to remit the GST.

In some situations, directors may become personally liable for unremitted amounts if their company fails to remit them.

Directors may be liable not only for actual unremitted amounts but also for amounts estimated as being liable.

Under the provisions of the tax legislation, the Commissioner of Taxation must give 14 days' notice to the directors setting out details of the unpaid amount and the penalty. Directors will not be penalised if one of the following occurs:

- the company pays the unremitted amount;
- the company enters an agreement relating to the unremitted amount;
- an administrator is appointed; or
- the company goes into liquidation.

Directors who may be liable are those who were in office on or before the due date for payment of the deducted amount and any persons who became directors after this date. Any amount paid to discharge the liability of either the company or a director discharges other liabilities to the extent of that amount.

Directors subject to recovery proceedings by the Commissioner may be able to utilise two defences:

- the director, because of illness or other reason, took no part in management of the company at the time when one of the four prescribed courses of action should have been taken; or
- the director took all reasonable steps to ensure deductions were paid; or the company complied with the four alternative courses of action by the due date; or there were no steps that the director could have taken.

## Employee entitlements

**[18.255]** Employees of insolvent companies are assisted to recover their entitlements by a number of provisions in the *Corporations Act*:

- A company incurs a debts for purposes of s 588G by entering into an uncommercial transaction: s 588G(1A). This enables a liquidator to pursue insolvent trading claims against individual directors. A liquidator also has the ability to seek court orders to undo uncommercial transactions under s 588FB. Uncommercial transactions are discussed at [32.520] onwards.
- Persons who deliberately enter into agreements and transactions for the purpose of avoiding employee entitlements may be guilty of a criminal offence: s 596AB. This provision was a response to situations where assets were stripped from employer companies resulting in employees being unable to enforce their entitlements while related entities held substantial assets.
- In addition to the criminal offence, s 596AC provides for payment of compensation.

Compensation may be payable even in the absence of a conviction as the burden of proof is lower than in the case of a criminal offence. Generally, the liquidator may bring an action seeking compensation and effectively lift the corporate veil so as to make anyone involved in the agreement or transaction liable to compensate the employees for otherwise lost entitlements. In some cases, the employees may bring the action where the liquidator does not do so.

## Fraudulent conduct

**[18.260]** It is an offence under s 592(6) for any person to be knowingly concerned in the doing of an act by a company with the intent of defrauding creditors of the company or any other person or for any other fraudulent purpose. Where a person has been convicted of an offence under s 592(6), the court may, on application by the Commission, creditors or members, order that that person be personally liable to the company without limitation of liability for an amount up to the whole of its debts as the court thinks proper: s 593(2). Creditors benefit because the insolvent company is then in a better position to pay its debts.

Creditors may be defrauded under s 592(6) where the intention is to defraud only some creditors and not all. It is not necessary, in order to establish an offence under s 592(6), to show that creditors were in fact defrauded. An intention to defraud is sufficient. An intention to defraud is an intention to deprive creditors, or some creditors, of an economic advantage or inflict upon them some economic loss: *Coleman v The Queen* [1988] WAR 196.

## Tutorial questions

*Further multi-issue directors' duty questions are located at the end of Chapter 13.*

1. Kelly Building Pty Ltd is a registered builder. Its managing director, John, controls the company's business activities. John's wife, Marsha, is the other director but she does not

concern herself with the day-to-day management of Kelly Building Pty Ltd's business. She is aware, however, that Kelly Building Pty Ltd has severe financial problems. In June John, on Kelly Building Pty Ltd's behalf, purchased \$150,000 worth of building supplies on 30-day credit terms from Collins Manufacturing Ltd. Despite numerous demands the \$150,000 has not been paid. In October Collins Manufacturing Ltd successfully applied to wind up Kelly Building Pty Ltd.

Explain whether the liquidator of Kelly Building Pty Ltd can make both John and Marsha personally liable for their company's unpaid debts. Can John and Marsha rely on any of the s 588H defences?

2. Harriet Ford is a director and 60 per cent shareholder of Ford's Catering Services Pty Ltd. Her sisters Cheryl and Margaret are the other directors and each own 20 per cent of the shares. For most of this year, Ford's Catering Services Pty Ltd has suffered acute financial problems. It has been continually late in paying debts due to its major suppliers.

The directors soon realise that the company's liquidation is imminent but they want to continue trading using the company's name as it is well known to the company's numerous customers. At the suggestion of the company's accountant, a shareholders' meeting of Ford's Catering Services Pty Ltd is convened and a resolution is passed changing the company's name to Black Pudding Pty Ltd. At the same time, a new company is incorporated called Ford's Catering Services (Aust) Pty Ltd, with Harriet, Cheryl and Margaret as its directors and shareholders. After the name change, Black Pudding Pty Ltd ceases operations and the new company simply takes over the business formerly conducted by Black Pudding Pty Ltd.

Recently the court orders, on the application of Acme Food Suppliers Ltd, that Black Pudding Pty Ltd be wound up in insolvency.

Advise the liquidator what legal action, if any, can be taken against Harriet, Cheryl and Margaret in connection with the transfer of the business and the name, Ford's Catering Services, to Ford's Catering Services (Aust) Pty Ltd.

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.
- For further corporations law links and material please refer to the Understanding Company Law website at <http://www.uclaw.com.au>.

## Chapter 19

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# Remedies and penalties for directors' breach of duty

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### Key points

- Directors' general law fiduciary duties are owed to the company and therefore the company is generally the proper plaintiff. The main common law remedies are compensation, account of profits and constructive trusts.
- The *Corporations Act 2001* (Cth) provides for civil penalties where certain statutory duties are breached.

- A breach of a civil penalty provision enables ASIC to seek a pecuniary penalty order, a disqualification order and/or an order for compensation. In such proceedings, the burden of proof is the civil burden, on the balance of probabilities.
- ASIC and a person whose interests are affected by a contravention of the *Corporations Act*, such as a shareholder or creditor, may apply for an injunction under s 1324.
- Criminal liability may arise in relation to breaches of statutory duty involving dishonesty or recklessness.



## Introduction

**[19.05]** A breach of directors' duty may harm the company, its shareholders or creditors. For example, directors who make undisclosed profits from the misuse of their position may deprive the company of profits or property to which it would otherwise be entitled. This indirectly affects the shareholders because the value of their investment in the company is thereby reduced.

In other circumstances, a breach of duty may affect shareholders directly. This can occur when the directors improperly refuse to register a transfer of shares.

When the company is in financial difficulties, creditors may also be adversely affected by improper use of the company's assets by its directors. Such acts may diminish the value of assets available for distribution to creditors on a winding-up.

The company is usually the proper plaintiff to remedy wrongs done to it by the directors.

As a general rule, the company is the proper plaintiff to remedy wrongs done to it by the directors. This is because directors' duties are owed to the company and it is regarded as a legal entity separate from its shareholders. If the company is in liquidation, its liquidator can bring an action in the name of the company against present or former directors. Under Pt 2F.1A of the *Corporations Act*, shareholders and other eligible applicants have the right, with prior court leave, to bring legal proceedings against directors on behalf of the company. This is discussed at [24.285]–[24.300].

Australian Securities and Investments Commission (ASIC) may bring proceedings in the name of a company to recover damages or property from directors who breach their duty or engage in misconduct: *Australian Securities and Investments Commission Act 2001* (Cth), s 50. These actions are discussed at [28.50]. ASIC may also bring proceedings in its own name against directors who have breached the statutory directors' duties which are designated to be civil penalty provisions by Pt 9.4B of the *Corporations Act*: s 1317E(1). Those statutory duties include:

- care and diligence (s 180);
- good faith and proper purpose (s 181);
- improperly using position (s 182); and
- improperly using information (s 183).

The consequences of breaching civil penalty provisions are discussed at [19.120]. Under s 184, a contravention of the duties contained in s 181, 182 or 183 is regarded as a criminal offence if the director or other officer did so recklessly or dishonestly.

## Company's remedies

**[19.10]** If directors or officers breach any of their fiduciary duties, the company has a variety of remedies available. The appropriate remedy depends on the circumstances. In some cases, a company may have more than one remedy available and it may seek the remedy that achieves the best result from its point of view.

*Tavistock Holdings Pty Ltd v Saulsman* (1991) 9 ACLC 450

**[19.15]** A director who breached his fiduciary duties was ordered to account for an overpayment made by a company to him and another company controlled by him. A manager of the company also breached his duties because he actively assisted the director to obtain payment. The court awarded equitable compensation to relieve the company against loss arising from the breach of fiduciary duty. The manager was liable to compensate the company to the extent it was unable to recover its losses from the director and his company.

**[19.20]** A company has similar remedies against outsiders who knowingly participate in a director's breach of duty.

*Green v Bestobell Industries Pty Ltd* [1982] WAR 1

**[19.25]** Bestobell's Victorian manager, Green, breached his duty to avoid a conflict of interests when he incorporated his own company to obtain a contract that rightfully belonged to Bestobell. The court held that Green's company knowingly participated in the breach and ordered that it account to Bestobell for the profits made under the contract. This case is an example of the court lifting the corporate veil where a company is formed to assist someone in his breach of duty.

**[19.30]** The company bears the onus of proving that the person had knowledge of the essential facts constituting the breach before property may be recovered. In this sense, "knowledge" may be actual knowledge, wilful shutting of the eyes to the obvious or knowledge of the circumstances which an honest and reasonable person would recognise as improper: *Abeles v PA (Holdings) Pty Ltd* [2000] NSWSC 1008.

## Damages or compensation

**[19.35]** If a director breaches the fiduciary duties owed to the company and it suffers loss as a result, the company may apply for the equitable remedy of compensation. This is similar to the common law remedy of damages. If the officer is fraudulent, the company has a common law action for the tort of deceit and may recover damages. If the breach of duty arises from a failure to exercise reasonable care, the company has an action for negligence and can recover damages for any loss that results.

The object of compensation or damages is to place the company, as near as possible, in the position it would have occupied had the breach of duty not occurred. All directors who participate in the breach of duty are jointly and severally liable. This means that the company can sue any one of several directors in breach of duty for the full amount of the damages or compensation. That director then has a right to seek contribution from the others who participated in the breach of duty.

*Markwell Bros Pty Ltd v CPN Diesels (Qld) Pty Ltd* [1983] 2 Qd R 508

[19.40] Markwell Bros Pty Ltd held a franchise to distribute marine engines manufactured by a Japanese supplier. The relationship between Markwell and the Japanese supplier deteriorated and the franchise was withdrawn and acquired by CPN Diesels (Qld) Pty Ltd. CPN was a company formed by two of Markwell's former directors and employees. After the loss of the franchise, Markwell agreed to purchase engines from CPN at landed cost plus 10 per cent. Two years later, it was discovered that CPN had sold engines to Markwell based on a price greater than the actual landed cost with the result that Markwell had been overcharged approximately \$23,000. Markwell brought an action against CPN and its former directors seeking equitable damages or compensation for breach of fiduciary duty.

The Queensland Supreme Court held that the former directors breached their duties and were liable to compensate the company. The measure of compensation was the same whether the breach was of a contractual nature or of fiduciary duty. It was also held that CPN was liable for damages resulting from breach of duty by the directors as it knowingly participated in the breaches of duty. As discussed at [19.90], CPN may also have been liable to account for profits as a constructive trustee.

[19.45] Where a company is entitled to compensation it may recover for the loss of the use of the money of which it has been deprived. This enables the company to be awarded compound interest at the bank overdraft rate paid by it. Overdraft interest rates are not appropriate where the company seeks an order for an account of secret profits paid by someone else because the company had not been deprived of the use of this money.

## Account of profits

[19.50] A director or officer breaches his or her fiduciary duty to the company when the officer makes undisclosed profits arising from a conflict of interest situation. In such circumstances, compensation may not be a satisfactory remedy for the company, since the breach can arise even if the company suffers no loss.

The company may obtain an order that the officer hand over the profit made in breach of duty to the company. This is called "an account of profits". For example, in *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134, the facts of which are set out at [16.110], the directors breached their duty when they profited from the sale of shares in the company's subsidiary. They were in breach even though their company suffered no loss because it could not afford to acquire the subsidiary's shares itself. The directors were still ordered to disgorge the profits they had made.

*Tavistock Holdings Pty Ltd v Saulsman* (1991) 9 ACLC 450

**[19.55]** A manager breached his fiduciary duties by taking a management fee without the authority of the company. He was held liable to repay the money; however, he did provide services that benefited the company and was entitled to a just allowance for these.

**[19.57]** Under equitable principles, where directors breach their fiduciary duties, a third party that knowingly assisted in the breaches may be ordered to account for both actual and anticipated profits it derived. This could also include profits which arose by reason of the breach that it participated in and that were made as an indirect result of knowing assistance in the breach of duty: *Ancient Order of Foresters in Victoria Friendly Society Ltd v Lifeplan Australia Friendly Society Ltd* [2018] HCA 43. In this case the third party that knowingly assisted the directors who breached their fiduciary duties, was ordered to account for the entire capital value of the business it acquired as a result of the breach of duty.

**[19.60]** If a director breaches the statutory duties contained in ss 180–183 and the company suffers loss as a result, the company may apply for a civil penalty compensation order: s 1317H. The application for compensation can be made regardless of whether a declaration of contravention has been made. A person who is found to have contravened the statutory directors' duties may be ordered by the court to pay compensation to the company for any loss suffered by the company. The amount of compensation may include any profits made by the person resulting from the contravention: s 1317H(2). The civil penalty provisions are discussed at [19.120]–[19.150].

## Rescission of contract

**[19.65]** Directors breach their duties if they have an undisclosed interest in a contract with the company. Subject to the company's constitution, the company may, at its option, rescind the contract. This enables the company to avoid an unfavourable contract to which the company no longer wishes to be bound. The aim of rescission is to put both parties to the contract in the position they would have been in had no contract been made. Thus, any money paid or property transferred is returned.

*Kinsela v Russell Kinsela Pty Ltd* (1986) 4 NSWLR 722

**[19.70]** The facts of this case are set out at [18.90]. A liquidator successfully sought a declaration that a lease was voidable at the company's option. This lease was granted by an insolvent company to its directors in breach of their duty to take into account the interests of the company's creditors.

**[19.75]** If the directors profited from the contract, they are liable to account for the profit, irrespective of whether the company exercises its right to rescind.

A company's right to rescind may be lost if it is no longer possible to restore the parties to their original positions, if outsiders have bona fide acquired rights in the subject matter of the contract, or if the company fails to rescind within a reasonable time.

## Injunctions

**[19.80]** Where directors or officers breach or threaten to breach any of their fiduciary duties, the company can apply to the court for an injunction. An injunction is an order which requires a person to refrain from doing a particular thing. It is a useful remedy if the breach by the director is of a continuing nature or if the directors are proposing to engage in activity which will constitute a breach of duty. Applications for injunctions are generally brought under the *Corporations Act*. Section 1324 enables ASIC, or a person whose interests are affected by conduct that constitutes a contravention of the *Corporations Act*, to apply to the court for an injunction restraining the person from engaging in the contravening conduct. A person whose interests are affected by the contravention could include the company, a shareholder or creditor. Applications for statutory injunctions by ASIC are discussed at [19.152] and by shareholders at [24.305]–[24.315].

## Return of property and constructive trusts

**[19.90]** Where a director acquires property as a consequence of a breach of duty, the company may seek a declaration that the director holds the property on a constructive or resulting trust for the company with the effect that the property is returned to the company. This remedy is most appropriate where the director misappropriates property or misapplies money belonging to the company for their own purposes and it has since increased in value.

*O'Brien v Walker* (1982) 1 ACLC 59

**[19.95]** One of the directors of the Nugan Hand group of companies misapplied funds from one of the companies in the group to purchase a house in his own name. After the director died and the companies went into liquidation, the liquidator obtained an order that the director's estate held the house on a constructive or resulting trust for the company. The company was then entitled to have the house registered in its own name. A similar remedy was obtained in *Cook v Deeks* [1916] 1 AC 554 (discussed at [16.240]).

*Paul A Davies (Aust) Pty Ltd v Davies* [1983] 1 NSWLR 440

**[19.100]** Directors acquired a house and business in their own names. The acquisition was financed partly from company funds and partly from interest free loans to the directors from the company and the balance from a bank loan. It was held that the directors breached their fiduciary duty because they used company funds for their

own private purposes. The company's liquidator successfully sued the directors and obtained an order that the directors held the property on a constructive trust for the company and in the circumstances any funds raised by way of mortgage to finance the acquisition of the property was not regarded as having come from the directors' own funds. Consequently, the directors were only entitled to be indemnified for debts incurred in the acquiring and running of the property and to be provided with reasonable remuneration associated with running the business.

**[19.105]** The law of constructive trusts enables a company to recover assets that have come into the hands of third parties as a result of a breach of duty by a director. The third party may be compelled to return the property to the company if the property was received with knowledge of the breach of duty or if the third party knowingly assisted the director to commit a breach of fiduciary duty. This doctrine was developed in the context of breaches of duty by trustees and also operates in relation to directors: *Barnes v Addy* (1874) LR 9 Ch App 244 (*Barnes v Addy*) and *Consul Development Pty Ltd v DPC Estates Pty Ltd* (1975) 132 CLR 373. The principle allowing property to be recovered after it was received by third parties who had knowledge of the breach of duty is referred to as the first limb in *Barnes v Addy*. The principle allowing property to be recovered from third parties who knowingly assist the directors to commit a breach of fiduciary duty is referred to as the second limb in *Barnes v Addy*. Only one limb need be established for property to be recoverable.

First limb of *Barnes v Addy*.

In *Bell Group Ltd (in liq) v Westpac Banking Corp (No 9)* [2008] WASC 239, the court held that the first limb in *Barnes v Addy* is made out where the following factors are established:

- the directors owe a fiduciary duty to the company;
- the fiduciary duty extends to or encompasses property the receipt of which is later called into question;
- the directors are in breach of their fiduciary duty;
- the third party receives the property in the course of, or arising from, the acts or omissions involved in the breach; and
- at the time when the property was disposed of or transferred, the third party knows of the existence of the fiduciary duty and of the breach of that duty.

*Bell Group Ltd (in liq) v Westpac Banking Corp (No 9)* [2008] WASC 239

**[19.110]** The facts of this case are discussed at [15.225] and [18.25]. The plaintiffs claimed that assets were recoverable under both limbs in *Barnes v Addy*.

Owen J held that the directors of the Bell Group of companies owed fiduciary duties to the companies in the group. The directors breached the fiduciary duties

to act bona fide in the best interests of the companies in the group and to exercise powers for proper purposes when they allowed companies in the group to enter into refinancing and security transactions with a group of banks. The transactions allowed the banks to take security over assets of the Bell Group of companies at a time when the solvency of many of the companies in the group was in doubt. These arrangements were found to have prejudiced the interests of the creditors of the Bell Group of companies. Owen J was satisfied that at the time the refinancing arrangements were put in place the banks knew of the existence of the fiduciary duties and knew of the breaches of duty. The money was recoverable from the banks under the first limb in *Barnes v Addy*.

Second limb of *Barnes v Addy*.

According to *Australian Staging & Rigging – Events Pty Ltd v Elite Systems Australia Pty Ltd* [2016] SASC 204, the second limb in *Barnes v Addy* is made out where the following factors are established:

- the director dishonestly and fraudulently breached their fiduciary duties;
- the accessory had knowledge of the directors' breach of fiduciary duties; and
- the accessory assisted the directors' breach of fiduciary duties.

*Westpac Banking Corporation v Bell Group Ltd (in liq) (No 3)* [2012] WASCA 157

**[19.112]** The decision in *Bell Group Ltd (in liq) v Westpac Banking Corp (No 9)* was appealed by the banks on a variety of grounds, one of which was that Owen J had erred in finding that the first limb of *Barnes v Addy* had been made out. The Court of Appeal found against the banks and upheld Owen J's findings in relation to the company's ability to recover assets under the first limb in *Barnes v Addy*.

As part of the same action the Bell group companies appealed Owen J's finding that the second limb of *Barnes v Addy* had not been made out. The Court of Appeal upheld the companies' claim and found that the second limb in *Barnes v Addy* had been made out. The banks had knowingly assisted the directors in a dishonest breach of their fiduciary duties and the fraudulent disposition of company property, and this was sufficient to make out the second limb in *Barnes v Addy*.

In order to recover property under the second limb in *Barnes v Addy*, it is necessary to prove that the director's breach of duty amounted to dishonest conduct: *Singtel Optus Pty Ltd v Almad Pty Ltd* (2014) 87 NSWLR 609.

**[19.115]** The meaning of "knowledge" for the purpose of the law of constructive trusts is very broad and includes constructive knowledge such as where the third party failed to make reasonable inquiries where the circumstances required inquiries to be made.

## Civil penalties

### What are civil penalty provisions?

**[19.120]** Certain provisions of the *Corporations Act* are deemed to be civil penalty provisions. If a civil penalty provision is breached, the civil penalty regime set out in Pt 9.4B applies. Under that regime ASIC may apply to the court for a declaration of contravention, a pecuniary penalty, a disqualification order and/or a compensation order. The civil penalty regime is intended to provide for the imposition of penalties on directors and officers who breach their duties, but which is less serious than criminal liability, and results in a higher success rate in imposing liability given the higher standard of proof that applies in relation to criminal convictions. The primary purpose of a civil penalty “is the promotion of the public interest in compliance with the provisions of the Act in question by the deterrence of further contraventions of that Act”: *ASIC v GetSwift Limited* [2023] FCA 100.

There is a long list of civil penalty provisions in s 1317E(2). The main civil penalty provisions we are concerned with in this chapter are those that relate to the duties of directors and officers, which are listed in Table 19.1.

**Table 19.1: Civil penalty provisions for directors’ breach of duty**

| Section                                                   | Topic                                                                | Discussed in |
|-----------------------------------------------------------|----------------------------------------------------------------------|--------------|
| ss 180(1), 181(1) and (2), 182(1) and (2), 183(1) and (2) | Officers’ duties                                                     | Chapter 15   |
| s 188(1) and (2)                                          | Responsibilities of secretaries for certain corporate contraventions | Chapter 12   |
| s 209(2)                                                  | Related parties rules                                                | Chapter 16   |
| ss 254L(2), 256D(3), 259F(2) and 260D(2)                  | Share capital transactions                                           | Chapter 8    |
| s 588G(2)                                                 | Insolvent trading                                                    | Chapter 18   |
| ss 727(6) and 728(4)                                      | Fundraising and disclosure                                           | Chapter 7    |

Section 1317E(3) also includes a long list of civil penalty provisions which apply for breaches of duties owed by persons and entities other than directors, including financial services civil penalty provisions that include continuous disclosure, market manipulation, false trading and market rigging, dissemination of information about illegal transactions, and insider trading. These are discussed in other sections of this book where these topics are discussed.

Part 9.4B provides for four types of civil penalty orders to punish people who contravene designated civil penalty provisions:

- *disqualification from management* (this is discussed at [19.138]);
- *a pecuniary penalty* (this is discussed at [19.140]);
- *a relinquishment order* (this is discussed at [19.143]); and
- *compensation* for damage suffered (ss 1317H, 1317HA and 1317HB). This is discussed at [19.150].



*ASIC v Vizard* [2005] FCA 1037

[19.125] The facts of this case are set out at [16.325].

Finkelstein J made the following observations for determining the orders which should be imposed under the civil penalty provisions:

- The main consideration is the nature of the offence rather than the character of the defendant and the likelihood of further offences in the future.
- It is irrelevant whether or not a profit was made.
- The aim of the orders is to act as a general deterrent to improper commercial conduct.
- Shaming is not a substitute for formal punishment imposed by the courts.
- Early acknowledgment of wrongdoing and co-operation with regulatory authorities entitle the defendant to a reduction of penalties.

## Declaration of contravention

[19.135] If a court is satisfied that a person contravened a designated civil penalty provision, it must make a declaration of contravention under s 1317E(1). A declaration of contravention must specify the matters set out in s 1317E(2). These matters include identification of the conduct which constituted the contravention and the section contravened.

The rules of evidence and procedure for civil matters apply in relation to hearings for a declaration of contravention and pecuniary penalty orders: s 1317L. This means that the burden of proof is the civil burden (on balance of probabilities) and not the criminal standard (beyond reasonable doubt): *ASIC v Plymin* [2003] VSC 123. However, given the nature of the penalties that can be imposed under the civil penalty regime the courts have stated that a modified version of the civil burden of proof is to be applied: *Briginshaw v Briginshaw* (1938) 60 CLR 336 at 368. In *ASIC v Adler (No 3)* (2002) 20 ACLC 576, Santow J stated that although the proceedings before the court were not criminal, the character of civil penalty proceedings required the court to invoke requirements for prosecutorial fairness and a standard of proof that took into consideration the gravity of the allegations.

A declaration of contravention under s 1317E provides the basis for the court to make a range of further orders, including disqualification orders, pecuniary penalty orders, relinquishment orders and compensation orders.

## Disqualification orders

[19.138] Where a court has made a declaration under s 1317E that a person has contravened a civil penalty provision, ASIC may seek an order disqualifying or banning that person from managing a corporation. The meaning of “managing a corporation” is discussed

at [12.195]. The court may make such an order if it is satisfied that the disqualification is justified and for such period as the court considers appropriate: s 206C(1). The court must be satisfied not only that an order for disqualification is justified, but that the period of disqualification is justified: *Gillfillan v ASIC* [2012] NSWCA 370.

In determining whether a disqualification order is justified, s 206C(2) directs the court to have regard to the person's conduct in relation to the management, business or property of any corporation and any other matters considered appropriate. The primary purpose of the disqualification provisions is to protect the public from harmful use of corporations and from use which is contrary to proper commercial standards: *ASIC v Adler (No 5)* [2002] NSWSC 483. A disqualification order aims at personal and general deterrence and may also be imposed for the purpose of punishment: *ASIC v Vizard* [2005] FCA 1037.

The *Corporations Act* does not specify the duration of any disqualification imposed under s 206C. Disqualification is for a period that the court considers appropriate. In *ASIC v Adler* [2002] NSWSC 171, Santow J considered that the following factors were relevant in determining an appropriate period of disqualification. Longer periods of disqualification are appropriate for contraventions which were of a more serious nature, such as where:

- dishonesty was involved;
- there was disregard for the law;
- there was serious incompetence and irresponsibility;
- the contraventions were recurring and large financial losses occurred; and
- there was a likelihood of similar conduct in the future which is likely to be harmful to the public.

The court will be inclined to impose longer periods of disqualification where a director has previously been subject to a disqualification order: *ASIC v Citrofresh International Ltd (No 3)* [2010] FCA 292. A mitigating factor is where contrition is shown and there is a likelihood of the disqualified person reforming, or where the defendant endeavoured to repay any amounts misappropriated.

Disqualification orders imposed by the courts have ranged from a period of six months (*Doyle v ASIC* [2005] WASCA 17) to permanent disqualification: *ASIC v Elm Financial Services Pty Ltd* [2005] NSWSC 1065; *ASIC v White* [2006] VSC 239 and *ASIC v Maxwell* [2006] NSWSC 1052.

Part 2D.6 of the *Corporations Act* contains a number of other provisions under which a person may be disqualified. These are discussed at [12.185]–[12.265].

## Pecuniary penalty orders

**[19.140]** Courts also have the power to make pecuniary penalty orders where directors breach their duties. Under s 1317G(3), the court may order a person to pay a pecuniary penalty to the Commonwealth of up to the greater of 5,000 penalty points (currently \$1.565 million) or three times the benefit derived and detriment avoided because of the contravention, if that amount can be determined by the court if the contravention of a

civil penalty provision is serious; or materially prejudices the interests of the corporation or its members; or materially prejudices the corporation's ability to pay its creditors.

In relation to a contravention of a civil penalty provision by a corporation, the maximum pecuniary penalty is the greater of:

- 50,000 penalty points (currently \$11 million); or
- three times the benefit derived and detriment avoided because of the contravention, if that amount can be determined by the court; or
- 10 per cent of the annual turnover of the body corporate for the 12-month period up to a maximum of \$525 million: s 1317G(4).

A pecuniary penalty is regarded as a civil debt payable to ASIC on the Commonwealth's behalf and may be enforced as if it were an order made in civil debt recovery proceedings: s 1317GAA.

Pecuniary penalties act as a personal and general deterrent.

The purpose of a pecuniary penalty is to act as a personal and general deterrent against failure to comply with appropriate standards of commercial conduct in the management of corporations: *Cruickshank v ASIC* (2022) 292 FCR 627; [2022] FCAFC 128.

The penalty should be no greater than is necessary to achieve this purpose and is at the discretion of the court. In exercising its discretion, the court will consider factors such as the amounts involved, whether efforts were made to repay misappropriated funds, whether actions involved dishonesty or negligence and carelessness, whether there were expressions of contrition or a likelihood of further contraventions and previous good character: *ASC v Donovan* (1998) 28 ACSR 583.

It is also relevant for the court to consider the capacity of the defendant to pay the penalty: *ASIC v Healey (No 2)* [2011] FCA 1003. However, the mere fact that a defendant lacks the means to pay a pecuniary penalty or that it would cause significant financial hardship does not mean the applicable penalty should be reduced: *ASIC v Forge* [2007] NSWSC 1489. The key question is whether the order imposed will serve the purpose of general deterrence.

Where there have been multiple contraventions, the "totality principle" applies so that the court reviews the entirety of the conduct to determine whether the proposed penalty is appropriate as a whole. Where there are a number of co-defendants, the penalties imposed should be similar unless there are factors present that justify the imposition of different penalties: *ASIC v Healey (No 2)* [2011] FCA 1003.

In assessing a pecuniary penalty order, it is relevant to consider the consequences of an associated disqualification order. If these consequences are significant, a lesser penalty may be appropriate: *ASIC v Adler (No 5)* [2002] NSWSC 483. The courts consider imposing a pecuniary penalty only if a civil penalty disqualification provides an inadequate or inappropriate remedy: *Rich v ASIC* [2004] HCA 42. Pecuniary penalty orders are therefore made in addition to disqualification orders: *Morley v ASIC (No 2)* [2011] NSWCA 110.

## Relinquishment orders

**[19.143]** The court may impose a relinquishment order on a person who has breached a civil penalty provision requiring them to pay to the Commonwealth an amount equal to the benefit they derived or the detriment they avoided because of the contravention: s 1317GAB. This order can be made in addition to a pecuniary penalty order: s 1317GAB(3).

## Compensation orders

**[19.150]** The court has the power to order a person who contravenes a corporation/scheme civil penalty provision to compensate a corporation for the damage that resulted from the contravention: s 1317H. The order must specify the amount of compensation. Applications for corporation/scheme compensation orders may be made by ASIC or the corporation: s 1317J. A company can apply to the court for a compensation order regardless of whether ASIC has obtained a declaration of contravention.

The damage suffered by a corporation for purposes of a compensation order includes any profits made by any person resulting from the contravention: s 1317H(2). The purpose of an account of profit order made pursuant to s 1317H(2) is to prevent the unjust enrichment of directors by compelling them to surrender any profits actually made improperly, and nothing beyond that. It is only profits properly attributable to the breach of duty that should be the subject of the compensation order: *V-Flow Pty Ltd v Holyoake Industries (Vic) Pty Ltd* [2013] FCAFC 16. The court can order that profits be repaid under s 1317H(2) even in situations where there is no corresponding loss to the corporation: *Grimaldi v Chameleon Mining NL (No 2)* [2012] FCAFC 6.

Where a compensation order is made against several defendants, the court has a discretion whether or not to make a compensation order against a particular defendant. However, the court should not differentiate between defendants in the apportionment of compensation as this is not authorised by the legislation and would not be in accord with the principles of joint and several liability applicable to multiple tortfeasors. Such issues should be determined in separate contribution proceedings involving the defendants: *ASIC v Adler (No 5)* [2002] NSWSC 483.

Under s 1317S, a person may be relieved from liability for contravention of a civil penalty provision if the court is satisfied that the person acted honestly and ought fairly to be excused for the contravention. This power of the court operates in conjunction with a similar general power contained in s 1318. These provisions are discussed at [20.30].

## “Involved” in a contravention

**[19.151]** As noted at [19.120], ss 180–183 are designated corporation/scheme civil penalty provisions. Directors and officers who contravene these provisions are liable to civil penalty orders. In addition, any person who is involved in the contravention also contravenes the relevant section: ss 181(2), 182(2) and 183(2). Under s 79, a person is “involved” in a contravention if the person has:

- aided, abetted, counselled or procured the contravention;
- induced the contravention;
- been in any way, by act or omission, knowingly concerned in or party to the contravention; or
- conspired with others to effect the contravention.

For a person to be involved in a contravention they must have actual knowledge of the essential, material factual ingredients of the contravention. Knowledge may be inferred from the fact of exposure to the obvious where the person has wilfully remained ignorant and failed to make appropriate inquiry: *ASIC v Adler* [2002] NSWSC 171.

In *ASIC v Somerville* [2009] NSWSC 934, Windeyer AJ said:

aiding and abetting a plan means helping or assisting or encouraging its implementation. Counselling means advising conduct (here wrongful conduct), and procuring means taking action to bring about the (improper) result in that there must be a causal connection between that action and the conduct impugned.

Windeyer AJ said that usually solicitors giving advice will not be “involved” in a contravention pursuant to s 79. However, in *ASIC v Somerville*, a solicitor was held to have aided and abetted a number of directors to breach their duty of care because:

he advised on and recommended the transaction which breached the sections in question, he prepared or obtained all documents necessary to carry out the transaction, he arranged execution of the documents in all cases with knowledge of the relevant facts. I think it clear that he aided, abetted, counselled and by carrying out the necessary work procured the carrying out of the transaction. There was a direct causal connection between his involvement and the breach. I find the transactions would not have taken place but for his involvement.

## Statutory injunctions

**[19.152]** ASIC has standing under s 1324 to apply to the court for an injunction restraining conduct where a person has engaged in conduct that constitutes a contravention of the *Corporations Act*, counsels or procures a person to contravene the Act or is in any way knowingly concerned in or party to the contravention. Section 1324 also enables any person whose interests are affected by a contravention of the *Corporations Act* to apply for an injunction. This is further discussed in the context of members' remedies at [24.305]–[24.315].

*ASIC v Macro Realty Developments Pty Ltd* [2016] FCA 292

**[19.153]** Macro and 21st Century marketed an investment proposal whereby an investor agreed to become a sole director and shareholder of a company which would be subject to the sole decision-making of Macro, over which the investor had no real or effective control and which had an obligation to finance the acquisition

of properties from Macro and assume legal liability for that finance. ASIC brought an application seeking an injunction restraining Macro from promoting and marketing the investment proposal and entering into any arrangements or dealing with funds in relation to it. ASIC alleged that Macro and 21st Century were counselling and procuring investors to contravene their duties as directors in contravention of s 181(1) by causing them to enter into contracts that fettered their powers and required them to follow directions and fail to retain their discretionary powers. This fiduciary duty is discussed at [15.260]. It was held that Macro and 21st Century urged, prevailed upon and sought to persuade investors to enter into arrangements by which the investors would contravene s 181 and so had the requisite state of mind in terms of counselling or procuring for the purposes of s 1324. In deciding whether to grant an injunction the court should consider whether the injunction will have some utility or will serve some useful purpose contemplated by the Act. The grant of an injunction marks the court's disapproval of the conduct and operates as a deterrent to others.

## Future reforms

**[19.154]** The Senate Economics References Committee's 2017 report *Lifting the Fear and Suppressing the Greed: Penalties for White-Collar Crime and Corporate and Financial Misconduct in Australia* recommended that the government consider reforms to provide greater clarity regarding the evidentiary standards and rules of procedure that apply in civil penalty proceedings involving white-collar offences. The Committee's Report is on the Senate Economics References Committee's website and is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## Criminal penalties

### Relationship between civil penalties and criminal penalties

**[19.155]** Under s 184, a contravention of the civil penalty provisions contained in ss 181–183 may constitute a criminal offence if a director or officer was reckless or intentionally dishonest. “Dishonesty is judged objectively by the standard of ordinary decent people”: *R v Fodera* [2007] NSWSC 1194. Contravention of s 180(1), the statutory duty of care and diligence, cannot give rise to criminal sanctions.

Criminal proceedings may be started against a person even though a civil penalty order has been made against that person: s 1317P. The rights of a defendant are protected to some extent by s 1317Q, which makes evidence previously given in civil proceedings inadmissible in a prosecution for a criminal offence involving substantially similar conduct.

A court hearing a criminal prosecution cannot make civil penalty orders if the defendant is found not guilty. ASIC must bring fresh civil penalty proceedings if it wishes to pursue civil penalty orders following an unsuccessful criminal prosecution.

## Criminal offences

**[19.160]** There are numerous provisions in the *Corporations Act* that expressly state that contravention is a criminal offence. For example, under s 184(1), a director or officer commits a criminal offence if they are reckless or intentionally dishonest and fail to exercise their powers in good faith in the best interests of the corporation.

Section 1311(1) and (1A) create criminal offences for sections of the *Corporations Act* that are listed in Sch 3. Under s 1311(1) and (1A), a person is guilty of an offence if they contravene a provision of the *Corporations Act* that is listed in Sch 3.

An example of a provision listed in Sch 3 is s 209(3) which makes it an offence to be dishonestly involved in a contravention of the related party transactions provisions contained in Ch 2E.

## Application of the Criminal Code

**[19.165]** Chapter 2 of the *Criminal Code* sets out the general principles of criminal responsibility that apply to criminal offences under the *Corporations Act*. Section 3.1(1) of the *Criminal Code* specifies that an offence consists of physical elements (defined in ss 4.1–4.3) and fault elements (defined in ss 5.1–5.6). A physical element of an offence includes conduct or the result of conduct. A fault element for a particular physical element may be intention, knowledge, recklessness or negligence.

Section 3.1(2) of the *Criminal Code* recognises that a law that creates an offence may provide that there is no fault element for one or more physical elements. This is the case with the *Corporations Act* which contains numerous offences that are characterised as either offences of strict liability or absolute liability.

A “strict liability” offence is one that has no fault elements for any of the physical elements: *Criminal Code*, s 6.1(1)(a). The defence of mistake of fact under s 9.2 is available for strict liability offences: s 6.1(1)(b). A mistake of fact defence arises if at the time of the conduct constituting the physical element, the accused person was under a mistaken but reasonable belief about those facts and had those facts existed, the conduct would not have constituted an offence.

An “absolute liability” offence is one that has no fault elements for any of the physical elements and the defence of mistake of fact is unavailable: s 6.2(1).

## Consequences of conviction

**[19.170]** A person who is guilty of an offence under the *Corporations Act* is punishable on conviction by a penalty not exceeding the penalty applicable to the offence: s 1311A. If the section that creates the offence is included in the Sch 3 list, then the maximum penalty is the penalty mentioned in that Schedule: s 1311E(1)(a). If a provision sets out its own penalty, then that is the maximum penalty on conviction: s 1311E(1)(b). Where a penalty is not otherwise provided, then the applicable penalty is 20 penalty units (\$4,200): s 1311F.



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## Revision questions on the material in this chapter

- Please see the *Corporations Law* **mentor** material at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.
- For further corporations law links and material please refer to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## Chapter 20

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# Exoneration and relief for directors' breach of duty

|         |                                                    |     |
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### Key points

- The general meeting has broad power to excuse directors who act in breach of duty.
- The company constitution cannot exempt a director from liability or provide an indemnity against liability arising from breach of duty which did not arise out of conduct in good faith.
- The court may order that a person be relieved from liability in any proceedings involving breach of duty where the person acted honestly.

## Exoneration by the company

### Shareholder ratification

**[20.05]** Historically, directors who breached their fiduciary duties to a solvent company could be excused from liability if shareholders passed an ordinary resolution to ratify their actions. This was because the duties of directors were regarded as private in nature, being a matter between directors and shareholders. Shareholders were entitled to determine whether the directors should be held liable for their breaches of duty to them. This is no longer the case with respect to statutory duties. Shareholders are unable to ratify a breach of directors' statutory duties under Ch 2D of the *Corporations Act* as civil penalty proceedings are aimed at not just protecting the company. They also aim to protect the broader public so that directors who contravene the *Corporations Act* may be disqualified from acting as officers of any company: *Angas Law Services Pty Ltd v Carabelas* [2005] HCA 23. In the context of the duty of care and diligence under s 180(1), it was held in *Cassimatis v ASIC* [2020] FCAFC 52 that the statutory duty was public in nature and imposes a "normative, objective, irreducible standard of care and diligence directors must live up to". This means that "conduct falling short of the standard cannot be sanctioned or ratified". The duty may be breached even though all shareholders approved of the actions of the directors.

The High Court noted in *Angas Law Services Pty Ltd v Carabelas* [2005] HCA 23 that, while shareholders cannot ratify breaches of statutory duty, acquiescence by the shareholders in a course of conduct undertaken by the directors "might affect the practical content of those duties", including the question of whether the directors had acted improperly.

Ratification of a breach of fiduciary duties may be either prospective or retrospective. The directors must fully disclose all relevant circumstances to the shareholders and have acted in good faith. If the directors are also shareholders, they are permitted to vote as shareholders in favour of ratifying their own breach of duty.

However, ratification may be ineffective if it amounts to oppressive or unfair conduct for purposes of a remedy under s 232: *Hannes v MJH Pty Ltd* (1992) 10 ACLC 400. This will be the case if the directors who breach their duty control the majority of votes at the general meeting and vote in favour of their own ratification. Section 232 is discussed at [24.15]–[24.280]. Further, as discussed at [24.285] onwards, Pt 2F.1A of the *Corporations Act* gives members, with prior leave of the court, the right to bring legal proceedings against directors in the name of the company. According to s 239(1), merely because conduct has been ratified or approved by a general meeting does not mean that a person cannot bring the legal proceedings or apply to the court for leave to do so under Pt 2F.1A. Under s 239(2), however, the court may take the ratification or approval into account in deciding what order or judgment to make.

Ratification is not available where it would constitute a misappropriation of company resources. In *Bell Group Ltd (in liq) v Westpac Banking Corp (No 9)* [2008] WASC 239, Owen J stated that the creation and disposal of security interests over the assets of the company (which involved a breach of duty) would be characterised as misappropriation.

## Ratification invalid where company insolvent

**[20.10]** In *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 NSWLR 722, the shareholders purported to excuse directors for a breach of duty.

This was held to be invalid because the company was insolvent or near insolvency at the time, so the interests of creditors became paramount.

Shareholders are unable to ratify breaches of duty where directors fail to take into account the interests of creditors.

*Bell Group Ltd (in liq) v Westpac Banking Corp (No 9)* [2008] WASC 239

**[20.15]** The facts of this case are outlined at [15.225] and [15.25]. Owen J found that the directors of the Bell group of companies had breached their fiduciary duty to act in good faith and in the best interests of the company by causing the companies in the group to enter into transactions that resulted in the banks gaining security over the assets of the Bell group of companies. The actions of the directors prejudiced the interests of the shareholders and creditors of the companies in the Bell group because at the time the transactions were entered into the main corporations in the group were insolvent.

The banks argued that any breaches of duty by the directors had been ratified because the shareholders and certain existing creditors had consented to the relevant transactions. Owen J stated that ratification may have been effective in this case if prior to or shortly after the execution of the transactions the appropriate, proper and fully informed consent of all creditors and shareholders of the companies had been obtained. In this case, ratification was not effective because of the lack of unanimous consent of all of the creditors of the Bell group.

Owen J's findings in relation to ratification were upheld on appeal: *Westpac Banking Corporation v Bell Group Ltd (in liq) (No 3)* [2012] WASCA 157.

## Ratification by the board

**[20.20]** As a general rule, a board is unable to ratify what would otherwise be a breach of directors' duty as this must generally be done by the shareholders. *Queensland Mines Ltd v Hudson* (1978) 52 ALJR 399, the facts of which are outlined at [16.260] and [16.410], provides an exception to this general rule. The Privy Council held that in the circumstances of that case, disclosure to the board of directors and its assent was sufficient to enable a director to retain his profits. The relevant circumstances of that case were that the company was a joint venture company and the only members of the company were two other companies, each of which was represented on the board that approved the director's conduct.

## Exemption from liability and indemnification

### By the company

[20.25] At common law, it was possible for a company to provide in its constitution that directors were exempt from liability for loss caused by negligent but honest acts or omissions. This is no longer the case.

The company constitution cannot exempt or indemnify an officer from liability.

A company or related body corporate must not exempt an officer or auditor, directly or through an interposed entity, from liability to the company: s 199A(1). Similarly, a company or related body corporate must not indemnify an officer or auditor against a liability owed to the company, under a civil penalty order or owed to someone else and which did not arise out of conduct in good faith: s 199A(2).

Legal costs.

Indemnity of legal costs incurred in defending an action for a liability incurred as an officer or auditor is generally permitted unless:

- the person is found in the proceedings to have a liability for which the company is prohibited from indemnifying that person under s 199A(2);
- the person is found guilty in criminal proceedings;
- the court grants an order in proceedings brought by ASIC or a liquidator; or
- the court denies relief in proceedings where this is sought by the officer or auditor: s 199A(3).

Legal costs incurred in relation to actions taken by ASIC or a liquidator as part of an investigation before commencing proceedings for a court order may be indemnified even if ASIC or the liquidator are later successful in court proceedings: s 199A(3).

In *Leckenby v Note Printing Australia Ltd* [2014] VSC 538, the court said that the entitlement to indemnification for legal costs is designed to ensure that an officer could, under certain circumstances, receive payments before the criminal proceedings are finalised. The provisions recognise the real, practical and possibly substantial burdens officers face when mounting defences in often complex and lengthy criminal proceedings. The court rejected the argument that the entitlement to indemnification arises only once the outcome of the criminal proceedings, including appeals, is known and there is a verdict of not guilty.

A company is able to give an officer a loan in respect of legal costs. The officer must pay back the loan if the result of the legal action is that the officer is found to have a liability for which they could not be indemnified under s 199A(2). If the result of the legal action is that the officer is not found to have a liability for which they could not be indemnified, the officer may retain the loan money as the indemnity to which the officer is entitled: s 212. This addresses a concern that arose under the previous

legislation, which did not allow an officer to receive an indemnity for legal costs until after the outcome of the court proceedings was known. This could impose a substantial burden where the court proceedings are lengthy and complex.

## By the court

**[20.30]** Officers of a corporation and certain other persons specified in s 1318(4) may be relieved from liability if in any civil proceedings against them for negligence, default, breach of trust or breach of duty, it appears to the court that they acted honestly and ought fairly to be excused either wholly or partly: s 1318(1). Where the court grants relief to an officer, or auditor, they may be indemnified under the constitution for legal costs in relation to the proceedings: s 199A(3). The court also has power to grant partial relief.

There is a similar corresponding power of the court to grant relief from liability under s 1317S where a civil penalty provision is contravened. This power does not include proceedings for an offence except so far as the proceedings relate to the question whether the court should make an order for compensation under ss 588K, 1317H or 1317HA. In determining whether a person ought fairly to be excused under s 1317S for a contravention of s 588G (insolvent trading), the court should consider any action the person took with a view to appointing an administrator of the company, when that action was taken and the results of that action: s 1317S(3). Section 1317S does not limit, nor is limited by, s 1318: s 1317S(7).

In *Daniels v Anderson* (1995) 37 NSWLR 438, the court stated that:

the purpose of the section is to excuse company officers from liability in situations where it would be unjust and oppressive not to do so, recognising that such officers are businessmen and women who act in an environment involving risk in commercial decision making.

|                  |
|------------------|
| Acting honestly. |
|------------------|

In determining whether a person has acted “honestly” for the purposes of the defences under ss 1317S and 1318, the court uses the ordinary meaning of the word and considers whether the person has acted without deceit or conscious impropriety, without intent to gain an improper benefit or advantage and without the degree of carelessness or imprudence that would indicate no genuine attempt to carry out the duties of office imposed by the law. In some cases, a failure to consider the interests of the company or its creditors may be the result of an error of judgment and does not amount to a failure to act honestly: *Hall v Poolman* [2007] NSWSC 1330.

In *ASIC v Adler (No 5)* [2002] NSWSC 483, Santow J considered that just because a court was not prepared to make a finding that a person was dishonest, does not mean that it is satisfied that the person has acted honestly for the purposes of granting relief from liability under ss 1317S and 1318.

Generally, the court before which proceedings to enforce the liability have been taken has the power to grant relief. Provision is also made for an application for relief where it

is anticipated that an action may be brought for negligence, default, breach of trust or breach of duty (s 1318(2)) or contravention of a civil penalty provision: s 1317S(4).

*ASIC v Vines* [2005] NSWSC 1349

**[20.35]** Several officers of a company breached their duties under s 180(1) by failing to disclose material information to the board during a takeover bid for the company. In exercising its discretion under s 1318 to exonerate the officers, Austin J took into account several considerations in weighing up whether they ought fairly to be excused:

- the degree of care with which a person has acted and the degree to which the contravening conduct departed from the standard of reasonableness prescribed by the statutory duty;
- the presence or absence of contrition after the event;
- the seriousness of the contravention which has three components:
  - the importance of the provision;
  - the degree of flagrancy of the contravention; and
  - the consequences of the contravention in terms of the harm caused to others;
- whether competent advice was obtained and followed before the acts in contravention;
- whether the conduct was in accordance with some established practice; and
- whether the defendant was paid for undertaking the contravening conduct.

*McLellan v Carroll* [2009] FCA 1415

**[20.40]** Carroll was the sole director of The Stake Man Pty Ltd which fell into financial difficulties. The company sought advice from an experienced accountant who provided advice on the company's business and also advised that the company was solvent. Carroll relied on this advice to continue the business and believed that the company could overcome its cash flow problems by selling its stock at a reduced price. Over the next few years, the company's financial position continued to deteriorate. It became unable to pay its creditors and eventually went into liquidation. Goldberg J held that the company had traded while insolvent however he excused Carroll under the honesty defence in s 1317S. The main consideration Goldberg J took into account was that Carroll sought the advice of an expert accountant who was experienced in the industry in which the company was engaged and so it was reasonable for Carroll to rely on this advice. On a number of occasions, Carroll asked the question whether the company was insolvent and he was advised that it was not. Further relevant circumstances were that Carroll



remained active in trying to increase production and sales and raise further capital. He acted promptly in appointing an administrator when confronted by the claim of the Australian Tax Office. Carroll did not profit personally from allowing the company to continue to trade.

### *ASIC v Cassimatis (No 8)* [2016] FCA 1023

[20.47] In this case, the facts of which are set out at [17.150], Mr and Mrs Cassimatis were found to have breached their duty of care under s 180(1). Despite finding that Mr and Mrs Cassimatis had acted honestly for the purpose of s 1317S, Edelman J determined that they ought not fairly be excused from liability. Edelman J stated that:

Their role and responsibilities in Storm were so significant, and the contraventions were sufficiently serious, that their conduct ought not fairly be excused. They were responsible for establishing the Storm model which provided for double gearing for thousands of clients. They exercised an extraordinary level of control and power over the Storm business and should reasonably have known that the consequences of inappropriate advice to any class of client could reasonably be expected to be catastrophic for Storm (to whom their duties were owed).

This case went on appeal to the Full Court of the Federal Court as *Cassimatis v ASIC* [2020] FCAFC 52, however the power of the court to excuse breaches of duty under s 1317S was not raised.

## Directors' and officers' insurance

[20.50] A company is prohibited from paying premiums insuring directors and officers against liability arising out of conduct involving a wilful breach of duty in relation to the company or improper use of their position or information under ss 182 and 183. This restriction applies irrespective of whether the premiums were paid directly or through an interposed entity: s 199B.

The restrictions set out in ss 199A and 199B do not authorise anything that would otherwise be unlawful: s 199C(1). Where an indemnity or payment of an insurance premium contravenes ss 199A or 199B, it is void to the extent of the contravention: s 199C(2).

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** material at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.
- For further corporations law links and material please refer to the Understanding Company Law website at <http://www.uclaw.com.au>.

## Chapter 21

# Shareholders' meetings

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## Key points

- Shareholders make decisions by passing resolutions at meetings. The calling and conduct of shareholders' meetings is governed by the *Corporations Act* well as a company's constitution (if any) and applicable replaceable rules. The ASX Listing Rules impose additional requirements for shareholders' meetings of listed companies.
- A shareholders' meeting must be held for a proper purpose.
- A company may hold a shareholders' meeting:

- at one or more physical venues; or
  - at one or more physical venues and using virtual meeting technology; or
  - using virtual technology only, if this is expressly required or permitted by the company's constitution.
- Shareholders must be given a reasonable opportunity to participate in a meeting. A shareholders' meeting must be held at a reasonable time and place. If the meeting is held at more than one physical venue, the technology used to hold the meeting must be reasonable. If a meeting is held using virtual meeting technology, the technology must be reasonable and allow shareholders participating virtually to exercise their rights to ask questions and make comments orally and in writing.
  - Public companies must hold an annual general meeting (AGM) at least once in every calendar year and within five months after the end of their financial year. A proprietary company needs to hold an AGM only if its constitution requires such a meeting.
  - An AGM enables shareholders to obtain information and an opportunity to ask questions and make comments regarding management of the company. To facilitate this, a public company's financial report, directors' report and auditor's report must be laid before its AGM. The usual business of an AGM is to enable shareholders to consider these reports, elect directors and appoint an auditor and fix the auditor's remuneration.
  - While an AGM must be held once every calendar year, companies may also hold other general meetings of shareholders. Such meetings are often referred to as "extraordinary general meetings".
  - A company's constitution (if any) and applicable replaceable rules specify who has the power to call a general meeting. In most cases, this power is given to the board of directors. The *Corporations Act* gives a single director of a listed Australian company the right to call a general meeting. The *Corporations Act* also allows a general meeting to be called at the request of shareholders.
  - Shareholders must be given at least 21 days' notice of a meeting (28 days in the case of a listed Australian company). The notice must include the general nature of the meeting's business and details of proposed resolutions. Shareholders also have a right to give the company notice of a resolution they propose to move at a general meeting.
  - Voting on resolutions is carried out by a show of hands or by a poll. Unless the company's constitution says otherwise, each shareholder has one vote on a show of hands and one vote per share on a poll. Shareholders may personally attend and vote at a meeting or appoint a proxy to attend and vote on their behalf.
  - There are two types of resolutions that can be passed at a shareholders' meeting: ordinary resolutions and special resolutions. An ordinary resolution is passed by a simple majority vote of the shareholders voting in person or by proxy. The *Corporations Act* requires certain types of decisions, such as changing the constitution, to be passed by a special resolution. This is passed by at least 75 per cent of the votes cast by shareholders entitled to vote on the resolution.

## Introduction

**[21.05]** A meeting is a gathering or assembly of a number of persons. Shareholder meetings are formal gatherings held for the purpose of making decisions which represent the decisions of the meeting as a whole even though there may be a diverse range of individual views. The rules governing the procedure and conduct of meetings aim to determine the view of the meeting by a fair and democratic process which allows for debate and discussion of a predetermined specific proposal and a vote. Shareholders make decisions by passing resolutions at general meetings. The term “meeting” generally implies the presence of at least two persons: *Sharp v Dawes* (1876) 2 QBD 26. However, it is possible to have a one-person meeting. For example, under s 249B, where a company has a single shareholder, that person may pass a resolution.

During the COVID-19 pandemic, the government made temporary changes to the *Corporations Act* to permit companies to hold shareholders' meetings using virtual technology, dispensing with the need to have meetings requiring shareholders' physical presence. The *Corporations Amendment (Meetings and Documents) Act 2022* (Cth) made the changes permanent. These changes are discussed at [21.110].

The calling and conduct of meetings is part of the internal regulation of companies and is governed by the replaceable rules and the company's constitution (if any). In addition, the *Corporations Act* sets out additional requirements that must be followed.

The *Corporations Act*, replaceable rules and the company's constitution confer various rights on the general meeting and are premised on the idea that shareholders wish to participate in the affairs of a company. However, as discussed at [12.75], the board of directors usually has very wide powers of management. In addition, the board is usually able to control the calling of meetings, the matters discussed and, to some extent, the voting at meetings.

Shareholder meetings enable shareholders to express their will and acquire significant information.

The provisions of the *Corporations Act* regarding shareholders' meetings are primarily aimed at ensuring that the will of the shareholders is reflected in the running of the company and that they have certain opportunities to acquire information regarding the affairs of the company. A meeting of a company's shareholders must be held for a proper purpose (s 249Q) and must be held at a reasonable time and place (s 249R).

ASX Listing Rules also impose requirements on listed companies for the holding of general meetings in certain situations. For example, shareholders must approve large share placements and major asset acquisitions and sales.

## Types of meetings

### Annual general meetings

#### *Requirement to hold AGM*

**[21.10]** Public companies must hold an annual general meeting (AGM). The first AGM must be held within 18 months after a company's registration: s 250N(1). Thereafter, an

AGM must be held at least once in every calendar year and within five months after the end of a company's financial year: s 250N(2). Default in holding an AGM is an offence of strict liability: s 250N(2A).

The requirement to hold an AGM once in every calendar year must be met even if other shareholders' meetings are held in that year: s 250N(3). A public company that has only one shareholder is not required to hold an AGM: s 250N(4).

Proprietary companies need not hold an AGM unless their constitution requires it.

A company may apply to ASIC for an extension of the period within which an AGM must be held: s 250P(1). The application must be made before the expiration of time during which the AGM was required to be held: s 250P(2). ASIC may extend the time for holding the AGM for a specified period and may impose conditions: s 250P(2) and (4). An extension will only be granted if, on balance, there is good cause to postpone an important right of shareholders to expect that an AGM will be held within the required time: *Exicom Ltd v Futuris Corp Ltd* (1996) 61 FCR 337.

|                     |
|---------------------|
| Order of the court. |
|---------------------|

A director or shareholder entitled to vote may apply to the court for an order that a general meeting, including an AGM, be called if it is otherwise impracticable to call the meeting in any other way: s 249G. It may be impracticable to call a meeting where there is management deadlock: *Skliros v Lefcadian Brotherhood Pty Ltd* [2003] FCA 865. The court may exercise its discretion by making any further orders it deems expedient: s 1319. These may include an order that one shareholder constitutes the quorum at the AGM or that a minority shareholder will not be removed as a director: *Limnios v Tambu Pty Ltd* (1995) 13 ACLC 278. The court may also extend the time within which a company must hold an AGM under s 1322(4)(d) which confers on the court a general discretion to extend the period for meeting any requirements under the *Corporations Act*. In *Re MDA National Ltd* [2014] FCA 1140, the court granted to a company an extension of time within which to hold its AGM due to the unusual circumstances arising from the need to call a further meeting to consider a merger, the resignation of the company's CEO and some directors, and the constitutional requirements for the appointment of new directors.

## Business of AGM

[21.15] The CAMAC discussion paper, *The AGM and Shareholder Engagement* (2012), identified four distinct functions of an AGM: reporting, questioning, deliberating and decision-making:

The AGM is a forum for:

- *reporting*: to inform shareholders about various financial and other matters concerning the company, principally through consideration of the annual report;
- *questioning*: to provide an opportunity for shareholders to ask questions or make comments on various matters, including the management of the company, the remuneration of directors and other senior corporate officers and the conduct of the company's audit;

- *deliberating*: to provide an opportunity for shareholders to discuss the matters on which they will be called to vote at the meeting; and
- *decision making*: to enable shareholders to vote (through binding or non-binding resolutions) on a limited range of matters at the AGM.

The CAMAC Discussion Paper is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

#### The usual business at AGMs.

Under s 250R(1), the business of an AGM may include any of the following matters even if these items are not referred to in the notice of meeting:

- consideration of the annual financial report, directors' report and auditor's report;
- election of directors;
- appointment of the auditor; and
- fixing the auditor's remuneration.

#### Non-binding vote on remuneration report of a listed company.

A listed company's directors' report must contain a remuneration report that sets out prescribed information about the remuneration paid to the directors and other key management personnel: s 300A(1). A non-binding shareholders' resolution on the remuneration report must be put to a vote at a listed company's AGM: s 250R(2). The notice of meeting must inform shareholders that the non-binding shareholders' resolution will be put at the AGM: s 249L(2). A "two-strikes and re-election" process gives shareholders the right to vote on a resolution requiring the directors to stand for re-election (known as a "spill") if resolutions on the remuneration report have received a "no" vote of 25 per cent or more at two consecutive AGMs. Where these circumstances arise, the notice of the AGM must state that there is a possibility that a "spill" resolution may be put to the shareholders at the AGM: s 249L(2). The remuneration report is discussed further at [12.305]–[12.310], and the non-binding vote and two strikes and re-election process is discussed further at [12.315].

According to s 317, the directors of a public company that is required to hold an AGM must lay the following reports before the AGM:

- the financial report;
- the directors' report; and
- the auditor's report for the last financial year.

The contents of these reports are described at [22.45].

Shareholders must be given a reasonable opportunity to ask questions or make comments regarding the company's management.

The chair of an AGM must allow a reasonable opportunity for the shareholders as a whole at the meeting, to ask questions or make comments regarding the management of the company: s 250S. At a listed company's AGM, the chair must also allow a reasonable opportunity for shareholders to ask questions about, or make comments on, the remuneration report: s 250SA. Section 250T gives shareholders a reasonable opportunity to direct questions to the auditor on matters relevant to the audit and auditor's report. Shareholders of a listed company (even if they do not attend the AGM) can also submit written questions to the auditor about the content of the auditor's report or the conduct of the audit: s 250PA. These questions must be given to the listed company no later than five business days before the AGM. The company is required to forward all the questions it has received to the auditor. The auditor must prepare a list of questions they have received that the auditor considers relevant to the content of the auditor's report or the conduct of the audit. The company must make this list available to shareholders who attend the AGM. Making the list available at the AGM highlights to shareholders possible areas of concern and may prompt them to ask further questions at the AGM. Under s 250T(1)(b), the chair of the AGM must allow a reasonable opportunity for the auditor or their representative to answer the written questions submitted under s 250PA.

An AGM may also deal with any other business allowed by the *Corporations Act* and the company's constitution.

Usually, directors set the agenda for a company's AGM and other general meetings. Consequently, the board controls the matters to be voted upon at shareholders' meetings. However, under s 249N, shareholders are given the right to require a company to put resolutions to be considered at a general meeting. This is discussed at [21.190].

## Extraordinary general meetings

**[21.20]** While the *Corporations Act* requires only public companies to hold an AGM, all companies may hold other general meetings of shareholders. A general meeting other than an AGM is often referred to as an extraordinary general meeting (EGM). If there is urgent business that requires shareholders to pass resolutions, an EGM may be called before the next AGM. For example, an EGM may be called to enable shareholders to vote on motions to replace one or more directors, change the company's constitution or, in the case of public companies, to approve giving a financial benefit to related parties as required by s 208. This is discussed at [16.40]–[16.80].

## Class meetings

**[21.25]** Where a company has different classes of shares, the *Corporations Act* provides for the calling of meetings of classes of shareholders in certain circumstances. As discussed at [8.155]–[8.195], the rights attaching to a class of shares may only be varied with the consent of the holders of three-quarters of the issued shares of that class. Usually, class meetings are held separately from general meetings of all shareholders: *Re Australian Consolidated Press Ltd* (1994) 117 FLR 451. Meetings of classes of shareholders may be called to initiate and approve a scheme of arrangement under s 411. A scheme may involve a re-organisation of share capital that affects the rights of holders of classes of shares in different ways. Schemes of arrangement are discussed at [29.155].



## Adjourned meetings

**[21.30]** Shareholders have the power to adjourn meetings. Under the replaceable rule in s 249U(4) the chair must adjourn a meeting if the shareholders present with a majority of votes agree or direct that the chair must do so. The chair may adjourn a meeting without shareholders' consent if the meeting becomes unruly or the venue is not large enough for all shareholders to attend and vote: *Byng v London Life Association Ltd* [1989] 1 All ER 560. Directors may also adjourn general meetings if the constitution gives them that right. However, directors cannot postpone a meeting: *Smith v Paringa Mines Ltd* [1906] 2 Ch 193.

Notice need not generally be given of adjourned meetings unless required by the company's constitution. However, s 249M requires new notice to be given if a meeting is adjourned for more than one month. Further, unless permitted by the constitution, once a notice of meeting has been sent specifying a particular time and place for the meeting, the meeting cannot be cancelled and another called in its place: *Bell Resources Ltd v Turnbridge Pty Ltd* (1988) 6 ACLC 970. The correct procedure in such cases is to convene the meeting on the date specified in the notice and then adjourn it.

A resolution passed at a meeting resumed after an adjournment is passed on the day of the resumed meeting and not on the date of the adjourned meeting: s 249W(1). The replaceable rule in s 249W(2) provides that only unfinished business is to be transacted at a meeting resumed after an adjournment.

## Calling meetings

### By directors

**[21.35]** The replaceable rules permit any director to call a meeting of the company's shareholders: s 249C. Company constitutions typically give this power to the board of directors. An individual director of a listed Australian company has the right to call a shareholders' meeting despite anything in the company's constitution to the contrary: s 249CA.

### At shareholders' request

**[21.40]** The directors of a company must call and arrange to hold a general meeting on the request of shareholders holding at least five per cent of the voting shares that may be cast at the general meeting: s 249D(1). The request must state any resolution to be proposed at the meeting and must be signed by the shareholders making the request: s 249D(2). The power to call a meeting is conferred on the directors collectively and they must pass a resolution that a meeting be called: *Mortimer v Proto Resources & Investments Ltd* [2015] FCA 654.

The directors must call the meeting within 21 days after the request is given to the company and the meeting must be held not later than two months after the request: s 249D(5). If the directors fail to call a meeting within 21 days after the request is given to the company, shareholders holding more than 50 per cent of the votes

of all shareholders who made the request may call and arrange to hold a general meeting: s 249E(1). The meeting must be held within three months after the request is given to the company: s 249E(2).

The company must assist shareholders to call the meeting by providing a copy of the register of shareholders to the shareholders requesting the meeting: s 249E(3). The company must pay reasonable expenses incurred by the shareholders in calling and arranging the meeting: s 249E(4). The amount of these expenses may be recovered by the company from the directors. A director is not liable where it can be shown that reasonable steps were taken to comply with s 249D: s 249E(5).

A meeting of shareholders must be held for a proper purpose.

A meeting of shareholders must be held for a proper purpose: s 249Q. A shareholders' meeting called to vote on resolutions to remove directors, elect new directors or to change the company's constitution are regarded as proper purposes under s 249Q. Provided the purpose of the meeting is proper, it is irrelevant that the shareholders requesting the meeting are motivated by ill will or self-interest: *NRMA v Scandrett* [2002] NSWSC 1123. Directors may validly refuse to call a general meeting requested by shareholders if the purpose of calling the meeting is to harass the company and its directors: *Humes Ltd v Unity APA Ltd* (1987) 5 ACLC 15. However, in the *Humes* case, the court held that a meeting is not improper just because a proposed resolution is likely to be defeated, causing inconvenience and expense to the company, its directors and majority shareholders.

Directors may also validly refuse to call a meeting requested by shareholders if its sole purpose is to pass a resolution that interferes with the directors' exclusive power to manage the company's business.

*NRMA v Parker* (1986) 6 NSWLR 517

**[21.45]** A member requested the calling of a general meeting. The proposed resolution purported to direct the board over a matter that NRMA's constitution exclusively vested in the directors. As this resolution could not effectively be passed by the members and this was the sole object of the meeting, it was held that the directors were entitled to refuse to act on the request. It is also improper for shareholders to propose a non-binding advisory resolution that purports to express their opinion on how directors should exercise their management powers.

The decision in *NRMA v Parker* was affirmed by the Full Court of the Federal Court in *Australasian Centre for Corporate Responsibility v Commonwealth Bank of Australia* [2016] FCACF 80.

## By shareholders

**[21.50]** Shareholders with at least five per cent of voting shares may also call a general meeting without first requesting the directors to call the meeting: s 249F. This right is

rarely invoked in practice because the shareholders calling the meeting must pay the incurred expenses.

Once a shareholder exercises the right to call and arrange to hold a general meeting under s 249F, the procedural rules set out in the *Corporations Act* and the company's constitution apply. The directors may postpone the meeting in accordance with the company's constitution where they act in good faith: *Pinnacle VRB Ltd v Ronay Investments Pty Ltd* [2000] VSC 330. Where the constitution authorises the directors to change the venue of a general meeting, they are able to change a meeting called under s 249F, which was convened at a physical venue, to a wholly online meeting: *Keybridge Capital Ltd v WAM Active Ltd* [2023] FCA 339.

## By court order

**[21.55]** The court has power to order that a meeting be called if it is impracticable to call a meeting in any other way. The application may be made by any director or shareholder entitled to vote: s 249G. The court may make an order under s 249G where there is management deadlock, inability to form a quorum or extreme inconvenience: *Jenashare Pty Ltd v Lemrib Pty Ltd* (1993) 11 ACLC 768.

*Re Totex-Adon Pty Ltd* [1980] 1 NSWLR 605

**[21.60]** The power of the court to order that a meeting of the company be called arose in this case. It was held to be “impracticable” to call a meeting because one of the two shareholders entitled to vote at meetings refused to co-operate in calling a meeting. It was ordered that a meeting be called and that the presence of one shareholder holding voting shares would constitute a quorum despite a provision in the constitution that required a quorum of two shareholders.

**[21.65]** The court will not usually exercise its discretion to call a meeting under s 249G where the procedure for calling a meeting in the ordinary course is set out in the replaceable rules and the company's constitution. Mere speculation as to what may occur at a meeting does not constitute impracticability: *Jenashare Pty Ltd v Lemrib Pty Ltd* (1993) 11 ACLC 768.

## Notice of meetings

**[21.70]** Shareholders must be given written notice of a forthcoming meeting. The purpose of the notice is to enable shareholders to know what business will be considered at the meeting so that they can decide whether to attend and how to vote. Where notice is given that particular business will be transacted at a meeting, no other business can be proceeded with unless all the shareholders are present and consent. A genuine amendment that comes within the scope of the business stated in the notice may be properly considered: *Efstathis v Greek Orthodox Community of St George* [1989] 1 Qd R 146.

Failure to give notice is a procedural irregularity. However, under s 1322, such irregularities are not invalidated unless a substantial injustice is caused. This is discussed at [21.200] onwards.

## Amount of notice

**[21.75]** As a general rule, notice of at least 21 days must be given of a meeting of a company's shareholders: s 249H. The constitution of a company may specify a longer minimum period of notice. Despite anything in the company's constitution, listed Australian companies must give at least 28 days' notice of shareholders' meetings: s 249HA.

Notice of the intention to move a resolution to remove a director or auditor, under ss 203D and 329, respectively, must be given to the company at least two months before the meeting is to be held. However, if the company calls a meeting after the notice of intention is given, the resolution may be passed even though the meeting is held less than two months after the notice is given: ss 203D(2) and 329(1A).

*Jervois Mining Ltd* [2016] NSWSC 1650

**[21.77]** The shareholders notified the directors that they proposed to move a resolution to remove them at the next AGM. Following receipt of the notice the directors set the date of the AGM so as to ensure that the shareholders failed to meet the requirement to give two months' notice. The shareholders then gave notice of an EGM at which the resolution would be put and sought permission from the court for the EGM to proceed at short notice. The court held that the shareholders' failure to meet the notice requirements was largely caused by calculated decisions of the directors to schedule the meeting on a date that was earlier than two months after the notice was given. The court was satisfied that the shareholders had acted honestly and that a declaration pursuant to s 1322 which had the effect of making the Notice of EGM valid, despite non-compliance with the time requirement, was just and equitable. Section 1322 is discussed at [21.200].

## Who must receive notice?

**[21.80]** Written notice of a meeting of shareholders must be given individually to each shareholder entitled to vote and to each director: s 249J(1). The replaceable rule in s 249J(2) provides that notice to joint shareholders must be given to the joint shareholder named first in the register of shareholders. An auditor is entitled to the same notice and to any other related communications that a shareholder is entitled to receive: s 249K.

Notice may be given personally, by post, fax or by electronic means (such as email) or any other means permitted by the company's constitution: s 249J(3). The replaceable rule in s 249J(4) provides that notice by post is taken to be given three days after posting. Notice by fax or email is taken to be given on the business day after it is sent.

## Shorter notice

**[21.85]** A company may call a meeting on shorter notice than 21 days if it obtains shareholder approval to do so. Section 249H(2) provides that if the meeting is an AGM, all shareholders entitled to attend and vote at the AGM must agree to the shorter notice

beforehand, while in the case of other general meetings the holders of at least 95 per cent of votes must agree beforehand.

Shorter notice is not allowed where the meeting is to consider a resolution to remove a director or appoint a replacement: s 249H(3). Similarly, shorter notice is not allowed where the meeting is to consider a resolution to remove an auditor: s 249H(4).

## Content of notice

**[21.90]** A notice of meeting of shareholders must include specified information under s 249L, including:

- place, date and time of meeting and the technology used to facilitate a meeting that is to be held at two or more places;
- if virtual meeting technology is to be used in holding the meeting, sufficient information to allow the shareholders to participate in the meeting by means of the technology;
- the general nature of the meeting's business;
- the intention to propose a stated special resolution, if any; and
- if a shareholder has a right to appoint a proxy, this must be stated as well as whether the proxy must be a shareholder. A shareholder must also be informed of the right to appoint two proxies and to specify the proportion of votes each proxy is appointed to exercise.

The information contained in the notice must be worded and presented in a clear, concise and effective manner: s 249L(3).

The requirement that a notice of meeting must contain an intention to propose a special resolution does not apply to circulating resolutions that are passed pursuant to s 249A: *Elders Forestry Ltd v Bosi Security Services Ltd* [2010] SASC 223. Section 249A allows for circulating resolutions of proprietary companies to be passed without the need to hold a meeting and is discussed at [21.175].

## Misleading information

**[21.95]** Directors have an obligation to ensure that the content of notices of meetings and accompanying explanatory documents sent to shareholders contains full and fair disclosure and is not misleading. This obligation is more significant where the directors have indicated how they propose to vote or have recommended to shareholders how they should vote. Where the information is misleading, the holding of the meeting may be restrained: *Chequepoint Securities Ltd v Claremont Petroleum NL* (1986) 4 ACLC 711. If the meeting is held, resolutions passed may be overturned.

The courts do not take a legalistic approach in determining whether the information is misleading. They judge it from the perspective of an ordinary shareholder who scans the documents quickly: *Devereaux Holdings Pty Ltd v Pelsart Resources NL* (1986) 4 ACLC 12.

Sometimes the need to make full and fair disclosure must be balanced against the need to avoid confusing the typical shareholders to whom it is directed.

*Fraser v NRMA Holdings Ltd* (1995) 55 FCR 452

**[21.100]** A complex proposal about which there were difficult questions of commercial judgment was put to a large number of shareholders, many of whom had little experience in dealing with shares or corporate re-organisations. The Full Federal Court considered that it was appropriate for the information provided to be selective and confined to matters that were realistically useful in the circumstances.

**[21.105]** Where a notice of meeting is accompanied by information that is false or misleading in a material respect or has omitted information that makes it misleading, an officer who furnishes the information may be guilty of an offence under s 1309.

Where directors issue a statement or furnish information in circumstances where opposing or dissenting directors are not given an opportunity to express their views or comments, a heavy onus is cast on the directors to ensure that the information is fair: *Browne v Panga Pty Ltd* (1995) 14 WAR 393.

While directors are not generally required to circulate the views of dissentient directors to shareholders, this may sometimes be an appropriate means of providing full information to shareholders to enable them to make a properly informed judgment: *Fraser v NRMA Holdings Ltd* (1994) 52 FCR 1.

## Proceedings at meetings

### Use of technology

**[21.110]** During the COVID-19 pandemic, temporary legislation was enacted permitting a company to conduct shareholders' meetings using virtual meeting technology instead of physical meetings. The *Corporations Amendment (Meetings and Documents) Act 2022* made the pandemic amendments permanent. Section 249R(c) was inserted and it allows a shareholders' meeting to be held using virtual meeting technology if that is permitted by the company's constitution. Shareholders' meetings may also be held at one or more physical venues (s 249R(a)) or at one or more physical venues and using virtual meeting technology (s 249R(b)).

A company holding a shareholders' meeting must ensure shareholders have a reasonable opportunity to participate in the meeting: s 249S(1). If a meeting is held at only one physical venue (whether or not it is also held using virtual meeting technology), it must be reasonable to hold the meeting at that physical venue: s 249S(4). If more than one venue is used, it must be reasonable to hold the meeting at the main physical venue as set out in the notice of meeting: s 249S(5). If more than one physical meeting is held, the technology used at each physical venue must be reasonable: s 249S(6). If the meeting is held using virtual technology, that technology must be reasonable and allow shareholders who are attending virtually the ability to ask questions and make comments: s 249S(7).

If a shareholder does not have a reasonable opportunity to participate in a meeting of shareholders held at one or more venues or virtually, the meeting will only be invalid on that ground if the court declares the meeting, or part of it, invalid. Such a declaration

will only be made if a substantial injustice has been caused and it cannot be otherwise remedied: s 1322(3A).

## Quorum

**[21.115]** A quorum is the minimum number of shareholders whose presence is necessary for a meeting to be able to validly transact business. The quorum for shareholders' meetings is set out in the company's constitution (if any) or the replaceable rules.

Under the replaceable rules, the quorum for a meeting of a company's shareholders is two and the quorum must be present at all times during the meeting: s 249T(1). A quorum is unnecessary for single shareholder companies. Resolutions of such companies are passed by the shareholder recording them and signing the record: s 249B.

In determining whether a quorum is present, proxies and body corporate representatives are counted. However, if a shareholder has appointed more than one proxy or representative, only one of them is counted: s 249T(2).

If a quorum is not present within half an hour after the appointed time of the meeting, it is adjourned to the time and place determined by the directors. If the directors make no such determination, the meeting is adjourned to a meeting at a later time: s 249T(3). The directors may specify the date, time and location of the resumed meeting: s 249T(3A). If the directors do not specify the date, the resumed meeting is adjourned to the same day in the next week: s 249T(3B)(a). If the resumed meeting's time is not specified, then the meeting is adjourned to the same time: s 249T(3B)(b). If a location is not specified, the resumed meeting is adjourned to the same location specified in the original notice of meeting: s 249T(3B)(c). If virtual technology was used in the original meeting, participation in the resumed meeting must be provided in the same manner as set out in the original notice of meeting: s 249T(3B)(d).

## Chairing meetings

**[21.120]** The chair is the person in charge of the meeting, with responsibility for ensuring that the meeting is properly conducted. Under the replaceable rules, the directors may elect an individual to chair shareholders' meetings: s 249U(1). The directors at a meeting must elect a person to chair the meeting if they have not previously done so prior to the meeting or if the previously elected person is not available for the meeting: s 249U(2). If the directors do not elect a chair for the shareholders' meeting or the chair is unavailable, the shareholders elect the chair: s 249U(3). The replaceable rule in s 250E(3) gives the chair a casting vote as well as any vote they have in their capacity as a shareholder

*Kelly v Wolstenholme* (1991) 9 ACLC 785

**[21.125]** The Supreme Court of New South Wales held that a chairman is a person who has control of a meeting. A person cannot merely say at a meeting that "I am the chairman" without actually exercising procedural control over it. Procedural control over the meeting involves nominating who is to speak, dealing with the order of business, putting questions to the meeting, declaring resolutions carried or not carried, asking for any general business and declaring the meeting closed.



**[21.130]** The chair of the meeting or the next meeting is required to sign the minutes of the meeting: s 251A(2).

*Corpique (No 20) Pty Ltd v Eastcourt Ltd (1989) 7 ACLC 794*

**[21.135]** The chair of the general meeting closed the meeting on legal advice that the proposed resolutions were not in compliance with the company's constitution. The resolutions sought to remove two directors, including the chair, and appoint two directors in their place. After closing the meeting, the chair and some other shareholders left the meeting. The remaining shareholders then purported to pass the resolutions. It was held that the chair was wrong in stating that he did not have the power to put the resolutions. However, he acted honestly and bona fide and was entitled to accept the legal advice given to him. In these circumstances it was not open to some of the shareholders to continue the meeting after other shareholders had left in reliance upon the decision of the chair.

**[21.140]** Shareholders may continue a meeting against the ruling of a chair if a lack of bona fides on the chair's part can be shown. This may arguably be the case where a chair disregards a motion of dissent or a no confidence motion. A chair cannot stop a meeting just because proceedings have developed in a way that the chair opposes.

## Voting

**[21.145]** Shareholders vote either by a show of hands or by a poll. In the case of a company with a share capital, a replaceable rule specifies that shareholders have one vote per person on a show of hands and one vote per share on a poll: s 250E(1). This is subject to any rights or restrictions contained in the company's constitution, which may confer weighted voting rights or diminished voting rights on certain members. Under the replaceable rules, a resolution put to a general meeting must first be decided on a show of hands unless a poll is demanded: s 250J(1).

For listed companies, voting on a poll, and not a show of hands, is required if the notice of meeting sets out an intention to propose a particular resolution, the company has given notice of a members' resolution under s 249N or a poll is demanded: s 250JA. A poll may be demanded by at least five members entitled to vote, members with at least 5 per cent of the votes that may be cast on the resolution or the chair: s 250L(1). The constitution may provide that fewer members or a lesser percentage of votes cast can demand a poll: s 250L(2). A poll may be demanded on any resolution: s 250K(1). The constitution may provide that a poll cannot be demanded on a resolution electing the chair of the meeting or the adjournment of the meeting: s 250K(2). A proxy may join in a demand for a poll: s 249Y(1)(c).

A declaration by the chair is conclusive evidence of the result of voting on a show of hands, provided that the declaration reflects the show of hands and the votes of the proxies received: s 250J(2).



A replaceable rule gives the chair the power to determine when and how the poll must be taken; however, a poll on the election of a chair or on the question of an adjournment must be taken immediately: s 250M.

Shareholders are generally entitled to exercise their voting rights in their own interests. This is subject to certain statutory rights conferred on shareholders. These are discussed in Chapter 24. Further, shareholders may enter into agreements whereby they bind themselves to vote in accordance with the directions of another person.

## Proxies

**[21.150]** Shareholders may wish to exercise their voting rights at general meetings, even if they are unable, or do not wish, to attend personally. A shareholder can do this by appointing an agent, known as a “proxy”, who is authorised to vote on behalf of the appointing shareholder. A proxy may be an individual or a body corporate: s 249X(1A). Shareholders of listed companies often appoint the chair or one of the other directors as their proxy.

### Who can appoint a proxy?

The rules regarding who can appoint a proxy are replaceable rules for proprietary companies and mandatory rules for public companies under s 249X. Under s 249X(1), a shareholder who is entitled to vote may appoint a proxy to attend and vote for the shareholder at a meeting. The reference to a proxy in s 249X(1) includes a person appointed under a power of attorney, provided the appointment complies with the requirements for appointment of a valid proxy. The power of attorney appointing the proxy may be irrevocable: *Cordiant Communications (Australia) Pty Ltd v The Communications Group Holdings* [2005] NSWSC 1005. The appointment may specify the proportion or number of votes that the proxy may exercise: s 249X(2). A shareholder holding two or more voting shares may appoint two proxies who may each exercise half the votes if the appointment does not specify the proportion of votes each proxy may exercise: s 249X(3).

A company must send out with the notice of meeting to shareholders entitled to appoint a proxy, a statement that the shareholder is entitled to appoint one or two proxies and, if two are appointed, to specify the proportion of votes each proxy is appointed to exercise: s 249L(1)(d).

### Rights of proxy.

A proxy has the rights of the appointing shareholder to speak at the meeting, to vote in accordance with the appointment and to join in the demand for a poll: s 249Y(1). The company's constitution may provide that a proxy is not entitled to vote on a show of hands: s 249Y(2). A proxy's authority to speak and vote at a meeting is usually suspended while the shareholder is present at the meeting. This reflects the common law view that a proxy is an agent of the appointing shareholder. By attending a meeting, the shareholder

impliedly revokes the appointment of the proxy. This can be made subject to a provision in the company's constitution that provides otherwise in relation to the effect that a shareholder's presence has on the authority of the proxy: s 249Y(3).

#### Proxy appointment forms.

If a company sends a shareholder a proxy appointment form for a meeting, it must send the form to all shareholders entitled to appoint a proxy: s 249Z.

To be valid, a proxy appointment form must be signed by the appointing shareholder and state the shareholder's name, the company's name, the proxy's name or position and the meetings at which the proxy may be used: s 250A(1). The required names need not strictly appear on the document appointing the proxy where they may be identified by reference to another document which is available to the parties concerned: *Cordiant Communications (Australia) Pty Ltd v The Communications Group Holdings* [2005] NSWSC 1005. An appointment does not need to be witnessed: s 250A(6). In *Fast Scout Ltd v Bergel* [2001] WASC 343, it was held that s 250A permits a company to send shareholders a pre-completed proxy form with the name of the proxy and filled-in voting boxes.

#### Receipt of proxy form by company.

The company must receive details of a proxy's appointment at least 48 hours before the meeting: s 250B(1). The company's constitution may reduce this period: s 250B(5). Prior lodgment gives the company time to investigate the validity of the proxy's appointment prior to the meeting. An appointment authority may be sent to the company's registered office by post or fax or to the company's electronic address. A company can also offer other electronic means for submission of proxy appointment forms: s 250B(3). A proxy form may be regarded as validly received by the company by other means apart from post, fax or email directly to the company. For example, in *Carson v Dynasty Metals Australia Ltd* [2011] FCA 621, the court held that a proxy form faxed to a director who passed it on to the company was validly received by the company.

The notice of meeting of a listed Australian company must specify a place for receipt of proxy appointments or sufficient information to allow members to send an appointment of proxy document to the company by means of an electronic communication such as email: s 250BA.

A person who is not entitled to vote as a shareholder may vote as a proxy for another shareholder in accordance with the appointment: s 250C(1).

#### Directed and open proxies.

When appointing a proxy, a shareholder may direct how the proxy should vote. This is referred to as a "directed proxy". The directed proxy need not vote on a show of hands, but if the proxy does so, the proxy must vote as instructed: s 250BB(1)(a). If the directed proxy is the chair of the meeting, the proxy must vote on a poll and must vote as directed: s 250BB(1)(c).

If the directed proxy is not the chair, the proxy need not vote on a poll, but if the proxy does vote, the proxy must vote as directed: s 250BB(1)(d). A shareholder may also appoint a proxy without specific voting instructions. This is referred to as an “open proxy” or undirected proxy. In such proxies, the person appointed has a discretion whether and how to vote on particular resolutions.

In *Campbell v Jervois Mining Ltd* [2009] FCA 401, a company sent blank proxy forms to shareholders with a statement that the chairman intended to vote undirected proxies in favour of resolutions to be put to the meeting. At the meeting the chairman changed his mind and voted the proxies against the resolutions. It was held that the chairman was able to change his mind as the statement sent to shareholders only indicated his intention at the time. Shareholders who submitted undirected proxies were directing the chair to vote as he saw fit at the meeting.

### *Whitlam v ASIC* [2003] NSWCA 183

[21.155] Whitlam, as chair of NRMA, was appointed by about 4,000 shareholders as their proxy with instructions to vote against a proposed resolution to increase the directors' remuneration. The rules applicable to the meeting required the proxy to sign the poll paper to constitute a valid vote. Whitlam omitted to sign the poll papers, which resulted in disenfranchising the shareholders who appointed him their proxy to vote against the proposed resolution. The New South Wales Court of Appeal held that despite this, Whitlam did not contravene the predecessor of s 250BB(1)(c). There was insufficient evidence to conclude beyond reasonable doubt that Whitlam's omission to sign was deliberate. Further, filling out and lodging poll papers was still a vote for the purposes of the predecessor of s 250BB(1)(c), even though the papers were unsigned. A director who acts as a proxy for members is not necessarily exercising a director's powers or discharging a director's duty. As a consequence, a contravention of s 250BB(1)(c) does not mean that the director also breached the statutory duties under ss 181 or 182.

[21.160] The s 250BB(1)(c) requirement that proxies vote as instructed applies only if the proxy is the chair. Other proxy holders do not have similar obligations and are not obliged to vote. Further, s 250BB(1)(d) appears to permit a non-chair proxy holder to “cherry pick” and choose to vote only those proxies with whose directions they agree. This effectively disenfranchises some shareholders and may influence the outcome of voting. Section 250BC is designed to prevent a non-chair proxy cherry picking. Under that provision, if the non-chair directed proxy does not attend the meeting or does not vote, the chair is taken to have been appointed as the proxy. Section 250BB(1)(c) then requires the chair to vote on a poll as directed.

Section 250BD prevents the chair or other key management personnel from voting undirected proxies given to them on resolutions connected with their remuneration. Such resolutions include shareholders' non-binding resolutions for the adoption of remuneration reports of listed companies under s 250R discussed at [12.315]. The *Corporations Act* makes it clear that the chair may vote undirected proxies for the non-binding remuneration resolution required under s 250R where expressly authorised by

the shareholder to do so even though the chair is a member or a closely related party of the key management personnel: s 250R(5).

Under a replaceable rule, a vote cast by a proxy will be valid even if the appointing shareholder has died, the appointment was revoked or the shareholder transferred the shares in respect of which the proxy was given unless the company received written notice of the matter before the meeting: s 250C(2).

A listed company must record in the minutes of a meeting, the total number of proxy votes exercisable by all proxies validly appointed and the number of proxy votes for, against and abstained on each resolution: s 251AA(1).

## Corporate representatives

**[21.165]** A company that owns shares in other companies may appoint an individual to exercise all the powers the body corporate could exercise at meetings of the shareholders, creditors or debenture-holders or relating to circulating resolutions or resolutions of one-shareholder companies: s 250D(1).

The appointment may set out restrictions on the representative's powers: s 250D(2). While more than one representative may be appointed, only one may exercise the powers of the body corporate at any one time: s 250D(3).

These provisions allow a corporate shareholder to have a physical presence at a meeting of shareholders. It is placed in the position of a natural person. In *Atkins v St Barbara Mines Ltd* (1997) 138 FLR 425, Ipp J distinguished between a proxy and corporate representative. A representative "is really a statutory example of an official acting as an organ of the company rather than as a mere agent". A proxy is an agent of the corporate shareholder. This distinction may be significant because it may mean that corporate representatives are not caught by the requirement under s 250B(1) and (2) to lodge documents appointing a proxy at least 48 hours before the meeting.

## Resolutions

### *Ordinary and special resolutions*

**[21.170]** There are different types of resolutions which reflect the importance of the motions being voted upon. Resolutions that require a simple majority vote in favour to be passed are called "ordinary resolutions". Ordinary resolutions are passed by a majority vote of the shareholders who are present and voting (in person or by proxy) at the particular meeting.

Special resolutions are passed by at least a 75 per cent majority vote.

Other matters may be more important and a resolution with respect to these matters may require a majority greater than a simple majority. A special resolution must be passed by at least 75 per cent of the votes cast by shareholders entitled to vote on the resolution: s 9.

The *Corporations Act* requires a company to pass a special resolution in certain circumstances such as where it seeks to modify or repeal its constitution under s 136(2) or where it wishes to reduce its capital by selective reduction: s 256C(2).

A special resolution of a class of shareholders must be passed before the rights of the holders of that class can be varied: s 246B.

The constitution of a company may provide that a special resolution is necessary in certain cases even though this is not required by the *Corporations Act*. In other cases, it is not open to a company to provide for a majority other than that specified in the legislation. For example, a company cannot alter its constitution by ordinary resolution in contravention of s 136(2).

Further, the constitution of a company or rules of an association may provide for a majority in excess of a simple majority other than a three-quarters majority. In *Alexander v Burne* [2015] NSWSC 345, the trust deed of a unit trust required a resolution by a majority vote of two-thirds of the “persons eligible to vote in respect of the resolution” approving a proposed merger of the unit trust’s business with another business. At a meeting held to consider the merger resolution, more than two-thirds of members present and voting at the meeting passed the resolution; however, the majority who voted at the meeting constituted less than two-thirds of all members. It was held that subject to a contrary meaning in the trust deed, the reference to special majority referred to those members who were present at the meeting rather than to all members. The situation is different in the case of a board or governing body where a majority or special majority is in reference to the entire membership.

If a special resolution is to be proposed at a shareholders’ meeting, the notice of that meeting must specify the intention to propose the special resolution and state the resolution: s 249L(1)(c). The holders of at least 95 per cent of the issued shares with the right to vote may agree to pass a special resolution with less than 21 days’ notice being given.

Certain resolutions must be lodged by a public company with ASIC within 14 days of their passing. These include documents or resolutions that vary or attach rights to shares: s 246F(3).

## *Resolutions without meetings*

### **Proprietary company circulating resolutions**

[21.175] A proprietary company with more than one shareholder may pass a resolution without holding a general meeting if all shareholders entitled to vote on the resolution sign a document containing a statement that they are in favour of the resolution: s 249A(2). This is referred to as a “circulating resolution”. Shareholders may sign separate copies of the document if the wording of the resolution and statement is identical in each copy: s 249A(3). The resolution is passed when the last shareholder signs: s 249A(4). Circulating resolutions cannot be used for resolutions to remove an auditor: s 329. Section 249A is not a replaceable rule. Therefore, it is not possible to remove or restrict the ability of shareholders to pass resolutions in this manner by an express provision in a constitution, contract or deed: *Elders Forestry Ltd v Bosi Security Services Ltd* [2010] SASC 223.

## One-shareholder companies

[21.180] A company with only one shareholder passes a resolution if the shareholder records the resolution and signs the record: s 249B. To be effective the signed resolution must strictly comply with the formalities of s 249B: *Sheahan v Londish* [2010] NSWCA 270. In that case the purported resolution was not expressed to be a resolution of the company, rather it was expressed to be an act of the sole member and therefore it did not comply with s 249B. Resolutions passed in accordance with s 249B must be recorded in the company's minute books: s 251A.

## The Duomatic principle

[21.185] A rule known as “the Duomatic principle” states that where all shareholders entitled to attend and vote at a general meeting of a company assent with full knowledge and consent to some matter that could have been carried into effect at a general meeting, that assent is as binding as a resolution in a general meeting would have been. It is open to all the shareholders to agree to disregard the formalities associated with the calling of a meeting.

According to *Bodikian v Sproule* [2009] NSWSC 599, the Duomatic principle does not enable shareholders to exercise a power that they do not have under the constitution. A broader approach was adopted in *Parker and Cooper Ltd v Reading* [1926] Ch 975 where the shareholders of a company informally ratified a debenture granted by the directors that was beyond their powers. The company was held bound by the unanimous ratification of the shareholders because the transaction was *intra vires* the company and was honest and for the benefit of the company. This doctrine does not operate where substantial rights are varied or where shareholders are not fully aware of the effect that the matter agreed to will have on their rights: *Herrman v Simon* (1990) 8 ACLC 1094. Only the consent of voting shareholders is required for such informal assent: *Re Duomatic Ltd* [1969] 2 Ch 365.

## Shareholders' resolutions and statements

[21.190] A company's board of directors usually sets the agenda for its AGMs and other general meetings. However, the *Corporations Act* recognises that minority shareholders also have the right to require the company to circulate their own proposed resolutions and statements.

In *Shareholder Participation in the Modern Listed Public Company: Final Report* (June 2000), CASAC explained that:

This gives them the opportunity to bring a matter to the attention of other shareholders and seek their support before they decide whether to attend the meeting or how to complete their proxies. This shareholder right may also act as a counterbalance to the right of the directors to circulate their views to shareholders at the company's expense.

Section 249N gives shareholders the right to require a company to put resolutions to be considered at a general meeting. Shareholders with at least five per cent of the votes that may be cast or at least 100 shareholders entitled to vote may give a company notice

of a resolution that they propose to move at a general meeting: s 249N(1). As discussed at [21.40]–[21.45], shareholders cannot require a resolution that interferes with the directors' management power to be put to the vote at a general meeting: *NRMA v Parker* (1986) 6 NSWLR 517. However, if a proposed resolution under s 249N does not interfere with the directors' powers, the directors are permitted to express an opinion on the proposed resolution and advise shareholders to vote against it: *Australasian Centre for Corporate Responsibility v Commonwealth Bank of Australia* [2015] FCA 785.

Shareholders' resolutions must be considered at the next general meeting occurring more than two months after the notice is given: s 249O(1). Notice of the resolution must be given to shareholders in the same way as notice of a meeting is given: s 249O(2).

Shareholders may require the company to circulate their own proposed resolutions and statements.

Under s 249P(1), a prescribed number of shareholders may request their company to distribute a statement to all shareholders about a proposed resolution to be moved at a general meeting or about any other matter that may properly be considered at a general meeting. Shareholders' associations and trade unions often use such statements to solicit shareholders for their proxies.

The company must distribute a copy of the statement to all shareholders in the same way it gives notice of a general meeting: s 249P(6). The company is responsible for the cost of distributing the statement to shareholders if it receives the statement in time to send it out to shareholders with the notice of meeting.

Under s 249P(2), the request to distribute a statement may be made by shareholders with at least five per cent of the votes that may be cast on a resolution or at least 100 shareholders who are entitled to vote at the meeting. A company need not comply with a request if the statement is more than 1,000 words long or defamatory.

## Minutes

**[21.195]** A company must keep minute books in which it records proceedings and resolutions of meetings of the company's members: s 251A(1)(a). Resolutions passed by members without a meeting must also be recorded: s 251A(1)(c). The minutes of listed Australian companies must also record details about votes cast by proxies: s 251AA.

Minutes must be kept that record the proceedings and resolutions passed at meetings: s 251A(1). Minutes must be recorded within one month and be signed within a reasonable time after the meeting by the chair of the meeting or the chair of the next meeting: s 251A(2). Where a resolution is passed without a meeting, the minutes must be signed by a director: s 251A(3).

The minute books must be kept at the company's registered office, principal place of business or another place approved by ASIC: s 251A(5). The recording and signing of a minute is evidence of the resolution or proceeding to which it relates unless the contrary is proved: s 251A(6).



Shareholders are entitled to inspect and request copies of the minutes of meetings of shareholders and the resolutions of shareholders passed without meetings: s 251B(1) and (2).

Section 253S, which was inserted into the *Corporations Act* by the *Treasury Laws Amendment (2021 Measures No 1) Act 2021* (Cth), allows the information in a company's minute book to be recorded in electronic form if it is reasonable to expect that the information would be readily accessible so as to be useable for subsequent reference.

## Irregularities

**[21.200]** Procedural irregularities are not invalidated unless the court is of the opinion that the irregularity has caused or may cause substantial injustice which may not otherwise be remedied by order of the court. In such cases, the court has power to declare the proceedings invalid: s 1322(2).

Examples of procedural irregularities include absence of a quorum and deficiency of notice or time.

*Bell Resources Ltd v Turnbridge Pty Ltd* (1988) 6 ACLC 970

**[21.205]** A resolution was passed reducing the number of directors. This was held to be a procedural irregularity because it had not been approved by the directors, the required notice had not been given and the nature of this item had not been specified in the notice as required by the articles. This caused substantial injustice because it deprived shareholders of notice of important and fundamental resolutions. The resolution was declared invalid under the equivalent of s 1322(2).

**[21.210]** The purpose of s 1322 is to enable the court to make orders in cases where the rights of shareholders or creditors are interfered with. The court must balance the real prejudice suffered by a shareholder against the prejudice to the company and other shareholders in considering whether to declare the proceedings invalid. The injustice must be real and not theoretical or insubstantial: *Re Compaction Systems Pty Ltd* [1976] 2 NSWLR 477.

Although “procedural irregularity” is given wide meaning, it does not extend to a failure to give notice to half the shareholders of a proposal to amend the company's constitution and to resolving to amend the constitution without the knowledge of those shareholders. The court could not validate such procedures under s 1322: *Jordan v Avram* (1998) 16 ACLC 867.

*Chew Investment Australia Pty Ltd v General Corp of Australia Ltd* (1988) 6 ACLC 87

**[21.215]** General Corp of Australia Ltd (GCA) called an EGM to consider resolutions required under ASX Listing Rules. Peppinck held proxies for 10 shareholders including Chew Investment Australia Pty Ltd (CIA). The chair, in contravention



of the company's constitution, rejected Peppinck's demand for a poll. It appeared that the resolutions would have been defeated on a poll. CIA sought orders under the predecessor of s 1322(2) declaring that the resolutions passed by the general meeting be declared invalid as there was an entitlement under the constitution to a poll. The court granted the application, as there was a clear injustice that prevented the exercise of voting rights, particularly because of the Listing Rule that required the resolutions to be passed and the fact that a poll would have resulted in the defeat of the resolutions.

**[21.220]** The procedure for a nomination of a person for election as a director at a general meeting of a company is not "a proceeding" within the meaning of s 1322(2). It is not a necessary part of an AGM to require nominations in advance: *Wesgo Ltd v Gabriel* (1991) 9 ACLC 1087.

Where a company accidentally omits to give notice to a person entitled to attend a meeting and the meeting is required to be held under the *Corporations Act*, or the legislation prescribes that particular notice must be given, or a shareholder does not have a reasonable opportunity to participate at a meeting held in more than one venue, the meeting is not invalidated unless the court so declares. An application for such an order may be brought by a shareholder who did not receive notice or by ASIC: s 1322(3) and (3A). These provisions enable minor irregularities to be disregarded.

Any interested person may apply to the court for an order declaring that any act or proceeding is not invalid by reason of a contravention of the *Corporations Act* or a provision of the corporation's constitution: s 1322(4)(a). A contravention of the *Corporations Act* is given a wide meaning and includes situations where the company, while not infringing the Act, fails to take advantage of a provision of the Act. In *Sheahan v Londish* [2010] NSWCA 270, a purported removal of a director was held to be invalid and as a result the appointment of an administrator was also invalid. The invalid appointment of the administrator fell within the meaning of a "contravention" for the purposes of s 1322(4).

The court may validate proceedings at meetings if the irregularity is essentially of a procedural nature and the parties to the contravention acted honestly or it is just and equitable that the order be made: s 1322(6).

It has been suggested that an order validating an irregularity will not be made where it involves a breach of the *Corporations Act* that constitutes a nullity and is rendered void. Irregularities will only be validated where the proceeding is voidable. This distinction depends on interpretation of the relevant section breached: *Harman v Energy Research Group Australia* [1986] WAR 123.

A broader approach was taken in *Abalcheck Pty Ltd v Pullen* (1990) 8 ACLC 1078, which held that s 1322 grants power "to validate something which otherwise would be completely and utterly void". This approach gives a wider operation to s 1322, which provides its own criteria in s 1322(6), rather than looking at the particular section that has been contravened: *Re Vanfox Pty Ltd* [1995] 2 Qd R 445.

## Tutorial questions

Mini-Me Ltd relies on the replaceable rules in the *Corporations Act*. The company's financial year is 1 July to 30 June the following year.

Advise the secretary of Mini-Me what needs to be done to organise the company's next AGM. What are the last legally permissible dates by which the various AGM steps must be taken?

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.
- For further corporations law links and material please refer to the Understanding Company Law website at <http://www.uclaw.com.au>.

## Chapter 22

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# Financial reporting and disclosure

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## Key points

- All companies must keep written financial records such as invoices, receipts and other documents of prime entry. A company's directors and its auditor are entitled to full access to the company's financial records to enable them to properly discharge their duties. ASIC also has the power to inspect a company's books and records. Shareholders do not have an automatic right to inspect a company's books and financial records.
- Companies other than small proprietary companies must prepare a financial report and a directors' report for each financial year. A small proprietary company need only prepare such reports as its shareholders or ASIC direct. Listed companies and other disclosing entities are also required to prepare half-year financial reports and directors' reports, as well as annual reports.
- The financial report comprises the financial statements, notes to the financial statements and the directors' declaration about the statements and notes.
- The financial statements, which must comply with accounting standards and give a true and fair view of the financial position and performance of the company, comprise a profit and loss statement, a balance sheet, a statement of cash flows and a statement of changes in equity.
- The directors' report must include general information about the company's operations and activities as well as the specific information prescribed by the *Corporations Act*.
- Listed entities must comply with continuous disclosure listing rules which require a notification to the ASX of any information concerning the company which could reasonably be expected to have a material effect on the company's share price.
- Companies other than small proprietary companies must send copies of their annual financial report, directors' report and auditor's report to their members by the prescribed deadline. These reports must also be lodged with ASIC.

## The purposes of the financial reporting requirements

**[22.05]** The financial reporting requirements in the *Corporations Act* require companies to disclose prescribed information about their business and financial position. Disclosure of such information enables a company's shareholders, potential investors and creditors to make informed decisions in relation to the company.

The financial reporting requirements of the *Corporations Act* vary depending on the type of company. Disclosing entities such as listed companies are subject to more detailed financial reporting obligations than other types of companies. Public and large proprietary companies are subject to greater financial reporting obligations than small proprietary companies. ASX listing rules impose additional disclosure obligations on listed companies.

This chapter deals with the financial reporting and disclosure requirements of the *Corporations Act*. There are various other provisions that also have the effect of requiring companies to disclose financial information in particular situations, for example:

- the fundraising provisions (discussed at [7.95]–[7.135]) require a company to disclose certain financial information if it offers its securities for issue; and
- under the takeovers provisions (discussed at [25.85]–[25.90]), both the bidder and the target must issue statements containing prescribed information.

**[22.10]** The disclosure of financial information by a company is primarily for the benefit of the shareholders. By receiving full, accurate information regarding the financial affairs of a company, its shareholders are able to assess the company's performance. This is recognised by s 314(1), which requires companies to report to members for a financial year by sending copies of the following:

- the financial report for the year;
- the directors' report for the year; and
- the auditor's report on the financial report.

The disclosure of financial information by a company is primarily for the benefit of the shareholders.

As a general rule, small proprietary companies are not required to prepare or provide the above reports unless ASIC or shareholders with at least five per cent of the votes, direct the company to do so: ss 293 and 294. However, under s 292(2)(c), a small proprietary company, that has one or more crowd-sourced funding (CSF) shareholders during a financial year, must prepare a financial report, directors' report and auditor's report.

**[22.15]** Other parties who may have an interest in disclosure of financial information include creditors, who may be concerned that a debtor company will be able to repay its debts and its financial position may be crucial in this regard. Potential shareholders and potential creditors often consider the financial position of a company before deciding whether to invest in, lend or extend credit to a company.

A sound disclosure regime serves the purpose of protecting members of the public from unduly risky investments made on the basis of inaccurate or incomplete information.

In broader terms, it is desirable for investment decisions, whereby scarce resources are allocated to, or withdrawn, from businesses, to be made on the basis of accurate information. Others who may be interested in the disclosure of financial information by a company include competitors, customers, security analysts, trade unions, wage-fixing bodies, securities exchanges, taxation authorities and various other government bodies.

Each of these users may have different needs regarding information in the financial reports, and there may be considerable variance in their understanding of financial information. This makes the task of formulating useful statutory requirements very difficult. However, certain core information is of value to diverse interest groups.

## Financial records

### Duty to keep financial records

**[22.20]** Under s 286(1), a company, registered scheme or disclosing entity must keep written financial records that:

- correctly record and explain its transactions and financial position and performance; and
- would enable true and fair financial statements to be prepared and audited.

The term “financial records” is defined in s 9 and includes invoices, receipts, documents of prime entry, working papers and other documents needed to explain the methods used to generate financial statements.

The obligation to keep financial records requires more than simply keeping the source materials (such as cashbooks, journals and ledgers) from which a set of documents of prime entry might be written up. The minimum books of account required by s 286 are a general ledger and general journal. Company transactions can only be properly explained by appropriate journal entries with clear explanatory narratives: *Van Reesema v Flavel* (1992) 10 ACLC 291.

ASIC’s information leaflet, INFO 76 *What Books and Records Should My Company Keep?*, provides guidance to directors about the financial records requirements. ASIC recommends that companies keep certain documents and records including:

- financial statements, such as profit and loss statements, balance sheets, depreciation schedules and tax returns;
- general ledgers and journals;
- cash records;
- bank account statements and loan documents; and
- sales and debtor records.

ASIC INFO 76 is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

The financial records must be retained by the company for at least seven years after the transactions covered by the records are completed: s 286(2). While the financial records may be kept in any language, if they are not kept in English, an English translation must

be made available within a reasonable time to a person who is entitled to inspect the records and asks for the translation: s 287. If the financial records are kept in electronic form, they must be convertible into hard copy: s 288.

The financial records may be kept in whatever location the company chooses: s 289(1). If financial records about particular matters are kept outside Australia, sufficient written information about those matters must be kept in Australia to enable true and fair financial statements to be prepared and ASIC must be notified of the place where the information is kept: s 289(2). ASIC may direct a company to produce specified financial records kept outside Australia: s 289(3).

## Consequences of non-compliance

**[22.25]** Directors are responsible for ensuring that the company complies with the financial records and financial reporting provisions of Pts 2M.2 and 2M.3 of the *Corporations Act*. Contravention of s 286 is a strict liability offence, and directors who fail to take all reasonable steps to comply with Pts 2M.2 and 2M.3 contravene s 344(1), a designated civil penalty provision under Pt 9.4B. Contravention of a civil penalty provision may result in a civil penalty order being imposed on the contravening director. The civil penalty provisions are discussed at [19.120]–[19.150].

A director will be regarded as having taken all reasonable steps to comply with the financial records provisions by ensuring the company employs competent staff and has appropriate procedures in place that define what the staff are required to do: *ASC v Fairlie* (1993) 11 ACLC 669.

Section 588E(4) provides that a company that fails to keep and retain financial records as required by s 286(1) or (2) is presumed to be insolvent for the purposes of:

- the s 588G director's duty to prevent insolvent trading; and
- the antecedent transactions provisions of ss 588FA–588FG.

These are discussed at [18.100]–[18.165] and at [32.475]–[32.595], respectively.

## Access to books and financial records

**[22.30]** As a general rule, shareholders have limited access rights to the company's books and financial records. The replaceable rule in s 247D provides directors may authorise a member to inspect the company's books. Members may also obtain authorisation by a resolution passed at a general meeting. As discussed at [24.440]–[24.470], a member may apply for a court order under s 247A to inspect the books of the company. The court will only grant such an order if it is satisfied that the applicant is acting in good faith and the inspection is made for a proper purpose.

Rights of directors to access the company's books and financial records.

To ensure that directors are fully informed so as to be able to properly discharge their duties, s 290(1) gives them a right of access to the financial records at all reasonable times. A director may be restrained from exercising this right of access only if it is

affirmatively established that the director intended either to misuse the information or that inspection would materially harm the company: *Deluge Holdings Pty Ltd v Bowlay* (1991) 9 ACLC 1486.

A director may also apply to the court for an order authorising a person acting for the director to inspect the financial records of the company: s 290(2). Under s 290(4), the court may limit the use that a person may make of information obtained during the inspection. This provision reflects the confidential nature of the financial records of a company and prevents such information being used against the interests of the company by competitors. The right to inspect the company's financial records under s 290 is confined to current directors.

Section 198F gives current directors a clear right to inspect the company's books (other than its financial records) at all reasonable times for the purposes of a legal proceeding to which a director is a party: s 198F(1). The right to inspect the books under s 198F is restricted to directors and does not authorise directors to act through an agent: *Oswal v Burrup Holdings Ltd* [2011] FCA 609. Section 198F does not enable a director to obtain information or to require the company to search for documents and have them, or extracts from them, produced: *Walden v Foodco Group Pty Ltd* [2009] NSWSC 45. Former directors have similar inspection rights which continue for seven years after they cease to be a director: s 198F(2).

A director's rights to inspect the financial records of the company under s 290(2) and to inspect the company's books under s 198F(1) are not automatic and may be denied where there are good reasons for doing so. For example, the right of inspection may be restricted where a receiver has been appointed and inspection would disrupt the activities of the receiver or divert human and financial resources away from the receiver's ability to realise the assets of the company: *Oswal v Burrup Holdings Ltd* [2011] FCA 609.

Both the company's auditor and a receiver also have a right of access to the company's financial records: ss 310 and 431. Auditors and receivers are discussed in Chapters 23 and 30, respectively. Sections 28–39A of the *ASIC Act* give ASIC the power to inspect a company's books and financial records.

# Annual financial reports

## Overview

[22.35] The table in s 285(1) provides an overview of annual financial reporting obligations.

Table 22.1: Overview of annual financial reporting obligations

| Annual financial reporting |                          |          |                                                                                                                                                                         |
|----------------------------|--------------------------|----------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                            | steps                    | sections | comments                                                                                                                                                                |
| 1                          | prepare financial report | s 295    | The financial report includes: <ul style="list-style-type: none"><li>• financial statements</li><li>• disclosures and notes</li><li>• directors' declaration.</li></ul> |



| Annual financial reporting |                                                                                                                          |                  |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
|----------------------------|--------------------------------------------------------------------------------------------------------------------------|------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                            | steps                                                                                                                    | sections         | comments                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              |
| 2                          | prepare directors' report                                                                                                | s 298            | Unless the report relates to a company limited by guarantee, it has a general component (ss 299 and 299A), a specific component (s 300) and a special component for listed companies (s 300A). See s 285A for an overview of the obligations of companies limited by guarantee.                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
| 3                          | have the financial report audited and obtain auditor's report                                                            | ss 301, 307, 308 | <p>A small proprietary company preparing a financial report because it has CSF shareholders only has to have an audit if it has raised a total equal or exceeding the CSF audit threshold from CSF offers.</p> <p>A small proprietary company preparing a financial report in response to a shareholder direction under s 293 only has to have an audit if the direction asks for it.</p> <p>There are similar rules for companies limited by guarantee (see s 285A for an overview).</p> <p>Under s 312, officers must assist the auditor in the conduct of the audit.</p> <p>ASIC may use its exemption powers under ss 340 and 341 to relieve large proprietary companies from the audit requirements in appropriate cases (s 342(2) and (3)).</p> |
| 4                          | provide the financial report, directors' report and auditor's report to members                                          | s 314            | Unless the report relates to a company limited by guarantee, a concise financial report may be provided to members instead of the full financial statements (s 314(1) and (2)). For deadline, see s 315(1)–(4). See s 285A for an overview of the obligations of companies limited by guarantee.                                                                                                                                                                                                                                                                                                                                                                                                                                                      |
| 5                          | lodge the financial report, directors' report and auditor's report with ASIC                                             | s 319            | For deadline, see s 319(3).                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
| 6                          | [public companies only] lay financial report, directors' report and auditor's report before annual general meeting (AGM) | s 317            | For the AGM deadline, see s 250N.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |

## Obligation to prepare annual financial report

**[22.40]** Section 292(1) requires a financial report and a directors' report to be prepared for each financial year by:

- disclosing entities;
- public companies;
- large proprietary companies; and
- registered schemes.

A small proprietary company's financial reporting requirements are discussed at [22.67].

## Contents

[22.45] According to s 295(1), a financial report for a financial year consists of:

- the financial statements for the year; and
- the notes to the financial statements; and
- the directors' declaration about the statements and notes.

### *Financial statements*

[22.50] Section 295(2) specifies that the financial statements for the year are the financial statements that are required by the accounting standards. Under Accounting Standard AASB 101 *Presentation of Financial Statements*, the following statements must be prepared:

- balance sheet;
- profit and loss statement;
- statement of changes in equity; and
- cash flow statement.

### *Consolidated financial statements*

[22.55] If required by the accounting standards, the financial statements in relation to a consolidated entity must include the requirements of the accounting standards: s 295(2)(b). Accounting Standard AASB 10 *Consolidated Financial Statements* requires an entity (the parent) that controls one or more other entities (subsidiaries) to present consolidated financial statements.

Whether a parent–subsidiary relationship exists depends upon whether the parent controls the subsidiary.

The determination of whether a parent–subsidiary relationship exists depends upon whether an entity *controls* another entity or entities. Under AASB 10, an investor controls an investee if, and only if, the investor has all of the following:

- Power over the investee. An investor has power over an investee when the investor has existing rights that give it the current ability to direct activities that significantly affect the investee's returns.
- Exposure, or rights, to variable returns from its involvement with the investee. This occurs when the investor's returns from its involvement have the potential to vary as a result of the investee's performance.
- The ability to use its power over the investee to affect the amount of the investor's returns.

Section 323 requires directors and officers of a controlled entity to supply all information that is necessary to prepare the consolidated financial statements and notes to those statements.

## *Notes to financial statements*

**[22.60]** Section 295(3) specifies that the notes to the financial statements are:

- disclosures required by the regulations; and
- notes required by the accounting standards; and
- any other information necessary to give a true and fair view.

## *Directors' declaration*

**[22.65]** A directors' declaration must be signed by the directors and be made in accordance with a resolution of the directors and specify on which date the declaration is made: s 295(5).

|                       |
|-----------------------|
| Solvency declaration. |
|-----------------------|

The directors' declaration must contain a solvency declaration that states whether, in the directors' opinion, there are reasonable grounds to believe that the company will be able to pay its debts as and when they become due and payable: s 295(4)(c). The solvency declaration required by s 295(4)(c) does not apply to directors of small proprietary companies, because, as discussed at [22.40], such companies are not obliged to prepare financial reports unless directed to do so by shareholders or ASIC. However, s 347A requires directors to pass a solvency resolution within two months after each review date for the company. The solvency resolution requirements of s 347A are discussed at [22.185].

|                     |
|---------------------|
| Other requirements. |
|---------------------|

As well as a solvency declaration, s 295(4) requires the directors' declaration to state:

- if the company has included notes to the financial statements, in compliance with the accounting standards, an explicit and unreserved statement of compliance with international financial reporting standards – that this statement has been included in the notes to the financial statements (s 295(4)(ca)); and
- whether, in the directors' opinion, the financial statement and notes are in accordance with the *Corporations Act*, including whether they comply with accounting standards and give a true and fair view (s 295(4)(d)); and
- in the case of a listed disclosing entity, whether the directors have been given the written and signed declarations by each of the CEO and CFO required under s 295A (s 295(4)(e)).

|                           |
|---------------------------|
| CEO and CFO declarations. |
|---------------------------|

Section 295A requires the CEO and CFO of a listed company to declare whether in their opinion, the financial records have been properly maintained in accordance with s 286, and the financial statements and notes comply with the accounting standards and give a true and fair view. Section 295A recognises that while directors have overall responsibility for the financial statements, the CEO and CFO, who are responsible for preparing those statements, must also turn their minds to the actual legal requirements and compliance with the accounting standards.

The declaration must be in writing, specify the date it is made and the capacity of the person making the declaration, and be signed by the person making it: s 295A(3). Generally, two declarations must be made unless one person occupies both positions. The CEO and CFO declarations do not derogate from the primary responsibility of directors to ensure the financial statements comply with the legislation.

In *ASIC v Healey* [2011] FCA 717, it was held that a management representation letter to the board from the CEO and CFO that merely acknowledged the directors' and management's responsibility for ensuring the company's financial statements complied with accounting standards and were true and fair was not a declaration of opinion for purposes of s 295A.

## Small proprietary companies

**[22.67]** A small proprietary company must prepare a financial report if it is directed to do so by shareholders entitled to at least five per cent of the votes: ss 292(2) and 293(1). The direction must be signed by the shareholders giving the direction: s 293(2)(a). A shareholders' direction must be made no later than 12 months after the end of the financial year concerned: s 293(2)(b). Under s 293(3), the direction may specify all or any of the following:

- that the financial report does not have to comply with some or all of the accounting standards;
- that the directors' report or a part of the report need not be prepared; and
- that the financial report is to be audited.

A small proprietary company must also prepare a financial report if ASIC directs it to comply with the annual financial reporting requirements: ss 292(2) and 294(1). ASIC's direction may be general or may specify the particular requirements that the company must comply with: s 294(2). ASIC's direction must specify the financial year concerned and the date by which the documents have to be prepared, sent or lodged: s 294(3) and (4).

A financial report and a directors' report must also be prepared by a small proprietary company if it is controlled by a foreign company, and it is not consolidated in the financial statements lodged with ASIC by a registered foreign company, a company, registered scheme or disclosing entity: s 292(2)(b).

A financial report and a directors' report must also be prepared by a small proprietary company if it has one or more CSF shareholders at any time during the financial year: s 292(2)(c).

## Australian financial reporting system

**[22.70]** The main objects of the Australian financial reporting system set out in s 224 of the *ASIC Act* are to facilitate the development of accounting and auditing standards. Accounting standards that require the provision of financial information should:

- allow users to make and evaluate decisions about allocating scarce resources;
- assist directors to discharge their obligations in relation to financial reporting;
- be relevant to assessing performance, financial position, financing and investment;
- be relevant and reliable;
- facilitate comparability; and
- be readily understandable.

The Australian financial reporting system seeks to facilitate the Australian economy by reducing the cost of capital, enabling Australian entities to compete effectively overseas and having accounting and auditing standards that are clearly stated and easy to understand. The financial reporting system aims to maintain investor confidence in the Australian economy including its capital markets.

The Australian financial reporting system comprises the Financial Reporting Council (FRC), discussed at [22.75]; the Australian Accounting Standards Board (AASB) discussed at [22.80]; and the Auditing and Assurance Standards Board (AUASB) discussed at [23.90].

### Financial Reporting Council

**[22.75]** The FRC is an advisory body with responsibility for the oversight of the Australian accounting standards setting process, as well as the auditor independence requirements and the auditing standard-setting process. The FRC's functions and powers were designed to ensure that while it had broad oversight of the standard-setting process, it would not be able to determine the content of particular standards. For example, the FRC does not have any direct influence over technical deliberation of the AASB and cannot veto any accounting standard made by the AASB.

Under s 225(1) and (2) of the *ASIC Act*, the FRC's functions include:

- providing broad oversight of the accounting and auditing standard-setting processes and giving the Minister reports and advice on the processes;
- appointing the members of the AASB, other than the AASB Chair (who is appointed by the Minister);
- approving and monitoring the AASB's priorities, business plan, budget and staffing arrangements;
- determining the AASB's broad strategic direction and giving the AASB directions, advice or feedback on matters of general policy and the AASB's procedures;
- monitoring the development of international accounting standards and the accounting standards that apply in major international financial centres; and

- monitoring the operation of accounting standards to assess their continued relevance and effectiveness in achieving their objectives in respect of both the public and private sectors of the Australian economy.

Under s 235A of the *ASIC Act*, FRC members are appointed by the Minister from nominations made by specified interest groups.

## Australian Accounting Standards Board

**[22.80]** The AASB formulates Australian accounting standards. Apart from the chair, who is appointed by the Minister, AASB members are appointed by the FRC: s 236B of the *ASIC Act*. Under s 227(1) of the *ASIC Act*, the functions of the AASB include:

- developing a conceptual framework for the purpose of evaluating proposed accounting standards and international standards;
- making and formulating accounting standards; and
- participating in the development of a single set of accounting standards for world-wide use.

In performing its functions, the AASB must follow the FRC's broad strategic and general policy directions: s 232. It must also take into account the advice and feedback on matters of general policy given by the FRC. However, the FRC does not have the power to direct the AASB in relation to the development or making of specific standards, nor does it have the power to veto standards formulated and recommended by the AASB: s 225(5) and (6). Further, when evaluating proposed accounting standards, the AASB must have regard to the interests of Australian corporations that raise or propose to raise capital in major international financial centres: s 227(2).

The AASB website contains information about the AASB, its standards, media releases, newsletters and publications and is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## Standards-setting framework

**[22.85]** Section 334 of the *Corporations Act* gives the AASB the power to make accounting standards for the purposes of the Act. The AASB also has the power to formulate accounting standards for other purposes, such as for the public sector and non-*Corporations Act* entities: *ASIC Act*, s 227(1)(c).

Section 227(4) of the *ASIC Act* also gives the AASB the power to make or formulate an accounting standard by issuing the text of an international accounting standard. The text of the international accounting standard may be modified to the extent necessary to ensure that any disclosure and transparency provisions in the standard are appropriate to the Australian legal or institutional environment.

Accounting standards are to be interpreted in a manner that promotes the s 224 objectives: *ASIC Act*, s 228. These objectives are set out at [22.70]. An accounting standard may be of general or limited application: *ASIC Act*, s 229(1). When making or formulating accounting standards, the AASB must have regard to the suitability of a proposed standard

for different types of entities: *ASIC Act*, s 229(2)(a). The AASB must also ensure that there are appropriate accounting standards for each type of entity that must comply with accounting standards: *ASIC Act*, s 229(2)(c).

Before making or formulating a standard, s 231(1) of the *ASIC Act* requires the AASB to carry out a cost/benefit analysis of the impact of a proposed accounting standard. A cost/benefit analysis is not required where the standard is being made or formulated by issuing the text of an international standard. The AASB is required to give the Minister details of a cost/benefit analysis if it is directed to do so: *ASIC Act*, s 231(4).

The Minister may, after receiving a report from the FRC, give the AASB a direction about the role of international accounting standards in the Australian accounting standards-setting system: *ASIC Act*, s 233.

## Australian accounting standards

**[22.95]** Accounting standards have legislative backing. The financial report of a company must comply with the accounting standards made by the AASB: s 296. A small proprietary company's financial report does not have to comply with particular accounting standards if the report is prepared in response to a shareholder direction under s 293, and the direction specifies that compliance is not necessary.

## True and fair view

**[22.100]** Under s 297, the annual financial statements and notes must give a true and fair view of the financial position and performance of the company. The term "true and fair view" does not have a precise meaning. Its interpretation has largely been left to the accounting profession. It is generally accepted that financial statements provide a true and fair view if they have been prepared in accordance with widely accepted contemporary accounting methods. If consolidated financial statements are required, these must also give a true and fair view of the financial position and performance of the consolidated entity. Section 297 does not affect the obligation for a financial report to comply with accounting standards. Additional information must be included in the notes to the financial statements if the financial statements and notes prepared in accordance with the accounting standards would not give a true and fair view: s 295(3)(c).

## Directors' reports

**[22.105]** Section 298(1) requires a company to prepare a directors' report for each financial year. The directors' report must include both general information about the company's operations and activities as required by s 299, as well as the specific information required by s 300. Directors' reports of listed companies must also meet the requirements of ss 299A and 300A and include a copy of the auditor's independence declaration under s 307C in relation to the audit for the financial year.

## General information

**[22.110]** Section 299(1) requires the directors' report to set out the following general information for a financial year:

- a review of the company's operations and the results of those operations;
- details of any significant changes in the company's state of affairs;
- the company's principal activities and any significant changes in the nature of those activities;
- details of any post-balance-date matter or circumstance that has significantly affected, or may significantly affect, the company's operations, results or state of affairs in future financial years;
- a reference to likely developments in the company's operations and expected results in future financial years; and
- if the company's operations are subject to any particular and significant environmental regulation, details of the company's performance in relation to environmental regulation.

The directors' report of a listed company or disclosing entity must also contain an operating and financial review (OFR) that enables shareholders to make an informed assessment of its operations, financial position, business strategies and future prospects: s 299A. An OFR is seen as an integral part of good corporate governance and financial reporting because it provides users of the financial reports with the directors' analysis of the company's business. ASIC regulatory guide RG 247 *Effective Disclosure in an Operating and Financial Review* assists directors in producing a useful and meaningful OFR. RG 247 discusses the overall principles that should guide the preparer of an OFR and indicates what information s 299A requires to be disclosed. The regulatory guide also sets out a number of good disclosure practices that may assist in producing an OFR. RG 247 is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## Specific information

**[22.115]** Section 300(1)–(9) requires the directors' report to set out a range of specific information for a financial year. Public companies, listed companies and registered schemes must also include the additional specific information listed in ss 300(10)–(13) and 300A. Table 22.2 highlights the specific information required.

**Table 22.2: Specific information required**

|                                                                                                                      |                                                    |
|----------------------------------------------------------------------------------------------------------------------|----------------------------------------------------|
| Dividends or distributions to members                                                                                | s 300(1)(a) and (b)                                |
| Directors' and officers' names and the names of the partners, directors and/or officers of the corporation's auditor | s 300(1)(c) and (ca)                               |
| Options over unissued shares                                                                                         | s 300(1)(d), (1)(e), (1)(f), (3), (5), (6) and (7) |
| Indemnities given and insurance premiums paid to officers or auditors                                                | s 300(1)(g), (8) and (9)                           |



|                                                                                                                                                                                                                                                                                                                                                                                        |           |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------|
| Public companies<br>– directors' qualifications, experience and special responsibilities<br>– attendance at board meetings<br>– attendance at committee meetings                                                                                                                                                                                                                       | s 300(10) |
| Listed companies<br>– directors' relevant interests in shares etc<br>– directors' rights or options over shares etc<br>– directors' contracts to call for shares etc                                                                                                                                                                                                                   | s 300(11) |
| Listed registered schemes<br>– directors' relevant interests in scheme interests<br>– directors' rights or options over scheme interests<br>– directors' contracts to call for scheme interests                                                                                                                                                                                        | s 300(12) |
| Registered schemes<br>– fees paid to responsible entity<br>– interests held by responsible entity<br>– issued interests<br>– withdrawals<br>– value of assets<br>– number of interests                                                                                                                                                                                                 | s 300(13) |
| Australian listed companies must prepare a remuneration report that has the following information<br>– discussion of board policy for determining remuneration of directors and other key management personnel<br>– discussion of relationship between such policy and company performance<br>– prescribed details of the remuneration of directors and other key management personnel | s 300A    |

## Continuous disclosure and disclosing entities

**[22.120]** Corporations and other entities that come within the Pt 1.2A definition of a “disclosing entity” are subject to an enhanced disclosure scheme. The basic aim of the scheme is to ensure that investors can make informed decisions about their investments in listed companies and other disclosing entities.

There are two main features of the enhanced disclosure scheme. There is a regime for ongoing or continuous disclosure of information that a reasonable person could be taken to expect would have a material effect on the price or value of a disclosing entity's securities. In addition, the enhanced disclosure scheme implements a system of periodic reporting under which disclosing entities are required to prepare and lodge half-year financial reports as well as end-of-year financial reports.

The implementation of the enhanced disclosure scheme resulted in a relaxation of the prospectus requirements for disclosing entities that satisfy certain criteria concerning their disclosure of information. This is discussed at [7.115].

## What is a disclosing entity?

**[22.125]** The enhanced disclosure scheme applies to disclosing entities. These include entities whose securities are listed on a financial market such as the ASX. A complex definition of “disclosing entity” is contained in Pt 1.2A, ss 111AA–111AX. Apart from ASX-listed entities, the effect of Pt 1.2A is that the following are also regarded as disclosing entities:

- entities that raise funds pursuant to a disclosure document lodged with ASIC under Ch 6D of the *Corporations Act*;
- entities that offer securities other than debentures as consideration for an acquisition of securities in a target company under an off-market takeover bid; and
- entities whose securities are issued under a compromise or scheme of arrangement.

## Half-year financial report and directors’ report

**[22.130]** Disclosing entities are required to prepare annual financial reports and directors’ reports: s 292(1)(a). In addition, a disclosing entity must prepare half-year financial reports and half-year directors’ reports: s 302. The half-year financial reports must be audited or reviewed. Copies of the half-year reports must be lodged with ASIC.

The half-year financial report consists of the half-year financial statements, notes to the financial statements and the directors’ declaration about the statements and notes: s 303(1). As is the case for annual financial reports, a half-year financial report must comply with accounting standards, and the financial statements must give a true and fair view: ss 304 and 305. The information that must be contained in the half-year directors’ report is not as extensive as is required for the annual directors’ report. Section 306 requires it to name the directors and provide a review of the entity’s operations during the half-year and the results of those operations.

## Continuous disclosure

**[22.135]** A disclosing entity is subject to the continuous disclosure provisions in Ch 6CA of the *Corporations Act*: ss 674–678. The continuous disclosure framework is designed to ensure a well-informed market leading to greater investor confidence. Continuous disclosure enhances the integrity and efficiency of capital markets by requiring timely disclosure of price or market sensitive information: *James Hardie Industries NV v ASIC* [2010] NSWCA 332. There are different disclosure requirements depending on whether the disclosing entity is a listed or unlisted disclosing entity. This is determined with reference to whether its securities are listed on a prescribed financial market: ss 111AL and 111AM. We are here concerned with listed disclosing entities.

## Listed disclosing entities

**[22.140]** Section 674(1) requires a listed disclosing entity to comply with the listing rules of a listing market which require the entity to notify the market operator of information about specified events or matters as they arise for the purpose of the operator making that information available to participants in the market. In the Australian context, this usually refers to the listing rules of the ASX.

### ASX Listing Rule 3.1.

In the case of ASX-listed disclosing entities, s 674(2) requires compliance with the continuous disclosure obligations of ASX Listing Rule 3.1. According to s 674(2)(c) and (d), a listed disclosing entity must notify the ASX information that:

- is not generally available; and
- is information that a reasonable person would expect, if it were generally available, to have a material effect on the price or value of the securities of the entity.

Listing Rule 3.1 provides that a listed company must immediately notify the ASX of any information concerning the company of which it is or becomes aware which is not generally available and which a reasonable person would expect to have a material effect on the price or value of the company's securities. ASX Listing Rule 3.1 is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

### Material information.

A company is deemed to be aware of material information when an officer of the company has, or ought reasonably to have, that information: ASX Listing Rule 19.12. Information required to be disclosed includes opinions about market sensitive matters that are not generally available, as well as opinions that an officer ought reasonably to have held by reason of facts known to the officer: *Crowley v Worley Ltd* [2022] FCAFC 33. In this case Worley overstated its expected net profit in a market release to the ASX and contravened its continuous disclosure obligations by later failing to notify the ASX that it did not have reasonable grounds for making its earnings guidance statement. It was held that certain senior executive officers of Worley had the information available to them to reasonably form the opinion that Worley had no reasonable basis to make the profit forecast, even though they did not actually form that opinion. Worley breached its continuous disclosure obligations as it was deemed to be aware of that information even though the board was not aware of it.

Even though Listing Rule 3.1 and ss 674 with 677 appear to have two tests for price sensitivity, the court in *Jubilee Mines NL v Riley* [2009] WASCA 62 held that the tests should be read together as the purpose of the legislation was to build upon and reinforce the Listing Rules rather than replace them.

### Price-sensitive information.

Section 677 explains that a reasonable person would be taken to expect information to have a material effect on the price or value of securities for the purposes of s 674(2)(d) if the information would, or would be likely to, influence persons who commonly invest in securities, in deciding whether to acquire or dispose of the securities. The reference to “reasonable person” in s 674 (2)(d) indicates that the element of materiality involves an objective inquiry: *ASIC v Big Star Energy Ltd (No 3)* [2020] FCA 1442. The fact that a company with an obligation to disclose might convince itself that information would not be expected to have a material effect on the price or value of its securities, does not answer the question whether the material was disclosable as required by s 674: *James Hardie Industries NV v ASIC* [2010] NSWCA 332.

The expression “commonly invest in securities” in s 677 covers both frequent investors and infrequent investors and embraces both sophisticated and unsophisticated investors including those who may have an occasional interest in investing: *Grant-Taylor v Babcock & Brown Ltd* [2016] FCAFC 60. To satisfy the “materiality” requirement in s 674 (2)(c), the information must be “non-trivial” and rise beyond information that merely “might” influence a decision by investors. This may involve balancing the probability that a particular event will occur and the potential impact of the event on the company’s business: *ASIC v Vocation Ltd* [2019] FCA 807.

Under ASX Listing Rule 3.1B, companies may be required to respond to media comment or market speculation when the ASX considers that these may create a false market in the company’s securities.

|                                     |
|-------------------------------------|
| Exceptions to ASX Listing Rule 3.1. |
|-------------------------------------|

Under Listing Rule 3.1A, there is no obligation to comply with Listing Rule 3.1 if all of the following are satisfied:

- The information is confidential and the ASX has not formed the view that the information has ceased to be confidential.
- A reasonable person would not expect the information to be disclosed.
- One or more of the following five situations applies:
  - It would be a breach of a law to disclose the information.
  - The information concerns an incomplete proposal or negotiation.
  - The information comprises matters of supposition or is insufficiently definite to warrant disclosure.
  - The information is generated for the internal management purposes of the company.
  - The information is a trade secret.

|                                |
|--------------------------------|
| How to disclose to the market. |
|--------------------------------|

ASX Guidance Note 8 assists listed companies in complying with Listing Rule 3.1. Price-sensitive information should be released through the ASX before being disclosed to analysts. The ASX considers that companies should make immediate disclosure upon

becoming aware that there will be a material change in revenue and profit for a financial period compared with the previous corresponding period, forecast projections in a prospectus or information previously provided to the market or consensus estimates made by analysts. The ASX recommends that companies place relevant information on their websites after disclosure to the ASX. Guidance Note 8 is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

Generally available information.

Information need not be disclosed if the information is “generally available”: s 674(2)(d). Section 676(2) explains that information is generally available for the purposes of s 674 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 in securities of a kind whose price or value might be affected by the information, and since it was so made known, a reasonable period for it to be disseminated among such persons has elapsed; or
- it consists of deductions, conclusions or inferences made or drawn from the above information.

In *Grant-Taylor v Babcock & Brown Ltd* [2016] FCAFC 60, it was held that it does not matter how many people actually observe the relevant information for it to consist of “readily observable matter” under s 676(2). “The test of whether material is readily observable is not whether the particular matter was actually observed but whether it could have been observed readily, meaning easily or without difficulty.”

Criminal liability.

Prior to the enactment of amending legislation in 2021, contravention of s 674(2) had both criminal and civil penalty consequences. Now, however, contravention s 674(2) only has criminal consequences. Failure to comply with ASX Listing Rule 3.1 is a criminal offence under s 674(2) to which the *Criminal Code* applies: s 678. A serious contravention of s 674(2) or a contravention which materially prejudices relevant parties enables the court to impose a maximum pecuniary penalty of 5,000 penalty units for an individual: s 1317G(3). For a body corporate the maximum pecuniary penalty is the greatest of 50,000 penalty units; and if the court can determine the benefit derived and the detriment avoided because of the contravention, three times that amount; and 10 per cent of the body corporate’s annual turnover up to a maximum of 2.5 million penalty units: s 1317G(4). In determining the pecuniary penalty, the court must take into account all relevant matters, including the nature and extent of the contravention, the nature and extent of any loss or damage suffered because of the contravention, the circumstances in which the contravention took place and whether the person has previously been found by a court to have engaged in similar conduct: s 1317G(6).

Civil penalties.

**[22.144]** Section 674A is a new financial services civil penalty provision under s 1317E, introduced in 2021 amendments. Section 674A is almost identical to the criminal liability provision contained in s 674(2) except that a listed disclosing entity's civil penalty liability only arises if the entity knows or is reckless or negligent with respect to whether the information is price sensitive: s 674A(2)(d).

A person involved in a listed disclosing entity's contravention of s 674A(2) also contravenes a civil penalty provision: s 674A(3). The person avoids civil penalty liability if the person can show that all reasonable steps were taken to ensure that the entity complied with its obligations under s 674A(2) and after doing so, the person believed on reasonable grounds that the entity did comply with its obligations: s 674A(4). The civil penalty provisions generally are discussed at [19.120]–[19.150], and the financial services civil penalty provisions are discussed at [26.345].

In August 2023, the government announced that it intended to review liabilities for failure to meet continuous disclosure obligations. The review report must be provided to the Treasurer by February 2024.

#### Shareholder class actions.

Section 674A was introduced because of the growth in the number of shareholder class actions, especially in relation to alleged contraventions of the continuous disclosure obligations and ASX Listing Rule 3.1. Such actions have been driven partly by the growth of the third-party litigation funding industry and the willingness of institutional investors to participate in the litigation. Often, the claims involved allegations that inaccurate financial forecasts were misleading or that new information should have been more quickly disclosed. The rapid growth of these class actions led to suggestions from director organisations that the continuous disclosure requirements were too demanding, especially in unpredictable times, and encouraged opportunistic litigation. Section 674A was introduced to limit the circumstances where a listed entity and its officers could be held liable for breaching the continuous disclosure civil penalty provision.

#### Market-based causation.

Civil liability may arise where a company contravenes its continuous disclosure obligations under s 674A(2), with the result that some shareholders acquired shares in the company at a higher price than would have been the case had the price-sensitive information been disclosed to the market. It has not been clearly established whether plaintiff shareholders in such circumstances would need to prove direct causation by showing that they actually relied on the contravening conduct. It was suggested in *Grant-Taylor v Babcock & Brown Ltd* [2015] FCA 149 that it may be sufficient for shareholders to show a contravention of s 674(2) artificially inflated the market price so as to lead to them suffering a loss and they would not need to establish that they directly relied on the contravening conduct. This is known as “market-based causation” and, while not yet conclusively accepted, has been put forward in cases involving misleading and deceptive statements under ss 728(1) and 1041H. These sections are discussed at [7.195] and [26.217], respectively.

## Infringement notices.

The infringement notice mechanism contained in Pt 9.4AA of the *Corporations Act* enables ASIC to issue a notice specifying a financial penalty to a person that ASIC believes has contravened the continuous disclosure provisions. An infringement notice is issued in cases involving less serious contraventions and presents an alternative to such cases being pursued in the courts. ASIC must first notify the entity of the nature of the case against it and the entity may give evidence and make submissions at a hearing. The size of an infringement notice penalty varies, depending on the type of provision. The maximum amount payable for most offences is half of the maximum pecuniary penalty payable for that offence: s 1317DAP(2)(a). For most civil penalty provisions, the maximum infringement notice penalty is 12 penalty units for individuals and 60 penalty units for corporations: s 1317DAP(2)(b).

The financial penalty specified in an infringement notice is significantly less than the maximum penalty that can be sought under the civil penalty provisions. Compliance with the infringement notice means that the person is not subject to further civil or criminal proceedings in relation to the contravention. Where a person fails to comply with the infringement notice, ASIC may bring civil penalty proceedings.

### *Unlisted and other disclosing entities*

**[22.145]** Sections 675(2) and 675A apply to unlisted disclosing entities and have similar effect to ss 674(2) and 674A discussed at [22.144]. Unlisted disclosing entities and disclosing entities listed on markets which do not have a continuous disclosure listing rule corresponding to ASX Listing Rule 3.1 must lodge a document containing the required information with ASIC. Section 675A(2) is also a financial services civil penalty provision operating in the same way as s 674(2) which applies to listed disclosing entities. Civil penalty liability is limited to situations where the unlisted disclosing entity was proven to have the requisite knowledge, recklessness or negligence: s 675A(2). There is also a corresponding accessorial liability provision where a person is involved in a disclosing entity's contravention of s 675A(3). A defence similar to that available in the case of listed disclosing entities is also available in the case of unlisted disclosing entities: s 675A(4). Contravention of the continuous disclosure obligations by a non-listed disclosing entity contained in s 675(2) is an offence to which the *Criminal Code* applies: s 678.

## **ASX Listing Rules and periodic disclosure**

**[22.150]** ASX-listed companies must also comply with the requirements for periodic disclosure set out in Ch 4 of the Listing Rules. ASX Listing Rule 4.10 sets out requirements in relation to the annual reports of listed companies that are additional to the *Corporations Act* requirements. These requirements include:

- a statement of the main corporate governance practices that the entity had in place (disclosure of corporate governance practices is discussed at [14.25]–[14.80]);
- the names of substantial shareholders and the number of securities in which each has an interest;

- the number of holders of each class of shares and the voting rights attaching to each class; and
- the names of the 20 largest holders of each class of shares and the number and percentage of capital held by each of them.

Listed companies are regarded as listed disclosing entities under s 111AL. As a result, they are required to prepare and lodge half-year financial reports with ASIC. In addition, ASX Listing Rule 4.2A requires listed companies to lodge half-year financial reports containing prescribed information with the ASX no later than two months after the end of a half-year period. Listed mining companies are required to lodge quarterly reports with the ASX.

As discussed at [26.60], compliance with the Listing Rules may be enforced by the courts.

The ASX Listing Rules are linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## Annual financial reporting to members

### Duty to report to members

**[22.155]** Section 314 requires a company, registered scheme or disclosing entity to report to members either by posting on a website or by sending them hard copies of:

- the annual financial report;
- the annual directors' report; and
- the auditor's report on the financial report.

The entity can choose which of the two methods of reporting it will use as its default method. Where the entity chooses to use its website as the default method, it must send hard or electronic copies of the reports to members who elect to receive copies in these forms: s 314(1AA)(a). Where it chooses to send hard copies as the default method, it may send electronic copies if the member has nominated that means as the one by which the member may be sent the reports: s 314(1AE)(b).

As an alternative to the above reports, members may be sent a concise report: s 314(1)(b). The concise report is intended to provide members with a summary of the company's financial position and prospects in a form that is more comprehensible to the average investor.

Under s 314(2), a concise report consists of a concise annual financial report drawn up in accordance with accounting standards and the full annual directors' report. A concise report must also include the auditor's statement that the financial report has been audited and the auditor's opinion on whether the concise financial report complies with relevant accounting standards. It must also include a copy of any qualification and emphasis of matter section of the auditor's report on the financial report.

Members who receive concise reports may request that they be sent, free of charge, the full financial report, directors' report and auditor's report: s 316(1)(b). The concise report



must indicate that members have this right: s 314(2)(e). Full or concise reports need not be sent if members so request: s 316(1)(a). Members' requests under s 316(1) may be standing requests or for a particular financial year: s 316(2).

Directors of a public company that is required to hold an AGM must lay the s 314 reports before its AGM: s 317. Public companies with only one member are not required to hold an AGM: s 250N. Section 318, which applies to borrowers in relation to debentures, requires copies of the reports to be sent to the trustee for debenture-holders before the deadline.

## Deadline for reporting to members

**[22.160]** There are different deadlines for sending members the annual financial reports depending upon the type of company or other entity. The following table highlights the various deadlines.

**Table 22.3: Deadlines for sending members annual financial reports**

| Type of entity                                                             | Deadlines                                                                                                                                         | Section  |
|----------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------|----------|
| Public companies and disclosing entities that are not registered schemes   | The earlier of:<br>(a) 21 days before the next AGM after the end of the financial year; or<br>(b) four months after the end of the financial year | s 315(1) |
| Small proprietary companies directed to report by shareholders under s 293 | The later of:<br>(a) two months after the date of the direction; or<br>(b) four months after the end of the financial year                        | s 315(2) |
| Registered schemes                                                         | Three months after the end of the financial year                                                                                                  | s 315(3) |
| Other proprietary companies                                                | Four months after the end of the financial year                                                                                                   | s 315(4) |

## ASIC lodgment of reports

**[22.165]** Companies, registered schemes or disclosing entities that are required to prepare or obtain reports under s 314 must lodge those reports with ASIC: s 319(1). This obligation also extends to concise reports.

Small proprietary companies that prepare reports in response to a direction from their shareholders or ASIC under s 293 or 294 are not required to lodge those reports: s 319(2). Companies must lodge their reports with ASIC within four months after the end of the financial year: s 319(3)(b). Disclosing entities and registered schemes must lodge their reports with ASIC within three months after the end of the financial year: s 319(3)(a).

Half-year reports of disclosing entities must be lodged with ASIC within 75 days after the end of the half-year: s 320.

## Updating ASIC database

**[22.170]** All companies are sent an Annual Statement provided by ASIC on the review date of each company. The Annual Statement includes an Extract of Particulars and review fee invoice.

The Extract of Particulars includes details recorded on ASIC's database such as:

- names and addresses of the company's officers;
- details of shares and options; and
- addresses of registered office and principal place of business.

The review date is generally the anniversary of registration of the company: s 345A. A company may apply to ASIC to change its review date: s 345B. If the information in the Extract of Particulars is correct, the company is required to pay the annual review fee (as at 1 July 2023, the fees are \$1,440 for public companies and \$310 for proprietary companies) within two months of the review date. It does not need to lodge further documents.

**[22.175]** Where changes have occurred that are not reflected in the Extract of Particulars, the company or its directors must notify ASIC of changes to the information within 28 days after the issue date of the Annual Statement: s 346C. Changes to company details must be notified to ASIC on Form 484 when they occur.

**[22.180]** ASIC may issue a Return of Particulars in certain circumstances: s 348A. These include where the review fee has not been paid on time, ASIC suspects the information on its database is incorrect or documents have not been lodged for more than a year.

## Solvency resolution

**[22.185]** A company's directors must pass a solvency resolution within two months of the review date unless the company lodged its financial report and directors' report with ASIC in the 12 months before the review date: s 347A. This requirement does not apply to directors of public companies and large proprietary companies that have lodged a financial report with ASIC. As discussed at [22.65], s 295(4)(c) requires the directors' declaration (one of the components of the financial report) of such companies to contain a solvency declaration.

Where directors pass a solvency resolution, notification to ASIC is not required. Where a negative solvency resolution is passed or no solvency resolution is passed, ASIC must be notified by Form 485: s 347B.

Payment of the review fee is taken to mean that the company has represented to ASIC that it is solvent as at the end of the two-month period after its review date: s 347C.

## Notification of proprietary company changes

**[22.190]** Proprietary companies must notify ASIC within 28 days of changes to:

- issued shares including total number, classes of shares and amounts paid and unpaid (s 178C);
- the particulars in the register of members regarding the top 20 members, including name and address, increase or decrease in the number of shares held and any new members (ss 178A and 178B); and
- their ultimate holding company (ss 349A–349D).

## ASIC exemptions and modifications

**[22.195]** Sections 340 and 341 give ASIC the power to make specific exemption orders and class orders relieving a specific company or class of companies from compliance with the financial records and financial reporting requirements of Pts 2M.2, 2M.3 and 2M.4 of the *Corporations Act*. Such orders can be made on the application of the directors, the company or its auditor. Before making an order, s 342(1) specifies that ASIC must be satisfied that compliance with the relevant provisions would:

- make the financial report or other reports misleading;
- be inappropriate in the circumstances; or
- impose unreasonable burdens.

## Consequences of contravention

**[22.200]** Directors contravene s 344(1) if they fail to take reasonable steps to comply with or secure compliance with the financial records and financial reporting provisions of Pts 2M.2 and 2M.3 of the *Corporations Act*. In *ASIC v Healey* [2011] FCA 717, the directors of the Centro group of companies were found to have contravened s 344(1) by approving the annual reports of two of the companies in the group which failed to disclose significant matters. Middleton J stated that one report:

failed to disclose some \$1.5 billion 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 billion that had been given after the balance date. In the case of (the other company), the 2007 annual report failed to disclose some \$500 million of short-term liabilities that had been classified as non-current.

The court also held that the Centro directors contravened their s 180(1) duty of care and diligence. This aspect of the case is discussed at [17.115].

Section 344(1) is a designated civil penalty provision, and the provisions of Pt 9.4B of the *Corporations Act* apply and provide for civil penalty consequences of breaching the section. Contravention of s 344(1) is a criminal offence if the contravention is dishonest: s 344(2).

The consequences of contravening the civil penalty provisions are discussed at [19.120]–[19.150].

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.
- For further corporations law links and material, please refer to the Understanding Company Law website at <http://www.uclaw.com.au>.

## Chapter 23

# Auditors

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## Key points

- The function of an auditor is to carry out an audit of a financial report and express an opinion as to whether it complies with relevant provisions of the *Corporations Act*, appropriate financial reporting standards and gives a true and fair view of the company's financial operations.
- Public companies and large proprietary companies must have an independent auditor. Small proprietary companies need only appoint an auditor and have their annual financial reports audited if they have one or more crowd-sourced funding (CSF) shareholders and raised more than \$3 million from all CSF offers made.
- An auditor's duties to a company arise under the contract of appointment and various provisions of the *Corporations Act*. The main duties of an auditor include duties to:
  - detect and report defects and irregularities;
  - be independent; and
  - use reasonable care and skill.
- An auditor may be liable in negligence to users of the audited accounts, including shareholders and creditors. The extent of this liability has been restricted to certain situations where there is a relationship of proximity between the auditor and a third party.

## Function of auditors

**[23.05]** The function of an auditor is to carry out an audit and present a reliable, independent report on a company's financial reports. According to Auditing Standard ASA 200, the overall objectives of an auditor are:

- to obtain reasonable assurance about whether the financial report as a whole is free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial report is prepared, in all material respects, in accordance with an applicable reporting framework; and
- to report on the financial report and communicate as required by the Australian Auditing Standards, in accordance with the auditor's findings.

An audit is the main external check on the integrity of the financial statements. In a broad sense, this independent verification of the financial statements aims to enhance the efficiency of the capital markets by helping to provide better-quality information and reducing information risk. The report *Independence of Australian Company Auditors* (October 2001) (the Ramsay Report) stated that “audited financial statements are an important part of the financial information that is available to the capital markets and an important part of effective corporate governance”. The Ramsay Report is on the Centre for Corporate Law and Securities Regulation website and is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

To ensure that the functions of an auditor can be properly carried out, s 310(a) provides an auditor with a right of access to the company's books at all reasonable times. An auditor may require any officer to provide information, explanations or other assistance for the purpose of the audit or review: s 310(b). An auditor who audits or reviews a financial report that includes consolidated financial statements has similar rights of access, information and assistance in relation to the books and officers of any controlled entity: ss 323A and 323B.

## When must an auditor be appointed?

### Statutory requirements

**[23.10]** Directors of public companies must appoint an auditor within one month after the company is registered unless the members appointed one at a general meeting: s 327A(1).

Under s 327A(2), the initial auditor holds office until the company's first annual general meeting (AGM). A public company must appoint an auditor at its first AGM: s 327B(1)(a). A public company must also appoint an auditor to fill any vacancy in the office of auditor at each subsequent AGM: s 327B(1)(b). Auditors appointed at an AGM hold office until death, removal or resignation: s 327B(2).

Small public companies limited by guarantee are exempted from the need to appoint and retain an auditor. This is discussed at [3.20] and [23.95].

The directors of a proprietary company may appoint an auditor if one has not been appointed by the company in general meeting: s 325. Small proprietary companies that do not have crowd-sourced funding (CSF) shareholders are not required to appoint

an auditor unless either the ASIC or shareholders holding at least five per cent of the votes direct the company to prepare an audited financial report: ss 293(3)(c) and 294. Small proprietary companies that have one or more CSF shareholders during a financial year must appoint an auditor if they raised more than \$3 million from all CSF offers made: s 325(2). CSF is discussed in Chapter 7 at [7.210]–[7.215].

## Audit relief for large proprietary companies

**[23.15]** ASIC may make exemption or class orders in respect of a specific company or specified class of companies, relieving them of the need to comply with certain financial reports and audit requirements contained in Ch 2M. To grant relief ASIC must be satisfied that complying with the relevant legislative audit requirements would be misleading, inappropriate to the circumstances of the company or would impose an unreasonable burden: s 342(1). ASIC Regulatory Guide RG 115 *Audit Relief for Proprietary Companies* sets out ASIC's policy in relation to the unreasonable burden criterion.

## Who may be an auditor?

### Registration requirements

**[23.20]** A company auditor may be an individual, a partnership firm or a company: s 324AA. The *Corporations Act* aims to ensure that auditors are competent by requiring them to meet certain education and practical experience requirements before they can be registered as company auditors. Individuals cannot act as auditors unless they are registered company auditors: s 324BA. Equivalent registration requirements in the cases of audit firms and companies are set out in ss 324BB and 324BC.

Auditors must be registered by ASIC.

An application to ASIC must be made for registration under s 1279. To be registered, an applicant must satisfy ASIC that they are capable of performing the duties of an auditor and are otherwise a fit and proper person to be registered as an auditor: s 1280(2)(c). As well as achieving the education requirements set out in s 1280(2A) and (2B), ASIC must be satisfied that applicants have either:

- satisfied all the components of an ASIC-approved auditing competence standard (s 1280(2)(b)(i)); or
- prescribed practical experience in auditing (s 1280(2)(b)(ii)).

Under the s 1280(2A) and (2B) education requirements, an applicant is required to hold a qualification from a prescribed university and to have passed examinations in accountancy and commercial law courses including auditing and company law.

### Authorised audit companies

**[23.25]** A company may apply to ASIC for registration as an authorised audit company: s 1299A.



A company may apply for registration as an authorised audit company.

A company is eligible for registration as an authorised audit company if the requirements contained in s 1299B are met. These include each of the directors is a registered company auditor, registered company auditors must hold a majority of voting shares, and the company has adequate and appropriate professional indemnity insurance to meet claims in relation to its audit activities.

## Lodgment of annual statement

**[23.30]** Registered company auditors must lodge an annual statement with ASIC setting out prescribed information: s 1287A. The required information includes the auditor's personal particulars and details of the nature and complexity of major audit work undertaken by the auditor.

## Cancellation and suspension of registration

**[23.35]** The cancellation and suspension of registration of auditors is governed by ss 1290–1298. Under these provisions, the Companies Auditors Disciplinary Board (CADB), on an application by ASIC or the Australian Prudential Regulation Authority (APRA), has the power to hold hearings and decide whether to cancel or suspend the registration of an auditor.

Section 1292(1) sets out the grounds for cancellation or suspension of the registration of auditors. These include failing to lodge an annual statement under s 1287A, failing to properly carry out the duties of an auditor or ceasing to have the necessary practical experience where audit work had not been carried out in the previous five years.

CADB also has the power to impose penalties in addition to or as an alternative to cancellation or suspension of registration: s 1292(9). These additional penalties include:

- admonishment or reprimand; and
- requiring the auditor to give an undertaking to engage in, or refrain from engaging in, specified conduct.

## Disqualification

**[23.40]** Persons who are disqualified from managing corporations under Pt 2D.6 of the *Corporations Act* cannot obtain registration as an auditor: s 1280(3). Part 2D.6 is discussed at [12.185]–[12.240]. Further, under s 1287, if a registered auditor is disqualified from managing corporations under Pt 2D.6, that auditor must provide ASIC with particulars of the circumstances by reason of which they were disqualified within three days of the disqualification.

## Auditor independence

**[23.45]** Auditor independence became a major corporate governance issue in the wake of several corporate collapses in 2001, most notably HIH Insurance in Australia, and

Enron in the United States. The report *Independence of Australian Company Auditors* (October 2001) (the Ramsay Report) was a response to these events. The report considered that the independence requirements of auditors had not kept pace with developments such as the growth of large international accounting firms and the growth of non-audit and consultancy services provided by them. This report made several recommendations concerned with strengthening auditor independence, including a considerable expansion of the circumstances which were indicative of a lack of independence. These recommendations formed the basis of the auditor independence provisions of the *Corporations Act*. The Ramsay Report is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

The importance of auditor independence.

The Parliamentary Joint Committee on Corporations and Financial Services, *Regulation of Auditing in Australia: Final Report* (November 2020) stated:

With regard to auditor independence, both real and perceived, the committee reiterates its view... that auditor independence is a key determinate of a robust audit regulatory framework and crucial in the process of building trust, confidence and stability in capital markets.

The main elements of the auditor independence provisions are:

- a general auditor independence requirement;
- a requirement that auditors make an annual declaration that the independence requirements of the *Corporations Act* and professional conduct codes have been complied with;
- restrictions on specific employment and financial relationships between auditors and their clients;
- the imposition of mandatory waiting periods before auditors may join an audit client as a director or senior manager;
- compulsory rotation of auditors, generally after five years;
- the assumption of responsibility by the Financial Reporting Council (FRC) to oversee the auditor independence requirements; and
- a requirement for listed companies to disclose in their directors' report the fees paid to the auditor for non-audit services and the nature of such services. Directors must also state whether they are satisfied that the provision of such services does not compromise auditor independence.

This Committee made a number of recommendations to strengthen auditor independence, which included:

3. The Financial Reporting Council, in partnership with ASIC oversee the introduction of Australian standards that establish defined categories and associated fee disclosure requirements in relation to audit and non-audit services. In addition, to establish a list of non-audit services that audit firms are explicitly prohibited from providing to an audited entity.

4. Amending the *Corporations Act* to so that an auditor's independence declaration is expanded to require the auditor to specifically confirm that no prohibited non-audit services have been provided.
5. The Accounting Professional and Ethical Standards Board should revise its Code of Ethics to include a safeguard that no audit partner can be incentivised, through remuneration advancement or any other means or practice, for selling non-audit services to an audited entity.

The Parliamentary Joint Committee on Corporations and Financial Services, *Regulation of Auditing in Australia: Final Report* is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## General independence requirement

[23.50] Section 324CA sets out the general requirement for auditor independence in the case of an individual auditor or audit company. An individual auditor or an audit company contravenes s 324CA(1) if they engage in audit activity while a conflict of interest situation exists of which they are aware. This provision is also contravened where the auditor or the audit company does not take all reasonable steps to ensure that the conflict of interest ceases as soon as possible: s 324CA(1)(d). The general requirement for auditor independence also applies to members of an audit firm and directors of audit companies: ss 324CB and 324CC. The purpose behind these provisions is to encourage a culture of compliance by the whole audit firm or company and encourage the establishment and maintenance of adequate internal control systems so as to prevent a breach of the independence requirements.

Conflict of interest situation.

Section 324CD(1) defines the term “conflict of interest situation”.

It is taken to exist where the auditor, or a professional member of the audit team, is not capable of exercising objective and impartial judgment in relation to the conduct of the audit of the audited body. A conflict of interest situation also exists where a reasonable person, with full knowledge of all relevant facts and circumstances, would conclude that the auditor, or a professional member of the audit team, is not capable of exercising objective and impartial judgment in relation to the conduct of the audit of the audited body.

In determining whether a conflict of interest situation exists, regard must be had to circumstances arising from any relationship between the auditor and audited entity. A contravention of s 324CA also occurs where a conflict of interest situation exists even though an individual auditor, audit firm or audit company was not aware of the existence of the conflict of interest situation but they would have been aware had a quality control system been in place which was reasonably capable of making them aware of the existence of the conflict of interest: s 324CA(2), (4) and (5).

The obligations imposed by s 324CA are in addition to any other obligations imposed by other provisions of the *Corporations Act* or code of professional conduct: s 324CA(6).

## Specific independence requirements

**[23.55]** There are further detailed specific requirements for auditor independence applicable to individual auditors (s 324CE), audit firms (s 324CF) and audit companies: s 324CG. Each of these sections includes a table that identifies the specific auditor independence requirements applicable to each of the persons listed in the table. These tables refer to a list of relevant relationships between an auditor and the audited body set out in s 324CH(1). The impermissible relationships are determined by reference to these various tables.

Restrictions on employment and financial relationships between auditor and audit client.

The effect of this complex legislative scheme is to restrict specific employment and financial relationships between an auditor and audit client.

Examples where the auditor independence requirements are contravened include where:

- an individual auditor is an officer or audit-critical employee of the audited body, being in a position to affect the efficacy or the conduct of the audit;
- a service company or trust acting on behalf of an individual auditor holds an investment in an audited company; or
- a person who is a non-audit services provider has significant investments in the audited body.

The auditor independence restrictions extend to a former owner of the individual auditor's business or former professional employee of an auditor. Similar legislative restrictions apply to audit firms and audit companies. The impermissible relationships set out in s 324CH(1) fall into the two broad categories of employment (items 1–9) and financial (items 10–19) relationships. The restrictions on employment relationships do not apply to small proprietary companies.

Examples of impermissible relationships include where an auditor has an interest in an investment in the audited body or has made a loan to or from the audited body.

## Prohibition on retiring partners becoming officers

**[23.60]** Section 324CI implements a recommendation of the HIH Royal Commission which found that former partners of HIH's auditor became directors of the company soon after leaving the audit firm. This was seen as compromising the independence of the auditor engaged in the audit of a company of which former partners were directors or senior officers and could be seen as exerting some influence over members of the audit team.

A person who was a partner of an audit firm or director of an audit company which was engaged in an audit of an audited body is prohibited from becoming an officer of the audited body for a period of two years after the date of the last audit in which the partner or director participated: s 324CI. A similar two-year waiting period restriction also applies to any person who was a professional employee of an audit company engaged in an

audit of an audited body if that person was a lead auditor or review auditor for the audit: s 324CJ.

Where a person becomes an officer of a company and that person was a partner in an audit firm or director of an audit company at the time that it was the auditor of the company, details must be disclosed in the directors’ report: s 300(1)(ca).

### Prohibition on multiple partners becoming directors

**[23.65]** Section 324CK prohibits any more than one former partner of an audit firm or director of an audit company being an officer of an audited body or related entity within a five-year period after ceasing to be a partner or director of the audit firm or company. This provision adopts a recommendation of the HIIH Royal Commission, which found that several former audit partners had become officers of HIIH and this resulted in a perception that the auditor was not independent of HIIH. This provision does not apply where the audited body is a small proprietary company.

### Auditor independence declaration

**[23.70]** An individual auditor must sign and give to the directors of the audited entity a written declaration that, to the best of the individual auditor’s knowledge or belief, there have been no contraventions of the auditor independence requirements in relation to the audit or review and no contraventions of any applicable codes of professional conduct: s 307C(1). An auditor is not required to report inadvertent breaches of the auditor independence requirements where a statutory defence under s 324CE(4), 324CF(4) or 324CG(4) would be applicable: s 307C(5B).

In the case of an audit firm or audit company, the lead auditor must sign and give the auditor’s independence declaration: s 307C(3). A copy of the declaration made under s 307C must be included in the annual directors’ report and half-year report: ss 298(1)(c) and 306(2).

### Rotation requirements

**[23.75]** The Ramsay Report recommended that auditors of listed companies should be required to rotate. This recognises that auditor independence may be compromised where the same auditor conducts audits of a company over a long period of time. This recommendation has been implemented in ss 324DA–324DD. Where an individual “plays a significant role” (as defined in s 9) in the audit of a listed company for a period of five successive financial years, the individual cannot play a significant role in the audit of that company for at least another two successive financial years: s 324DA(1). An individual may also not play a significant role as auditor for more than five out of any seven successive financial years: s 324DA(2). The rotation requirements also apply to audit firms and audit companies: ss 324DC and 324DD. In both cases, the rotation obligation is placed on the lead and review auditors as defined in s 324AF.

|                                         |
|-----------------------------------------|
| Contravention of rotation requirements. |
|-----------------------------------------|

Where an individual plays a significant role in an audit of a listed company in contravention of the rotation requirements, another member of the audit firm contravenes the legislation if that other member of the firm becomes aware that the individual is ineligible to play a significant role in the audit of the listed company and the other member fails to take the necessary steps as soon as possible, either to ensure that the firm resigns as auditor or ensure the individual ceases to act as lead or review auditor: s 324DC(1). This is a strict liability offence: s 324DC(3).

Directors of a listed company may by resolution, approve the extension of their auditor's rotation period for up to an additional two years: s 324DAA(1). This approval must be granted before the end of the five successive financial years rotation period.

A member of an audit firm has a defence where the member had reasonable grounds to believe that the audit firm had in place at that time a quality control system that provided reasonable assurance (taking into account the size and nature of the audit practice of the audit firm) that the audit firm and its employees complied with the requirements of the auditor independence provisions: s 324DC(4). This approach to liability of members of a firm is consistent with the liability imposed in other cases of contravention of the auditor independence obligations. Responsibility is imposed on members of the firm who become aware that an individual is ineligible to play a significant role in the audit of the listed company in order to encourage a culture of compliance with the legislation within the audit firm. The individual auditor who breaches the rotation requirements also commits an offence under s 324DB. Where the auditor is an audit company, contraventions of the rotation requirements are treated in much the same way as in the case of an audit firm, except that the audit company also commits an offence: s 324DD.

ASIC's power to modify auditor rotation requirements.

**[23.77]** ASIC has power to modify the operation of the auditor rotation requirements within the terms of s 342A. ASIC's modification power introduces some flexibility into the rotation requirements, recognising that these may sometimes impose an unreasonable burden on auditors and listed companies.

This could arise in the circumstances stated in s 342A(7), where the listed company engages in activities which require specialist knowledge to properly carry out the audit or there are few available auditors to provide satisfactory audit services for the listed company. The circumstances where ASIC may grant relief from the rotation requirements are set out in Regulatory Guide RG 187 *Auditor Rotation*.

Where an auditor acts in reliance on an ASIC declaration under s 342A, the company must receive written notice of the declaration: s 342B. The annual directors' report must include details of the declaration: s 300(11A).

## Disclosure of non-audit services

**[23.80]** The HIH Royal Commission recognised that auditor independence could be compromised where the audit firm also provides non-audit services to the company.

It recommended that boards of listed companies should be required to state all non-audit services provided by the audit firm and the fees payable for those services. This recommendation was implemented by s 300(11B), which requires disclosure in the annual directors' report of the amount paid to the auditor for non-audit services during the year and a statement of the directors' reasons for being satisfied that the provision of the non-audit services by the auditor did not compromise the auditor independence requirements of the legislation.

## ASIC relief powers

**[23.85]** ASIC has the power to grant relief from the auditor independence requirements to members of an audit firm who are not registered as auditors or who have ceased to be a member of an audit firm or a director or professional employee of an audit company: s 342AA(1). ASIC may also make class orders in respect of a specified class of audit firms or audit companies granting relief from the auditor independence requirements in those circumstances: s 342AB. ASIC can only grant relief under ss 342AA and 342AB where it is satisfied that compliance with the requirements would make financial or other reports misleading, be inappropriate in the circumstances or impose unreasonable burdens: s 342AC.

## Auditing standards

**[23.90]** The Auditing and Assurance Standards Board (AUASB) was established under s 227A(1) of the *ASIC Act* and s 227B gives it the power to make auditing standards under s 336 of the *Corporations Act*. The FRC has responsibility to monitor the AUASB in a similar way to its oversight of the Australian Accounting Standards Board. The FRC is discussed at [1.135].

An audit or an audit review must be conducted in accordance with auditing standards and an auditor's report must include any statements or disclosures required by the auditing standards: ss 307A, 308(3A) and 309(5A). A contravention of the requirement to conduct an audit or review in accordance with auditing standards is a strict liability criminal offence: ss 307(A)(4), 308(5) and 309(7).

## Accounting Professional and Ethical Standards Board

**[23.92]** The Accounting Professional and Ethical Standards Board (APESB) is an independent body whose members come from CPA Australia, Chartered Accountants Australia and New Zealand and the Institute of Public Accountants. APESB's main purpose is to develop and maintain professional and ethical pronouncements, including a Code of Conduct, for the Australian accounting and auditing professions. By virtue of Auditing Standard ASA 102 *Compliance with Ethical Requirements when Performing Audits, Reviews and Other Engagements*, auditors must comply with APESB's Code of Ethics for audits of entities subject to the *Corporations Act*.

## Appointment of auditors

**[23.95]** As a general rule, an auditor is appointed by the members at an AGM. In the case of a newly formed public company, the first auditor must be appointed by the directors within one month after registration of the company: s 327A(1). In such a case, the duration of the first auditor appointment is only until the first AGM of the company: s 327A(2).

At the first AGM, an auditor is appointed by the members and any vacancy in the office of auditor is to be filled at each subsequent AGM: s 327B.

Small companies limited by guarantee are exempted from the need to appoint and retain an auditor in circumstances where they are not required to have their financial reports audited. The audit requirements for companies limited by guarantee are discussed at [3.20].

Vacancy in the office of auditor.

Where a vacancy occurs in the office of auditor, other than a vacancy caused by the removal of an auditor, the directors must fill the vacancy within one month: s 327C(1). In such cases, the auditor holds office until the next AGM (s 327C(2)) and the auditor must then be appointed at that AGM in accordance with s 327B. If a company does not appoint an auditor when required by the *Corporations Act*, an application may be made by a member to ASIC for the appointment of an auditor: s 327E. The auditor so appointed only holds office until the next AGM: s 327E(6).

An individual, audit firm or audit company may only be appointed to act as auditor of a company if they have consented in writing before the appointment: s 328A. Appointment without such consent is of no effect and constitutes an offence by the company and any officer in default: s 328A(4). A company is not entitled to appoint an individual, firm or company as auditor at its AGM unless prior notice of nomination is given to the company by a member: s 328B(1).

## Removal and resignation

**[23.100]** An auditor holds office until death, removal, resignation or otherwise ceasing to be an auditor: s 327B(2). An individual auditor, an audit firm or an audit company ceases to be an auditor of a company if they inform ASIC of a conflict of interest situation in relation to the company: s 327B(2A), (2B) and (2C). An auditor also ceases to hold office after a company goes into liquidation: s 330.

Removal requires members' resolution.

An auditor may be removed from office only by resolution of the company at a general meeting: s 329(1). At least 21 days' notice must be given to members of a meeting at which a resolution will be moved to remove an auditor: s 249H(4). For listed companies,



28 days' notice is required: s 249HA. Where the resolution is proposed by members, notice of intention to move the removal resolution must be given to the company at least two months before the meeting is to be held: s 329(1A). However, if the company calls a meeting after the notice of intention is given, the meeting may pass the resolution even though the meeting is held less than two months after the notice of intention is given. The provisions restricting the removal of an auditor strengthen the auditor's independence.

When a company receives notice of a resolution to remove an auditor, it must send a copy of the notice to the auditor and lodge a copy with ASIC: s 329(2).

Auditor has opportunity to make representations.

The auditor is then given the opportunity to make representations in writing and may request that copies of the representations be sent by the company to all members entitled to attend the meeting: s 329(3). The company must send a copy of the representations to members in accordance with the auditor's request and the representations may be read out at the meeting: s 329(4). An auditor has a right to be heard at general meetings: s 249V.

Where an auditor is removed from office at a general meeting, the company may appoint another auditor at that meeting by passing a special resolution: s 327D. If such a resolution is not passed or a notice of nomination has not been sent to the auditor under s 328, the auditor may be appointed at an adjourned meeting by ordinary resolution: s 327D(3).

Resignation of auditor.

Auditors who wish to resign must apply to ASIC for consent to resign, stating their reasons. The company must be notified in writing of the application and if ASIC gives its consent, the auditor may resign after giving written notice to the company: s 329(5). The resignation of an auditor of a proprietary company or small company limited by guarantee does not require ASIC's consent: s 329(9).

Protection is afforded by s 329(7) to auditors who intend to resign. This section provides that statements made by auditors in relation to their application to ASIC for consent to resign are not admissible in evidence in any proceedings, nor may they be made the ground of any action against the auditor.

Where an auditor resigns or is removed, notice of the resignation or removal must be lodged with ASIC within 14 days and a copy of the notice must also be sent to the trustee for the holders of debentures if one has been appointed: s 329(11).

## Duties to the company

**[23.105]** By accepting an appointment, an auditor enters into a contractual relationship with the company. There are express or implied terms in such contracts that the auditor will:

- carry out an audit;
- report to members an opinion, based on the audit, whether the financial statements are properly drawn up in accordance with the *Corporations Act* – including their compliance with accounting standards and whether they present a true and fair view;
- be independent of the company; and
- exercise a reasonable degree of care and skill.

In addition, the *Corporations Act* imposes specific statutory duties.

## Statutory duties of auditors

### *Reporting to members*

**[23.110]** Auditors have a statutory duty to report to members. An auditor who audits the annual financial report must report to members whether the auditor is of the opinion that the annual financial report is in accordance with the *Corporations Act*, including ss 296 and 297 – the provisions dealing with compliance with accounting standards and true and fair view: s 308(1).

An auditor of a disclosing entity must carry out either an audit or a review of the disclosing entity's half-year financial report: s 302(b). If the half-year financial report is audited, the auditor must report to members whether the auditor is of the opinion that the report is in accordance with the *Corporations Act*, including ss 304 and 305 – the half-year provisions dealing with compliance with accounting standards and true and fair view: s 309(1).

An auditor who reviews the financial report for a half-year must report to members on whether the auditor becomes aware of any matter in the course of the review that makes the auditor believe that the financial report does not comply with the half-year financial reporting requirements of the *Corporations Act*: s 309(4).

Companies, registered schemes and disclosing entities must send the auditor's report to members together with the annual financial report and directors' report for the year: s 314(1). Alternatively, members may be sent a concise financial report. A concise financial report includes a statement by the auditor that the financial report has been audited and the auditor's opinion of whether the concise financial report complies with the accounting standards: s 314(2)(c). The concise financial report must also include a copy of any qualification in the auditor's report: s 314(2)(d).

### *Submission of members' written questions to auditor*

**[23.113]** A member of a listed company who is entitled to cast a vote at an AGM is entitled to submit a written question to the auditor that is relevant to the content of the auditor's report or the conduct of the audit of the annual financial report to be considered at the AGM: s 250PA(1). The question is submitted to the auditor by giving it to the company at least five business days before the AGM. The company must pass the question on to the auditor and the auditor must prepare a question list: s 250PA(3) and (4). The company must make the question list reasonably available to members at the AGM: s 250PA(9).

## Auditor attendance at AGM

**[23.115]** Auditors of listed companies, or their representatives, must attend the company's AGM at which the auditor's report is to be considered: s 250RA(1) and (2).

Auditors of unlisted companies are entitled to attend any general meeting and be heard at the meeting on any business that concerns them in their capacity as auditor; however, their attendance is not compulsory: s 249V.

If the auditor or representative attends a company's AGM, the chair must allow a reasonable opportunity for the members as a whole to ask questions relevant to:

- the conduct of the audit;
- the preparation and content of the auditor's report;
- the company's accounting policies; and
- the independence of the auditor: s 250T(1)(a).

An auditor has qualified privilege under s 1289 in respect of any statement made in the course of the auditor's duties as auditor. This includes answering questions at the AGM and providing answers to questions put in writing under s 250PA. Qualified privilege also applies to responses to requests for information by the FRC. Section 1289 protects the auditor from actions of defamation and thereby encourages candid responses to questions.

## Auditors of debenture issuers

**[23.120]** The auditor of a borrower in relation to debentures must give the trustee for debenture-holders a copy of the auditor's report within seven days of giving the originals to the borrowing corporation: s 313(1). In addition, an auditor of a borrowing corporation must give the borrower or guarantor a written report about any matter that, in the auditor's opinion, is likely to be prejudicial to the interests of debenture-holders and is relevant to the exercise of the powers of the trustee for debenture-holders: s 313(2).

## Reporting to ASIC

**[23.125]** Auditors have a statutory duty to report to ASIC if they have reasonable grounds to suspect that a significant contravention of the *Corporations Act* has occurred or an attempt has been made to unduly influence, coerce, manipulate or mislead a person involved in the conduct of an audit or otherwise interfere with the proper conduct of the audit: s 311(1). Auditors who have such suspicions must notify ASIC as soon as practicable and in any case within 28 days after becoming aware of the circumstances: s 311(1) and (2).

According to s 311(4) a contravention of the *Corporations Act* is regarded as significant having regard to the level of penalty and the effect that the contravention has, or may have, on either the company's overall financial position or the adequacy of the information available about the company's overall financial position.

## Contents of auditor's report

**[23.130]** Tables 23.1 and 23.2 set out the matters that must be included in an auditor's report and auditor's review.

**Table 23.1: Contents of auditor's report**

|                                                                              |                                                                                                                                                                                                                                               | Annual<br>financial report | Half-year<br>financial report |
|------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------|-------------------------------|
| Auditor's opinion                                                            | Whether financial report is in accordance with the <i>Corporations Act</i> , including:<br>– compliance with accounting standards; and<br>– true and fair view.<br><br>If the auditor is not of this opinion, the report must state why.      | s 308(1)<br>s 296<br>s 297 | s 309(1)<br>s 304<br>s 305    |
| Non-compliance with accounting standards                                     | Quantify the effect of non-compliance to the extent it is practicable to do so.                                                                                                                                                               | s 308(2)                   | s 309(2)                      |
| Description of any defects or irregularities                                 |                                                                                                                                                                                                                                               | s 308(3)(a)                | s 309(3)(a)                   |
| Description of any deficiencies, failures or shortcomings                    | In respect of whether:<br>– auditor given all information, explanation and assistance necessary for the conduct of the audit;<br>– sufficient financial records have been kept; and<br>– other required records and registers have been kept. | s 308(3)(b)                | s 309(3)(b)                   |
| Disclosures required by auditing standards                                   |                                                                                                                                                                                                                                               | s 308(3A)                  | s 309(5A)                     |
| Auditor's opinion on additional information in notes to financial statements | Whether the inclusion of the additional information was necessary to give a true and fair view of financial position and performance.                                                                                                         | s 308(3B)                  | s 309(5B)                     |
| Opinion on remuneration report                                               | Whether remuneration report complies with s 300A and, if not, why not.                                                                                                                                                                        | s 308(3C)                  |                               |
| Date auditor's report made                                                   |                                                                                                                                                                                                                                               | s 308(4)                   | s 309(6)                      |

**Table 23.2: Contents of auditor's review of half-year financial report**

|                                                                    |                                                                                                                                                                            |             |
|--------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------|
| Auditor's awareness                                                | Whether any matter that makes the auditor believe that the financial report does not comply with the <i>Corporations Act's</i> half-year financial reporting requirements. | s 309(4)    |
| Description of non-compliance                                      |                                                                                                                                                                            | s 309(5)(a) |
| Reasons why auditor believes that financial report does not comply |                                                                                                                                                                            | s 309(5)(b) |

## Duty to carry out audit

**[23.135]** An audit must be carried out in accordance with auditing standards before an auditor can form an opinion on whether the financial reports are properly drawn up in the manner required by s 308(1). In carrying out an audit, particularly where the company's accounts are complex, an auditor is required to devise procedures and a program to assist in the detection of errors or fraud: *Pacific Acceptance Corp Ltd v Forsyth* (1970) 92 WN (NSW) 29.

Auditors are entitled to seek assistance from the company's directors, accountants and other employees in carrying out their functions. However, auditors, breach their duty if they rely on them for information on which they are required to form their own independent opinion: *Dominion Freeholders Ltd v Aird* [1966] 2 NSW 293.

## Duty to detect and report fraud and irregularities

**[23.145]** An auditor is appointed to safeguard the interests of the members. As discussed at [23.110], the auditor must provide a report that is sent to members. Among other matters (see [23.130]), the auditor's report must describe any defect or irregularity in the financial reports: s 308(3)(a).

Auditing Standard ASA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report* states that the primary responsibility for the prevention and detection of fraud rests with those charged with the governance and management of an entity: para 4.

In *Arthur Young & Co v WA Chip & Pulp Co Pty Ltd* [1989] WAR 100, it was held that an auditor will breach their duty of care if, having detected a possible irregularity not amounting to a suspicion of fraud, the auditor fails to investigate further and report the matter to the appropriate officers of the company. There will be a breach even if the amount involved was immaterial.

Under Auditing Standard ASA 240, an auditor who detects an irregularity, regardless of materiality, has a duty to promptly report that finding to the board of directors or to an appropriate level of management. In addition, under s 311, if an auditor has reasonable grounds to suspect that there has been a contravention of the *Corporations Act*, and the circumstances are such that the matter has not been or will not be adequately dealt with by comment in the auditor's report or by bringing the matter to the notice of the directors, the auditor is required to report the matter to ASIC.

*Daniels v Anderson* (1995) 37 NSWLR 438

**[23.150]** The question as to which level of management an auditor must report defects or irregularities was considered by the New South Wales Court of Appeal, which held that the auditors breached their duty to report to the company's management the absence of proper accounting records and weaknesses in internal controls. If the management did not take prompt action, the auditors should report the deficiencies to the board of directors. The court's decision on the contributory negligence of AWA and its directors is discussed at [23.170].

**[23.155]** The *ASX Corporate Governance Principles and Recommendations* (4th ed) sets out recommended corporate governance practices for entities listed on the ASX. Recommendation 7.1 suggests that a listed entity should have a committee to oversee risk, either a stand-alone risk committee or a combined audit and risk committee or a combination of board committees addressing different elements of risk. The risk committee should be comprised of at least three members, a majority of whom are independent non-executive directors. Its role usually includes monitoring management's performance against the entity's risk management framework, reviewing and making recommendations to the board in relation to managing risk and incidents involving fraud or breakdown of the entity's internal controls. The powers of the committee usually include the right to interview the external auditors, with or without the presence of management. These Recommendations seek to ensure that the board is made aware of any concerns the auditor may have regarding information discovered during the audit and the process of the audit itself including any disagreements between the auditor and management. Risk management and risk committees are further discussed at [14.70].

## Duty to use reasonable care and skill

**[23.160]** An auditor has a contractual obligation to use reasonable care and skill in carrying out the audit and in forming an opinion on the company's financial report. A failure to exercise reasonable care and skill renders an auditor liable to the company in damages for breach of contract.

An auditor may also be liable to the company in negligence.

Auditors may also be liable to the company for negligence. It has long been held that professionals owe a duty of care to their clients. However, from a plaintiff's point of view, damages for breach of contract in some circumstances provide a better remedy than damages from a negligence action. Further, if a company proceeds against an auditor on the basis of breach of contract, there is a divergence of judicial opinion on whether an auditor can raise a defence of contributory negligence by the company to reduce liability. Contributory negligence is discussed at [23.200]. An auditor who exercises less than the required degree of care and skill is liable to the company for any loss suffered as a result but is not liable just because of failure to detect errors or frauds.

## Standard of care and skill

**[23.165]** A high standard of care and skill is expected from auditors. This is in line with the public's high expectations of the competence of auditors. An auditor must use a reasonable degree of care. The standards of reasonableness depend on the circumstances and are affected by changed expectations.

In *Pacific Acceptance Corp Ltd v Forsyth*, it was held that in determining what was reasonable care and skill expected of an auditor, the court should be guided by accepted auditing standards.

*Daniels v Anderson* (1995) 37 NSWLR 438

**[23.170]** In this case, the facts of which are outlined at [17.40], the New South Wales Court of Appeal held that the auditor failed to exercise reasonable care and skill in a number of respects. The court found that the auditor was aware that:

- while the company changed its record-keeping system, no proper accounting records in relation to foreign exchange trading were being kept;
- senior managers had not heeded the auditor's warnings that the company's internal controls in relation to foreign exchange trading were inadequate;
- the foreign exchange trading was not tied into the company's computerised accounts;
- foreign exchange trading was both a high audit risk area and a high commercial risk;
- foreign exchange trading was an area where internal controls are critical; and
- the company's exposure to foreign exchange losses was high.

Given the auditor's awareness of the above matters, his failure to promptly warn the company's directors of the deficiencies in the accounting records and inadequate internal controls meant that he breached his duty to exercise reasonable care and skill and so was negligent.

## Causation and damage

**[23.175]** If an auditor breaches a contractual duty to exercise reasonable care and skill, the auditor will be liable to pay damages to the company. The aim of an award of damages for breach of contract is to put the company in the position it would have been in had the contract been properly performed. However, before damages are awarded it must be shown that the breach of duty caused the loss. In determining whether a breach of contract causes a loss, the courts usually adopt a "but for" test – would the loss not have occurred but for the breach? Even if a breach caused a loss, damages will not be awarded if the loss is too remote.

## Remoteness of loss.

A loss is regarded as being too remote if the loss is outside the contemplation of the parties to the contract at the time they contracted.

*Alexander v Cambridge Credit Corp Ltd* (1987) 9 NSWLR 310

**[23.180]** It was held that while an audit had been negligently conducted, this was not the cause of the loss suffered by the company on the basis of the “but for” test. One significant factor causing its disastrous losses was the dramatic change in economic conditions in Australia that occurred at the time.

*Daniels v Anderson* (1995) 37 NSWLR 438

**[23.185]** Causation was also an important issue in this case. The New South Wales Court of Appeal held that the auditor’s negligence had caused loss. As a result of the failure to promptly report deficiencies in the accounting records and internal control procedures, AWA lost the chance to take steps to avoid losses in foreign exchange dealings. AWA also lost the chance to take remedial action. However, as discussed at [23.170], [23.205] and [17.40], the Court of Appeal held that AWA was also negligent and contributed to the losses suffered.

## Indemnification from liability

**[23.195]** Under s 199A(1) and (2), a company or related body corporate must not exempt or indemnify an officer or auditor from liability to the company incurred as an officer or auditor, or liability under the civil penalty provisions. The members in general meeting may, however, ratify an auditor’s breach of duty. Companies can indemnify auditors against any costs incurred by them in successfully defending any civil or criminal action or where the court grants them relief under s 1318. The power of the court to grant relief to officers and auditors is discussed at [20.30].

## Defences

### Contributory negligence

**[23.200]** Auditors who are sued by a company for the tort of negligence may seek to reduce their liability for damages by raising the defence of contributory negligence by the company. The apportionment of damages for contributory negligence is permitted by State legislation such as s 26 of the *Wrongs Act 1958* (Vic) and s 10 of the *Law Reform (Miscellaneous Provisions) Act 1965* (NSW). In order to establish contributory negligence, an auditor must prove that the loss suffered by a company was partly due to the company’s own negligence. For example, contributory negligence arises if the loss suffered by the company is partly due to the negligence of its officers and their negligent actions are imputed to their company.



While it is clear that the defence of contributory negligence can be relied on where an auditor is sued for the tort of negligence, in the past the cases, both in Australia and overseas, were divided on whether that defence can be used if the auditor is sued for breaching the contractual duty of care.

*Daniels v Anderson* (1995) 37 NSWLR 438

**[23.205]** The New South Wales Court of Appeal was of the opinion that contributory negligence was a valid defence for breach of contract and AWA was guilty of contributory negligence because of the negligence of its board of directors and management.

The court held that AWA's management were negligent in that:

- they failed to establish an adequate system of internal controls in relation to foreign exchange operations;
- they failed to maintain an adequate system of records of contracts, books and accounts for those operations;
- they failed to adequately supervise the activities of Koval, AWA's foreign exchange manager;
- they did not heed the auditor's warnings on the inadequacies of the internal controls; and
- the board of directors, as a collective unit, was also negligent in that the board permitted a grossly negligent management to persevere with foreign exchange dealings in an entirely unsatisfactory manner.

For these reasons the Court of Appeal reduced the damages payable by the auditor by one-third.

## Contribution

**[23.210]** The loss suffered by a victim of negligence may be caused by the concurrent, but independent acts or omissions of two or more joint tortfeasors. For example, the loss suffered by a company may have been caused by the negligence of its auditor as well as that of the company's directors and managers. In such circumstances, State legislation formerly provided that all joint tortfeasors were jointly and severally liable to pay damages to the company. Further, where the company sued only the auditor, the auditor had a right of contribution against the negligent directors.

As a result of several reviews of tort laws, the Commonwealth and all States passed legislation that replaces the joint and several liability of joint tortfeasors with proportionate liability for all claims involving economic loss in negligence actions. The effect is that if an auditor's negligence causes only a proportion of the loss suffered by a company, the amount of damages the auditor will have to pay will be limited to that proportion. There is now a proportionate liability regime for damages claims under s 236 of the *Australian Consumer Law*. As a result, the right of contribution by joint tortfeasors has become less important. Proportionate liability is discussed at [23.230].

## Liability of auditors to particular shareholders and outsiders

### Negligence

**[23.215]** An auditor has a contractual relationship with the company. If an auditor breaches their contractual duty of care, it is only the company that can sue the auditor as a party to the contract.

Liability to third parties.

However, shareholders, creditors and other users of the audited accounts may also be able to sue auditors in an action for the tort of negligence if they can establish that the auditors owe them a duty of care in carrying out the audit and in making their report.

It was once thought that professionals owed a duty of care only to their clients and not to third parties who rely on their statements: *Candler v Crane Christmas & Co Ltd* [1951] 2 KB 164.

Auditors' liability for negligent misstatement.

Since the decision in *Candler v Crane Christmas & Co Ltd*, the law of negligence with respect to negligent misstatements has developed significantly to encompass a wider range of plaintiffs. In a case that did not concern auditors, the High Court in *Shaddock & Assoc Pty Ltd v Parramatta City Council* (1981) 150 CLR 225 held that the duty to take reasonable care arises:

Whenever a person gives information or advice to another upon a serious matter in circumstances where the speaker realises, or ought to realise, that he is being trusted to give the best of his information or advice as a basis for action on the part of the other party and it is reasonable in the circumstances for the other party to act on that information or advice – the speaker comes under a duty to exercise reasonable care in the provision of the information or advice he chooses to give.

At the same time, the courts have been concerned to ensure that auditors should not be subject to “liability in an indeterminate amount for an indeterminate time to an indeterminate class”: *Ultramares Corp v Touche* (1931) 174 NE 441. For this reason, while acknowledging that auditors may be liable to third parties, the courts have restricted the range of people to whom auditors owe a duty of care.

*Esanda Finance Corp Ltd v Peat Marwick Hungerfords* (1997) 188 CLR 241

**[23.220]** A lender of money who relied upon an unqualified audit report on a borrower failed in an action against the auditor. However the case established that an auditor can owe a duty of care to a third party.

The court held that in order to establish whether an auditor does owe a duty of care to third parties in negligent misstatement cases, it was not sufficient for a plaintiff merely to allege that it was reasonably foreseeable that a third party might rely on audited financial statements.

Brennan CJ put forward the following test and held that an auditor will owe a duty of care to a third party if it is alleged and can be proved that:

- the auditor knew or ought reasonably to have known that the auditor's report on the financial statements would be communicated to the third party, either individually or as a member of an identified class; and
- the audited financial statements would be so communicated for a purpose that would be very likely to lead the third party to enter into a transaction of the kind that the third party did enter into; and
- it would be very likely that the third party would enter into such a transaction in reliance on the audited financial statements and thereby risk the incurring of economic loss.

Dawson J held that in negligent misstatement cases claiming damages for pure economic loss, a third party must also establish a relationship of proximity between the maker of the statement and the third party. Such a relationship could arise if the negligent misstatement was supplied at the request of the third party. It could also arise if the maker of the statement intended to induce the third party to act on the statement. In this case, there was no suggestion of a request for the audited financial information by the lender or an intention by the auditor to induce it to act. Dawson J left open the possibility that the statutory scheme governing auditors' duties may be relevant in determining whether an auditor's report is made with the intention to induce a particular person to act on it in a particular way.

In a joint judgment, Toohey and Gaudron JJ observed that there was nothing in the circumstances of the case to suggest that it was reasonable for the lender to act on the audited report without further inquiry as it was able to have its own accountants ascertain the borrower's financial position as a condition of granting the loan.

McHugh and Gummow JJ both relied on public policy considerations to support the auditor's appeal. McHugh J could find no good reason for extending the liability of auditors to those members of a class who the auditor knows or ought to know will rely on the audit where the auditor has not assumed responsibility to those members or intended to induce them to rely on the audit. He found it difficult to accept that giving third parties unqualified rights against auditors would serve the public interest by raising auditors' standard of care any higher than is presently the case. Extending the liability of auditors will possibly result in a reduction in the number of auditors willing to act for high-risk businesses. It may also lead to a reduction in demand for auditors because increasing negligence insurance premiums will result in increased audit fees. In this case, the lender was a well-informed creditor and could have taken steps to avoid the risk of loss. There was no good reason to extend auditors' liability to such third parties.

## Misleading and deceptive conduct

[23.225] Section 18 of the *Australian Consumer Law* may provide third parties with an alternative and simpler basis for suing auditors. This section prohibits a person from engaging in misleading or deceptive conduct. Contravention of s 18 provides a plaintiff with a wide range of remedies against a corporation, including damages: *Australian Consumer Law*, s 236. Failing to qualify financial reports when they should be qualified may amount to misleading or deceptive conduct. No intention to mislead or deceive is required. As discussed at [23.230], a proportionate liability regime was incorporated into the *Australian Consumer Law* as well as the *Corporations Act* and the *ASIC Act*.

## Proportionate liability of auditors

[23.230] Prior to 2004, auditors were subject to joint and several liability in conjunction with other parties, such as company directors, for economic loss caused by negligence or misleading and deceptive conduct. This system raised increasing concern that professionals such as auditors were targeted by plaintiffs because they were seen as having “deep pockets”. This was largely because they were invariably covered by professional indemnity insurance, with the result that insured professionals bore a disproportionate burden of claims in comparison with uninsured co-defendants. It therefore became increasingly difficult for professionals to obtain insurance and premiums rose rapidly. From a public policy point of view, it is important that professionals have ready access to insurance so as to protect consumers by enabling them to recover damages in the event of negligent provision of professional services.

Amendments introduced in 2004 addressed these concerns by introducing a proportionate liability system to improve the availability and affordability of professional indemnity insurance for professional service providers, such as auditors. These amendments apply the proportionate liability regime to misleading and deceptive conduct in the *ASIC Act* (s 12GF(1)), the *Corporations Act* (ss 1041L–1041S) and the *Australian Consumer Law*: s 87CD. The basis of this system is that a particular defendant can only be liable for that portion of the damage for which that defendant was responsible. This involves a court determining the respective responsibilities of wrongdoers who are not parties to the proceedings. A defendant to a claim to which proportionate liability may apply is required to notify the plaintiff of any other persons who have contributed to the plaintiff’s loss. The contributory negligence of a plaintiff is also taken into account in apportioning liability.

Intentional torts, claims involving fraud, the liability of partners and a principal for the acts of an agent are excluded from the proportionate liability system.

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** material at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.
- For further corporations law links and material please refer to the Understanding Company Law website at <http://www.uclaw.com.au>.



## Chapter 24

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# Members' remedies

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## Key points

- There are various statutory rights under which shareholders may bring an action to seek a remedy where the controllers of a company act unfairly. This usually arises where the relationship between the shareholders has broken down and they are no longer able to properly work together.
- These statutory remedies largely replace the common law rules, which imposed greater difficulties on minority shareholders.
- The oppression remedy allows for a flexible range of remedies that the court can order in appropriate circumstances. The court has a wide discretion to make an order where the affairs of the company are conducted contrary to the interests of the shareholders as a whole, oppressively or in a manner unfairly prejudicial to, or unfairly discriminatory against, shareholders.
- A statutory derivative action enables an individual shareholder to bring legal proceedings on behalf of a company where the company is unwilling or fails to do so. This action is usually brought to enforce rights against directors who breach their duties to the company. A company will rarely bring such an action itself because the directors who breached their duties usually control the company. The right to bring a derivative action at common law has been abolished.
- Other statutory remedies allow shareholders to seek an injunction to prevent conduct that contravenes the *Corporations Act* and to apply to the court to wind up the company.
- To assist in bringing a legal action, shareholders may apply to the court for the right to inspect the company's books where it can be shown that they act in good faith and the inspection is for a proper purpose.
- A shareholder may also enforce personal rights at common law. These include rights conferred by the *Corporations Act* and constitution, voting rights and protection against expropriation of shares.



## Introduction

[24.05] Many companies are controlled by either a single shareholder or a group of shareholders. This is particularly common in proprietary and closely held companies. Shareholders who can command a majority of the votes cast at a shareholders' meeting have the ability to elect directors of their choosing and pass resolutions at general meetings to thereby control the company. Minority shareholders of majority-controlled companies face significant problems if the controlling shareholders, in their capacity as either directors or majority shareholders, run the company in their own interests to the detriment of the minority shareholders. This type of situation is most likely to occur in the case of closely held companies which are usually proprietary companies. Minority shareholders who disagree with the actions of the majority will usually be outvoted at shareholders' meetings and will therefore be unable to remove the directors who have acted unfairly or in the directors' own interests. Dissenting minority shareholders will also often be locked in because they will be unable to find a buyer of their shares or force the company or its controllers to buy them out. In these circumstances, the only ones who may be willing to buy their shares would be the controllers for less than a fair price. The lock-in problem does not often arise in the case of listed public companies because there is a market for the listed company's shares and for minority shareholders, selling their shares on the market is generally preferable to initiating expensive and uncertain litigation. However, even then, minority shareholders may not be offered a "fair" price for their shares if the opportunistic behaviour of the controllers has adversely affected the market value of the company's shares.

The *Corporations Act* enables members ("members" includes shareholders) to obtain several remedies in circumstances where the controllers of a company act oppressively or unfairly towards them. The most significant of these remedies discussed in this chapter are:

- s 232, which provides a remedy where the affairs of a company are conducted in a manner that is contrary to the interests of the members as a whole, oppressive, unfairly discriminatory or unfairly prejudicial;
- ss 236–242, which enable members and officers to bring legal proceedings on behalf of a company where the company fails to do so;
- s 461(1)(e), which permits the court to wind up a company where the directors have acted in the affairs of the company in their own interests, rather than in the interests of the members as a whole, or in any other manner that appears to be unfair or unjust to other members;
- s 461(1)(f) and (g), which permits the court to wind up a company where the grounds set out in s 232 are established;
- s 461(1)(k), which permits the court to wind up a company where it is of the opinion that it is just and equitable to do so; and
- s 1324, which allows the court to restrain contraventions of the *Corporations Act*.

There are some remaining common law members' remedies available to enforce personal rights which are rarely used. These are discussed at [24.480]–[24.580].

Sections 247A–247D provide assistance to minority shareholders by enabling a member to apply to the court for an order allowing inspection of the books of the company: see [24.450]–[24.470]. A successful application enables a member to gain access to information that may be helpful in establishing the necessary grounds for the remedies outlined above.

ASIC may also cause civil proceedings to be brought in the name of a member, the company or other person under s 234(e) discussed at [24.20] or the *Australian Securities and Investments Commission Act 2001* (Cth) (ASIC Act), s 50, discussed at [28.50].

## Statutory remedies

**[24.10]** There are various statutory remedies available to members where the controllers of companies unfairly misuse their positions of power, breach their duties or otherwise contravene the *Corporations Act*. To assist in bringing these actions, shareholders have rights of access to inspect the company's books: see [24.440]–[24.470].

## Oppressive or unfair conduct

**[24.15]** Under s 232, members may apply to the court for a wide range of remedies if they can show that the conduct of a company's affairs is contrary to the interests of the members as a whole, or is oppressive, unfairly prejudicial or unfairly discriminatory. The conduct may affect members in their capacity as members or in any other capacity. The conduct of the company's affairs may comprise an actual or proposed act or omission by or on behalf of the company, or a resolution or proposed resolution of members or a class of members of a company.

Members have a wide range of remedies if they can show oppressive or unfair conduct.

Section 232 covers a broad range of conduct, including conduct that would justify winding-up on the just and equitable ground under s 461(1)(k). The requirements of s 232 also constitute grounds for winding-up under s 461(1)(f) and (g). An important effect of s 232 is that its threatened use may force controllers of companies to consider the interests of minority shareholders.

In most cases, the member seeking a s 232 remedy will be a shareholder in a small, tightly held company who is unable to continue in a workable relationship with other shareholders. In such circumstances, there is a likelihood that the minority shareholder becomes “locked-in”. It is unusual for this to occur in the case of a listed public company. Where there is a market for a company's shares, aggrieved shareholders will usually sell their shares rather than incur considerable costs in attempting to enforce legal rights.

Proprietary companies also offer more scope for the majority to abuse their positions. Listed companies must comply with the Australian Securities Exchange (ASX) Listing Rules. These require listed companies to gain shareholder approval where they seek to make certain significant structural changes. The affairs of listed companies are also under closer public scrutiny. Nevertheless, there have been several cases involving listed

companies where the oppression remedy has been used as a means of challenging actions of directors that involved a breach of duty or other unfair conduct.

Another type of company where recourse may be found in s 232 is a joint-venture company. This is where investors, who may themselves be incorporated, form together in a venture where each of the participants contributes equity, expertise, rights or goods and services. Companies formed for joint ventures are similar in many respects to small, tightly held companies, even though the joint venture may involve a large-scale business operation. They are closely held and without public listing; therefore the possibility exists that in the event of a breakdown in the relationship, a party may be locked in, unfairly treated or “squeezed out” by being excluded from management.

### *Who may apply?*

**[24.20]** Section 234 sets out who may apply for an order under s 232. In most cases, the applicant is a registered member. The register of members is discussed at [9.20]–[9.60].

It is unclear whether an applicant must necessarily be registered as a member in order to apply for a remedy under s 232. In *Niord Pty Ltd v Adelaide Petroleum NL* (1990) 54 SASR 87, it was held that an applicant for an order under s 232 must be registered. A broader view was expressed in *Re Independent Quarries Pty Ltd* (1994) 12 ACLC 159, where it was held that registration as a member was not decisive in circumstances where a share certificate had been duly issued but the transfer had not been registered because the register was under the control of the controlling shareholder and the directors were unable to complete the registration.

**[24.35]** If a member's name is removed from the register pursuant to some power in the constitution, before seeking relief under s 232, the member must first apply for correction of the register under s 175: *Re M Dalley & Co Pty Ltd* (1968) 1 ACLR 489. Correction of the register is discussed at [9.75].

The conduct of which members complain may affect them in their capacity as a member or in any other capacity.

The conduct of which members complain may affect them in their capacity as a member or in any other capacity: s 234(a)(i). Therefore, a remedy can be sought under s 232, even though the applicant is complaining of conduct such as removal as a director or manager of the company. A member also has standing to seek a remedy even if the person is not a member of the particular group of aggrieved members. This is as long as the application relates to an act or omission that is against the other members in their capacity as members: s 234(a)(ii).

A member has standing to apply for a remedy even though that person was not a member at the time the oppressive or unfair conduct took place: *Re Spargos Mining NL* (1990) 3 WAR 166.

An application for a remedy may be brought by a past member if the application relates to the circumstances in which they ceased to be a member (s 234(c)) or by a person to whom a share in the company has been transmitted by will or by operation

of law even though that person is not registered as a member: s 234(d). A person whom ASIC thinks appropriate may also apply having regard to an investigation conducted by ASIC into the company's affairs: s 234(e).

## *Conduct where a remedy may be sought*

### **Company's affairs**

[24.40] Under s 232, an applicant must allege that the conduct of a “company's affairs” is contrary to the interests of the members as a whole, oppressive, unfairly prejudicial or unfairly discriminatory.

The “company's affairs” includes conduct of the directors, majority shareholders, substantial shareholders as well as the company itself.

The term “affairs” of a company includes conduct of the directors, majority shareholders and substantial shareholders, as well as the company itself. According to the s 53 definition, “affairs of a body corporate” has a broad meaning to include a reference to:

- the promotion, formation, membership, control, business, trading, transaction and dealings, property, liabilities, profits and the income, receipts, losses, outgoings and expenditure;
- the internal management and proceedings; and
- the power of persons to exercise, or to control the exercise of, the rights to vote attached to shares in the body corporate or to dispose of, or to exercise control over the disposal of, such shares.

It is unsettled whether the conduct of a holding company, or of nominee directors who are also directors of a subsidiary, may constitute conduct in the affairs of that subsidiary and whether conduct of a subsidiary may be within the affairs of its holding company. A broad view was taken in *Re Norvabron Pty Ltd (No 2)* (1987) 5 ACLC 184 where the court disregarded the distinction between a holding company and its subsidiary where the directors of the holding company knew what was happening in the subsidiary because they were also the subsidiary's directors. Their failure to take action as directors of the holding company to prevent their own conduct as directors of the subsidiary, constituted an omission that was oppressive and unfair conduct for purposes of the predecessor of s 232.

A narrower approach was taken in *Morgan v 45 Flers Avenue Pty Ltd* (1986) 5 ACLC 222 where an applicant argued that a nominee director of a joint-venture company, appointed by one of its shareholders, had acted oppressively and unfairly in the affairs of the shareholder company. The court held that a nominee director, by participating in board decisions, could not be said to be acting in the affairs of the appointor company. This was because nominee directors have an overriding duty to the company on whose board they sit, in preference to the interests of their appointors. In *Ubertini v Saeco International Group SpA (No 4)* [2014] VSC 47, the court noted that while the meaning of “affairs” was not settled in Australia, it meant that the narrow approach in *Morgan v 45 Flers Avenue Pty Ltd* (1986) 5 ACLC 222 did not necessarily apply.

[24.55] A refusal by directors to allow shareholders to inspect the financial records of a company and its subsidiaries is not “conduct” in the affairs of the company. Inactivity or negative action can only be regarded as “conduct” where there is a duty at law or in equity to act in a positive way: *Re Dernacourt Investments Pty Ltd* (1990) 20 NSWLR 588.

### Acts or proposed acts

[24.60] Section 232(b) makes it clear that a single act by or on behalf of a company may constitute conduct that is contrary to the interests of the members as a whole, oppressive, unfairly prejudicial or unfairly discriminatory. For example, in *Wayde v NSW Rugby League Ltd* (1985) 180 CLR 459, the High Court held that a single resolution of the board of directors could be an oppressive or unfair act on behalf of the company. The conduct may also consist of an act that is merely proposed and has not yet occurred: s 232(b).

### Resolutions or proposed resolutions

[24.65] Under s 232(c), conduct of the company's affairs may also take the form of a resolution or proposed resolution of members or a class of members. This modifies the general law principle that shareholders are able to exercise their voting rights in their own interests: *North-West Transportation Co v Beatty* (1887) 12 App Cas 589.

In *MacKay Sugar Ltd v Wilmar Sugar Australia Ltd* [2016] FCAFC 133, the court held that a resolution to amend the constitution of Queensland Sugar Ltd (QSL) to remove the ability of a QSL member to appoint independent directors to QSL's board was oppressive to, unfairly prejudicial to, or unfairly discriminatory against the member.

As discussed at [24.215], s 232 provides class members with a wider range of remedies than is the case for contraventions of the variation of class rights provisions in s 246B. Variation of class rights is discussed at [8.155].

### Omissions

[24.70] Section 232(b) also applies to omissions or proposed omissions. This may enable a member to obtain a remedy where the controllers repeatedly refuse to call directors' meetings: *Shum Yip Properties Development Ltd v Chatswood Investment & Development Co Pty Ltd* [2002] NSWSC 13 or where a company with sufficient profits persistently refuses to pay dividends: *Sanford v Sanford Courier Service Pty Ltd* (1986) 5 ACLC 394.

A remedy may also be available under s 232(b) where the omission or proposed omission is a refusal by the directors to register a transfer of shares and this refusal is oppressive or unfairly prejudices or unfairly discriminates against a member. The reference to omissions or proposed omissions may mean that a member will be able to obtain a remedy under s 232 in circumstances similar to *Re Smith and Fawcett Ltd* [1942] Ch 304, where the decision of the board to refuse to register a transfer was held to be valid because it was not shown to have been made in bad faith. The requirements under s 232 may encompass circumstances that are not shown to involve bad faith. The facts of *Re Smith and Fawcett Ltd* are set out at [9.190].

### Meaning of oppressive and unfair

[24.75] A statutory remedy for oppressive conduct has been part of Australian company legislation since the mid-1950s. These earlier provisions, based on English legislation, provided a remedy only where there was “oppressive conduct”.

This expression was at first interpreted narrowly and focused on the nature of the conduct rather than its effect on the minority shareholder.

Conduct is oppressive if it is “burdensome, harsh and wrongful”.

According to *Scottish Co-operative Wholesale Soc Ltd v Meyer* [1959] AC 324, “oppressive conduct” is conduct that is “burdensome, harsh and wrongful”. In *Re Jermyn Street Turkish Bath Ltd* [1971] 1 WLR 1042, the English Court of Appeal added the requirement that oppression involves “some overbearing act or attitude on the part of the oppressor”. The effect of these interpretations was that the oppression remedy was not available except in the more extreme circumstances where the controllers of a company deliberately abused their powers.

Under s 232(e), the oppression remedy has since been extended to cover not only oppressive acts and conduct, but also conduct that was unfairly prejudicial or discriminatory against a member whether in that capacity or any other capacity.

The individual elements of s 232 are merely different aspects of “commercial unfairness” which is determined objectively.

In *Morgan v 45 Flers Avenue Pty Ltd* (1986) 5 ACLC 222, the Supreme Court of New South Wales held that it is inappropriate to focus on each of the individual elements of s 232(e). The correct approach is to regard them as a “composite whole”. The individual elements “should be considered merely as different aspects of the essential criterion, namely commercial unfairness”.

Where there is a pattern of actions which targets a particular shareholder in various ways, the courts can look at the cumulative effect and impact of the conduct and find that it amounts to oppressive or unfair conduct even if none of the actions in themselves amount to oppression: *Hylepin Pty Ltd v Doshay Pty Ltd* [2021] FCAFC 201.

The High Court explained the meaning of “unfair” in the context of directors’ decisions.

*Wayde v NSW Rugby League Ltd* (1985) 180 CLR 459

[24.80] Brennan J explained the test of unfairness in the following terms:

It is not necessarily unfair for directors in good faith to advance one of the objects of the company to the prejudice of a member where the advancement of the object necessarily entails prejudice to that member or discrimination against him ... The test of unfairness is objective and it is necessary, though difficult, to postulate a standard of reasonable directors possessed of any special skill, knowledge or acumen possessed by directors. The test assumes ... that reasonable directors weigh the furthering of the corporate object against the disadvantage, disability or burden which their decision will impose, and address their minds to the question whether a proposed decision is unfair

... The operation of [s 232] may be attracted to a decision made by directors which is made in good faith for a purpose within the directors' powers but which reasonable directors would think to be unfair.

**[24.85]** In determining whether conduct is oppressive or unfair, a court must often balance the conflicting interests of majority and minority shareholders. This balance is achieved by examining the company's background and the reasonable expectations of its shareholders. It is not necessarily oppressive or unfair just because there are irreconcilable differences between the parties or the controllers of a company are pursuing management or dividend policies with which a minority shareholder disagrees. It is also not necessarily unfair just because the majority shareholders refuse to buy the minority's shares: *Re G Jeffrey (Mens Store) Pty Ltd* (1984) 2 ACLC 421.

### *Conduct contrary to the interests of the members as a whole*

**[24.100]** Most of the court decisions in relation to s 232 have focused on whether conduct was oppressive or unfair. However, a court may also grant a remedy if it is satisfied that the conduct was contrary to the interests of the members as a whole: s 232(d). In *Campbell v Backoffice Investments Pty Ltd* [2008] NSWCA 95, Giles JA suggested that conduct that was "contrary to the interests of the members as a whole" had a separate and distinct area of operation from oppressive or unfairly prejudicial or unfairly discriminatory conduct. A s 232 remedy may be available where there was conduct that was contrary to the interests of the members as a whole even though that conduct was not necessarily oppressive or unfair. This could arise where conduct is pointlessly wasteful. According to Goldberg J in *Szencorp Pty Ltd v Clean Energy Council Ltd* [2009] FCA 40, "an example of such conduct may be found where a company is formed for the purpose of undertaking particular activities but the directors and management disregard those activities and direct the company into different commercial areas".

### *Examples of oppressive and unfair conduct*

#### **Diversion of corporate opportunity**

**[24.105]** Section 232 provides a remedy for minority shareholders if the majority shareholders divert a corporate opportunity to themselves or their associates. An illustration of such a fact situation can be seen in *Cook v Deeks* [1916] 1 AC 554, which is discussed at [16.240].

*Scottish Co-operative Wholesale Soc Ltd v Meyer* [1959] AC 324

**[24.110]** A company was formed for the purposes of purchasing yarn and selling material. The majority shareholders, who also controlled the board of directors, owned a mill that wove the yarn and then sold the material to the company. The majority shareholders set up another company which conducted the same activities as the company and so stopped selling material to it, with the result that the company's activities shrank. The House of Lords held that this constituted oppressive conduct under the English equivalent of s 232 and ordered that the majority buy the shares of the minority.



*Re Bright Pine Mills Pty Ltd* [1969] VR 1002

**[24.115]** A company was engaged in a sawmilling business. Its shareholders were Swallow, who held 5,500 shares, Denton, who held 1,250 shares and another, who held 250 shares. The three shareholders were also its directors. Denton was voted off the board and replaced by the company's solicitor. A partnership consisting of Swallow's relatives and associates was established to utilise the waste from the sawmilling business. Both Denton and the company itself were excluded from this profitable business. The operations of the partnership were conducted on the company's premises, used the labour of the company's employees and were managed by the company's manager. The company also resolved to allow the partnership the benefit of a lucrative licence for the peeling of logs, which had been negotiated by the company. Denton brought an action under a predecessor of s 232, complaining that both these lucrative businesses should have been undertaken by the company and that the majority shareholders sought to deprive him, as a shareholder, from participating in the profits derived from the businesses. It was held that Swallow, as the person in control of the company, was conducting its affairs in such a way as to benefit himself and others of his choice and to harm Denton. This conduct decreased the value of the assets of the company. Swallow's conduct was "burdensome, harsh and wrongful" so that the affairs of the company were being conducted in a manner oppressive to Denton.

**Refusal to pay dividends**

**[24.125]** It is generally the case that where companies are in essence "quasi-partnerships", there is the reasonable expectation of shareholders that profits of the business are to be divided up fairly among themselves, in accordance with the number of shares held, in a similar way to partnerships. The majority may act oppressively or unfairly where a minority shareholder is removed as a director and a significant proportion of profits is used for generous payments to directors while modest or no dividends are paid to shareholders. However, the mere fact that dividends were not as high as they could have been is not necessarily an indication of unfairness. Further, of itself, a decision by the directors to pay themselves large bonuses and fees instead of dividends is not oppressive or unfair if the company's profitability had increased significantly because of their efforts: *Morgan v 45 Flers Avenue Pty Ltd* (1986) 5 ACLC 222.

*Sanford v Sanford Courier Service Pty Ltd* (1986) 5 ACLC 394

**[24.130]** The court held that the majority shareholders acted oppressively towards the minority shareholder because after he was no longer a director, they excluded him from the profits of Sanford Courier Service. This was done by payment of high director salaries, provision of motor vehicles and retirement benefits to majority shareholders while refusing to pay dividends. This meant that a distribution of the company's profits was made to the majority shareholders while the minority shareholder was excluded after he was no longer a director. In these circumstances, a refusal to pay dividends was part of oppressive conduct and the court ordered that the other shareholders purchase the minority shareholder's shares.



*Wambo Coal Pty Ltd v Sumiseki Materials Co Ltd* [2014] NSWCA 326

**[24.140]** Wambo's constitution provided that its sole B class shareholder, Sumiseki, was entitled to certain dividends. It was held that Wambo acted oppressively towards Sumiseki by entering into a loan agreement with its parent company, which contained certain debt covenants which prevented the payment of dividends. Objectively fair behaviour on the part of Wambo would have entailed payment of dividends in accordance with the established course of conduct as set out in the constitution. The loan agreement with its contractual constraint was a means of unfairly enabling Wambo to refuse the payment of dividends. Wambo's conduct was oppressive because it involved commercial unfairness.

*Shamsallah Holdings Pty Ltd v CBD Refrigeration & Airconditioning Services Pty Ltd* [2001] WASC 8

**[24.145]** The company had a policy of restricting dividends to 50 per cent of net profits after tax. This policy had not been reviewed for a number of years even though its profits had quintupled and it had substantial cash reserves that were surplus to its needs. The Supreme Court of Western Australia held that the directors' failure to review the dividend policy in light of the company's changing and improving circumstances was oppressive, especially when at the same time the directors were increasing their own remuneration.

### Exclusion from management

**[24.150]** Family companies are often run as if they were family partnerships, with family members having a reasonable expectation of participating in the management of the family company's business. In companies that run a family business, it may be oppressive or unfair to exclude a particular family member from the company's management.

*Fexuto Pty Ltd v Bosnjak Holdings Pty Ltd* [2001] NSWCA 97

**[24.155]** Bosnjak Holdings Pty Ltd, a family company controlled by various members of the Bosnjak family, had three directors: two brothers, Bob and Jim Bosnjak, and Carol, the wife of their deceased brother John. Fexuto Pty Ltd, Bob's family company owned two-sevenths of Bosnjak Holdings shares and sought a remedy under a predecessor of s 232. It was held that even though Bob remained a director, the practice of the other directors of excluding Bob from involvement in the company's decision-making process was one of the relevant factors in their conclusion that there was oppressive and unfairly prejudicial conduct. The court found that, in essence, Bosnjak Holdings was a family partnership which had taken a corporate form. It was established to provide for the economic wellbeing of the Bosnjak family. In the circumstances, there was a legitimate expectation that Bob, as one of the senior members of the family, would be involved in the company's management.

**[24.160]** Exclusion from management as an example of oppressive or unfair conduct can also arise where a company is a joint-venture vehicle or quasi-partnership between two or more independent investors.

*Campbell v Backoffice Investments Pty Ltd* [2008] NSWCA 95

**[24.170]** A company was set up as a 50–50 joint venture between two investors who were the joint managing directors. Their respective family companies owned the shares. The court held that one of the managing directors had acted unfairly for purposes of s 232 when he excluded the other managing director from participating in day-to-day management of the company's business resulting in the excluded director not being paid. The excluded managing director was also prevented from accessing the company's accounting systems when the required password to login was changed. It was also unfair for the managing director to refuse the excluded director's reasonable attempts to hold a board meeting to discuss company business.

### **Directors' failure to act in the interests of the company**

**[24.175]** Minority shareholders may apply for a remedy under s 232 where directors breach their fiduciary duties by failing to act in the company's best interests and do not permit the company to take action against them. In such cases, a shareholder may also apply to the court for leave to bring proceedings on behalf of the company under s 236(1). This is discussed at [24.285]–[24.300].

*Re Spargos Mining NL* (1990) 3 WAR 166

**[24.180]** The company was, together with Enterprise Gold Mines NL, a member of the Independent Resources Ltd group. The court found that the affairs of the company were conducted in a manner that was oppressive and unfair. The directors exhibited "an endemic incapacity" to deal with the company's affairs by giving sole attention to its interests. There were clear cases of conflicts of interest that were detrimental to the company, its shareholders generally and the minority shareholders not otherwise interested in other companies in the group for whose benefit the transactions were undertaken. The transactions were almost entirely devoid of any commercial benefit to the company.

*Re Overton Holdings Pty Ltd* [1985] WAR 224

**[24.190]** Overton's managing director and majority shareholder, arranged for the company to lend money to two other companies controlled by him. These loans were made without the knowledge of Overton's other director and minority shareholder. The court held that the managing director had breached his duty because there appeared to be no commercial advantage to Overton in lending the money. The loans were unsecured and the borrowing companies were in financial difficulties. It was held that this conduct was oppressive because it was unlikely that

the board would take action against the managing director where the circumstances indicated the company had a reasonable cause of action.

### Improper share issues

**[24.200]** As discussed at [15.150]–[15.170], directors breach their fiduciary duties if they issue shares for improper purposes. This may also constitute oppressive or unfair conduct as the improper share issue will result in a dilution of the shareholdings held by non-participating shareholders.

If the directors who breached their duty are also the majority shareholders, they may also act oppressively or unfairly if, as shareholders, they vote to ratify their improper actions.

#### *Hannes v MJH Pty Ltd* (1992) 10 ACLC 400

**[24.205]** Hannes was the governing director and controlling shareholder of a family company. The constitution gave him total control of management as well as control of the majority of votes at a general meeting. Without disclosure to, or approval from, the other shareholders, Hannes and another director resolved to issue additional shares to Hannes. They also agreed that Hannes be employed under a service contract which provided for a large termination payment, and decided to establish a superannuation fund for Hannes. When the other shareholders discovered this, they applied for a remedy under a predecessor of s 232, arguing that the board's decisions were oppressive or unfairly prejudicial or discriminatory. The court granted the remedy and ordered that the company's constitution be changed to remove Hannes' absolute control over the voting at shareholders' meetings. The court held that Hannes' self-interest was the dominant motive in relation to the share allotment and service contract. He sought to provide himself with additional financial benefits at a time when his relationship with the other shareholders was deteriorating. The court also decided that Hannes, as majority shareholder could not ratify his own breaches of duty as this would be oppressive or unfair. The particular decisions made by the directors could only be ratified by the disinterested shareholders.

#### *Re Dalkeith Investments Pty Ltd* (1984) 3 ACLC 74

**[24.210]** Smith and his wife each held one-third of the shares of a company, the remaining shares were held by Inglis and his wife. Smith was chairman and a director; his wife was the other director. After Smith and his wife separated, the affairs of the company were conducted in an atmosphere of animosity. Smith arrived late at a general meeting of the company and, in his absence, Inglis took the chair and, together with his wife, was appointed a director of the company. Control thereby passed to Inglis and his wife with the acquiescence of Smith's wife. The directors then resolved to issue shares to all members. This resulted in Smith

having a choice of either investing more money in a company whose shareholders were hostile to his interests or allowing his shareholding to be diluted. It was also resolved that the company would acquire land from Inglis, the purchase price being paid partly in cash and partly by allotment of shares in the company. Smith brought an action seeking the winding-up of the company or, alternatively, that his shares be purchased at valuation. It was held that the actions of Inglis, his wife and Smith's wife were taken for the purpose of diluting Smith's shareholding and were not in the interests of the company as a whole. The directors acted oppressively by excluding Smith from an opportunity to participate in, or oppose, their decisions. The conduct also resulted in giving control of the company to one of the three groups of shareholders. This was unfairly prejudicial to, or discriminatory against Smith in his capacity as a member and the court ordered that his shares be purchased at an appropriate valuation.

## Remedies

**[24.215]** The court has wide powers to make any order it considers appropriate if shareholders can prove that the conduct of a company's affairs is contrary to the interests of the members as a whole, oppressive, unfairly prejudicial or unfairly discriminatory: s 233(1). There are two objectives in granting remedies under s 233; to bring an end to the oppressive or unfair conduct and to compensate the injured party: *Re Hollen Australia Pty Ltd* [2009] VSC 95. In determining an appropriate remedy the courts may take into account the conduct of both applicant and respondent: *Ubertini v Saeco International Group SpA (No 4)* [2014] VSC 47. The court may deny a remedy where the applicant has delayed bringing the proceedings and thereby adversely affected other parties: *Falkingham v Peninsula Kingswood Country Golf Club Ltd* [2015] VSCA 16.

Examples of orders that may be appropriate are set out in s 233. These include orders:

- that the company be wound up (s 233(1)(a));
- that the existing constitution be modified or repealed (s 233(1)(b));
- regulating the future conduct of the company's affairs (s 233(1)(c));
- for the purchase of the shares of any member by other members or a person to whom a share has been transmitted by will or by operation of law: s 233(1)(d). This is the most common order made;
- for the purchase of the shares with an appropriate reduction of the company's share capital (s 233(1)(e));
- that the company institute or defend legal proceedings or authorise a member to institute or defend legal proceedings in the name of the company (s 233(1)(f) and (g)). Such an order would be appropriate in cases where a company ratifies a breach of duty by directors or if it fails to bring an action against a director for breach of duty in circumstances where the ratification or failure is oppressive or unfairly prejudicial or unfairly discriminatory to one or more members;
- appointing a receiver or a receiver and manager (s 233(1)(h));
- restraining a person from engaging in specified conduct or from doing a specified act (s 233(1)(i)). Such an order would be appropriate where an act or conduct that

is oppressive, unfairly prejudicial or discriminatory has not yet been carried out but has merely been proposed. It is also appropriate where the conduct is of an ongoing nature; and

- requiring a person to do a specified act (s 233(1)(j)). This remedy enables omissions to be rectified.

The policy behind ss 232 and 233 is to enable an oppressed member to be released from the company in the circumstances set out in s 232: *Fedorovitch v St Aubins Pty Ltd* (1999) 17 ACLC 1558. A remedy under s 233 should not include an element of compensation. This excludes matters such as the incurring of capital gains tax and legal costs incurred in the transfer of assets.

Where an order is made under s 233, the applicant must lodge a copy of the order with ASIC within 14 days after it is made: s 235.

### Share buy-out

**[24.220]** The most common remedy sought by minority shareholders in s 232 cases is an order that the majority shareholders buy their shares: s 233(1)(d). While it is unusual, the court may also require the majority to sell their shares to the minority shareholder.

#### *Slea Pty Ltd v Connective Services Pty Ltd (No 9) [2022] VSC 136*

**[24.221]** Slea Pty Ltd owned one-third of the shares in the Connective Services group of companies which carried on a profitable business as mortgage aggregators. The dominant director of the group owned 50 per cent of the shares through companies he controlled. The remaining shares were held by another director of the Connective Services group. The directors other than Slea's director implemented a plan to remove Slea as a shareholder in the Connective Services group and by misleading conduct, to acquire Slea's shares at a depressed price. After Slea's director was asked to resign his directorship, the remaining directors determined to put Slea under financial pressure by failing to pay dividends. They purported to prevent Slea from selling its shares to anybody other than to interests associated with the remaining directors. The directors, in breach of their proper purpose duty, arranged for a restructure of the group, the effect of which was to dilute Slea's one-third shareholding to 25 per cent and Macquarie Bank was introduced as a new shareholder.

The court found that the majority shareholders engaged in oppressive and unfair conduct and ordered that Slea should buy out the shares of the majority shareholders, even though this is an unusual remedy in s 232 cases. A minority shareholder buy-out of the majority's shares may be appropriate where the conduct of the majority shareholder demonstrates unfitness to exercise control over the company and allowing them to remain in control would be damaging to the company or its business, or would pose a serious risk to the public.

The court has a wide discretion in determining a valuation for the purposes of a purchase of shares of members by other members or by the company. For example, in *Scottish Co-operative Wholesale Soc Ltd v Meyer* [1959] AC 324, the court ordered that the majority shareholders purchase the shares of the minority members at a price based on the value the shares would have had, had the oppressive conduct not taken place.

*Re Bagot Well Pastoral Co* (1993) 11 ACLC 1

[24.225] In this case, the court took into account a number of considerations in determining a valuation of shares. The shares were valued at the date of lodging the application under the predecessor of s 232. The valuation took into account the minority shareholder's disadvantageous position under the constitution. The majority shareholder had a right to require further shares to be issued and sole right to participate in distribution of surplus assets on a winding-up. The valuation assessment was based on revised annual accounts, which assumed proper commercial arrangements between the company and interests associated with the majority shareholder. The annual accounts were also revised to take into account the position that would have occurred had the directors paid reasonable dividends. The advantage to the majority shareholder of gaining full control was also a relevant factor.

### Replacement of directors

[24.230] The court has the power to replace directors.

*Re Spargos Mining NL* (1990) 3 WAR 166

[24.235] The court ordered that two directors of the company be replaced by a newly constituted board, comprising people who were independent of the controlling shareholders. The new board was ordered to investigate certain transactions entered into by the company and cause the company to commence proceedings against the former directors if that was appropriate.

### Appointment of receiver

[24.240] In appropriate circumstances, the court has the power to appoint a receiver to safeguard the company's assets and investigate alleged breaches of directors' duties and, where necessary, institute proceedings against the directors: *Jenkins v Enterprise Gold Mines NL* (1992) 10 ACLC 136. The general power of the court to appoint a receiver is discussed at [30.55]–[30.70].

### Authorisation of legal action

[24.250] The court may permit an oppressed or unfairly treated shareholder to bring a legal action against directors in the name of the company.

*Re Overton Holdings Pty Ltd* [1985] WAR 224

**[24.255]** The Supreme Court of Western Australia granted an order authorising a member to institute legal proceedings on behalf of the company under the equivalent of s 233(1)(g) against the managing director and his associated companies for breach of their duties to Overton Holdings. The court, in effect, allowed a derivative action to be brought.

**[24.257]** This remedy may be granted even though the particular conduct may also give rise to an action by the company against its directors. In such a case, a member may seek a remedy under s 233 and may also apply for leave to bring proceedings on behalf of the company under s 236 as these sections are not mutually exclusive: *LPD Holdings (Aust) Pty Ltd v Phillips* [2013] QSC 225. The right of a member to bring proceedings on behalf of a company is discussed at [24.285]–[24.300].

**Director not to participate in management**

**[24.260]** A director may be ordered not to interfere with the company's management.

*Re HR Harmer Ltd* [1959] 1 WLR 62

**[24.265]** A father and two sons were the directors of a family company. The father was chairman and governing director; however, the company's constitution did not confer any special powers upon him. Together with his wife, he controlled more than three-quarters of the shares and generally regarded the business of the company as his own. He ignored the wishes of the other directors and disregarded resolutions of the board. It was held that this conduct amounted to oppression. An order was made that the father, the company's governing director, should not interfere with valid decisions of the board of directors and that he enter into a contract with the company as a consultant at a specified salary.

**Alteration of constitution**

**[24.270]** The court has the power to order the company to alter its constitution.

*Hannes v MJH Pty Ltd* (1992) 10 ACLC 400

**[24.275]** The facts of this case are set out at [24.205]. The court ordered that the share issue and service agreement be set aside. In addition, it ordered that the company's constitution be altered so as to give the other shareholders a right to appoint their representatives to the board, a role in relation to alteration of the company's constitution and director's remuneration and advance notice of further issues of shares.



If the court orders that the constitution of the company be repealed or modified, the company cannot make any further alterations inconsistent with the order unless permitted by the order or with the leave of the court: s 233(3).

### Winding-up

**[24.280]** The courts are generally reluctant to wind up a solvent company as an alternative remedy will usually be of greater benefit to members as a whole. A winding-up order may be appropriate where the parties are unable to arrive at a commercial resolution; there has been an irretrievable breakdown of the relationship between shareholders causing a deadlock; or both parties have engaged in oppressive conduct. In such circumstances a liquidator is best able to investigate the most suitable course the company could take in seeking remedies against the parties: *Catalano v Managing Australia Destinations Pty Ltd* [2014] FCAFC 55. Where a provisional liquidator or liquidator has been appointed and a company's assets sold, the court should only order that the company be wound up: *Campbell v Backoffice Investments Pty Ltd* [2009] HCA 25. Where an order to wind up is made, the *Corporations Act* provisions apply as if the winding-up was ordered under s 461: s 233(2). Winding-up on the application of a member is discussed at [24.330]–[24.435].

### Proceedings on behalf of a company

**[24.285]** Part 2F.1A of the *Corporations Act* provides for a statutory derivative action which enables shareholders and other eligible applicants to bring legal proceedings on behalf of a company where the company is unwilling or unable to do so itself. The aim of Pt 2F.1A is to strengthen shareholders' rights and thereby provide more effective internal mechanisms to encourage appropriate corporate behaviour by directors.

To better reflect the nature of the proceedings involved, the expression "proceedings on behalf of a company" is used instead of "statutory derivative action". In order to clarify the law, shareholders' common law rights to bring derivative actions under the exceptions to the proper plaintiff rule in *Foss v Harbottle* have been abolished: s 236(3). The rule in *Foss v Harbottle* and its exceptions are discussed at [24.480]–[24.580].

Part 2F.1A of the *Corporations Act* recognises that a consequence of making it easier for shareholders to bring an action on behalf of a company is that directors may be unnecessarily inconvenienced by inappropriate legal actions brought by disgruntled shareholders. Part 2F.1A therefore requires the leave of the court to be obtained before this legal action can proceed. Such leave is only granted where the court is satisfied that the action is appropriate and in the best interests of the company.

There have been conflicting cases on the question whether courts have the power to grant leave to applicants to bring proceedings under Pt 2F.1A where the company is insolvent or under a form of external administration. *Chahwan v Euphoric Pty Ltd* [2008] NSWCA 52 held that Pt 2F.1A applies only to companies that are going concerns and not under the control of a liquidator. Similarly, in *Re CGH Engineering Pty Ltd* [2014] NSWSC 1132 it was held that Pt 2F.1A did not apply to companies in voluntary administration, as in the case of both a liquidation and voluntary administration, control of the company passes from the directors to the external administrator. The granting of leave where the



company is under external administration would usually delay the completion of the winding-up and prejudice creditors.

On the other hand, in *Re Barokes Pty Ltd (in liq)* [2022] VSC 642, the court granted a creditor leave to bring an action in the name of a company against its liquidators. It found that the liquidator had failed to consider the applicant's offer to buy the company's business and instead sold the business on materially inferior terms to another party associated with the directors. The applicant had shown that it had reasonable prospects of success in an action against the liquidators claiming that they breached their duties of care and skill thereby causing loss to the company and reducing the returns to its creditors in the liquidation. The court considered it was relevant in deciding to grant leave to bring an action in the name of a company in liquidation that the applicant proposed giving an indemnity and security for any costs awarded against the company.

### Who may apply?

**[24.290]** Under s 236(1), the following persons may bring proceedings on behalf of a company:

- a member, former member or person entitled to be registered as a member of the company or of a related body corporate; or
- present or former directors and officers of the company.

To ensure that company management is not diverted by vexatious litigation, eligible applicants must obtain leave from the court before commencing a proceeding on behalf of a company or intervening in proceedings to which the company is a party: s 236(1)(b).

#### Criteria for court leave.

The court must grant an application for leave if it is satisfied that all of the requirements in s 237(2) are met: *Charlton v Baber* [2003] NSWSC 745. These are:

- *it is probable that the company will not itself bring the proceedings*: s 237(2)(a). The applicant must show an authoritative refusal by the company to take specific proceedings after a request by the applicant to do so or the refusal can be inferred: *Swansson v RA Pratt Properties Pty Ltd* [2002] NSWSC 583. The refusal by a company to bring proceedings may arise because the proceedings involve breaches of duty by current directors, the company has insufficient funds to bring the action or the company is deadlocked by shareholder divisions;
- *the applicant is acting in good faith*: s 237(2)(b). This criterion requires the court to be satisfied that the applicant honestly believes that a good cause of action exists and has a reasonable prospect of success, and the applicant is not seeking to bring the derivative action for some collateral purpose that would amount to an abuse of process: *Swansson v RA Pratt Properties Pty Ltd* [2002] NSWSC 583. This criterion requires the applicant to show that they would suffer a real and substantive injury if a derivative action were not permitted, provided that the injury was dependent upon or connected with the applicant's status as a shareholder or director: *Chahwan v Euphoric Pty Ltd (t/as Clay & Michel)* [2008] NSWCA 52. The fact that the applicant has a personal interest in the outcome of the proposed derivative proceedings does

not indicate the absence of good faith: *Maier v Honeysett & Maier Electrical Contractors Pty Ltd* [2005] NSWSC 859. It will be relatively easy to satisfy the requirement that the applicant is not seeking to bring the application for a collateral purpose that would amount to an abuse of process where the application is made by a current shareholder who has more than a token shareholding and the proceedings seek recovery of property which, if returned, would mean that the value of the applicant's shares would be increased (*Huang v Wang* [2015] NSWSC 510);

- *it is in the best interests of the company that the applicant be granted leave*: s 237(2)(c). This requires an applicant to establish on the balance of probabilities a fact which can only be determined by taking into account all the relevant circumstances: *Swansson v Pratt* [2002] NSWSC 583. The court must consider the company's "separate and independent" welfare rather than the applicant's interests: *Jeans v Deangrove Pty Ltd* [2001] NSWSC 84. In considering what is in the best interests of the company, it is necessary to consider whether there will be a practical benefit to the company if the action is successful. This may involve consideration of the prospects of success of the action, the likely costs and likely recovery if the action is successful and likely consequences if it is not. It is also necessary to consider the resources the company will have to devote to the action, the effect the action may have on other aspects of the company's business and whether an alternative remedy may be sought by the applicant: *Re Gladstone Pacific Nickel Ltd* [2011] NSWSC 1235. Where the company is a going concern, the interests of the company correspond to the interests of its shareholders as a whole; while if the company is insolvent, its interests correspond to the interests of its creditors so the court will consider whether allowing the proceedings will in likelihood increase the return to creditors. Granting leave is unlikely to be in the best interests of the company where the plaintiff is able to pursue a claim via another cause of action and the relief sought under the alternative cause of action is the same as the relief sought under the proposed derivative action (*Hackett v Nambucca Valley Quarries Pty Ltd* [2012] NSWSC 1189);
- *there is a serious question to be tried*: s 237(2)(d). The applicant must identify the specific legal rights to be determined at the later trial. This criterion requires applicants to provide evidence merely to show an arguable case as the courts do not consider the merits of the applicant's case in depth at this stage (*Zhu v Orico Australia Pty Ltd* [2019] VSC 313); and
- *the applicant gave notice to the company* at least 14 days before making the application of the intention to apply for leave and the reasons for applying, or it is appropriate to grant leave even though notice was not given: s 237(2)(e). The courts will generally only dispense with the requirement to give notice where the company is clearly aware of the applicant's intention to seek leave or there are good reasons for the application to be brought urgently: *Hislop v Paltar Petroleum Ltd (No 3)* [2017] FCA 1253.

Section 237(3) assists a court in deciding whether it is in the best interests of the company that an applicant be granted leave for purposes of the s 237(2)(c) requirement. Where the company's decision not to bring legal proceedings is made by its directors, s 237(3) creates a rebuttable presumption that granting leave is not in the best interests of the company in the following circumstances:

- all directors who participated in the decision not to bring, defend or settle proceedings made the decision in good faith for a proper purpose;
- the directors did not have a personal material interest in the decision;

- the directors informed themselves about the subject matter of the decision to the extent they reasonably believed to be appropriate; and
- the directors rationally believed the decision was in the best interests of the company. Such a belief is a rational one unless the belief is one that no reasonable person in the position of the directors would hold.

These circumstances correspond to the requirements of the business judgment rule discussed at [17.160]–[17.170].

Section 241(1)(d) also assists the court in deciding whether to grant leave. That provision gives the court the power to appoint an independent person to investigate and report on the financial affairs of the company, the surrounding circumstances of the cause of action and the costs incurred in the proceedings by the parties to the proceedings and the person granted leave.

### *Ratification by general meeting*

[24.295] At common law, a shareholder could not bring a derivative action against directors if the directors' conduct was either ratified at a general meeting of shareholders or capable of being ratified at such a meeting. However, some breaches of duty were non-ratifiable and it was unclear when this was the case.

Section 239(1) simplifies the common law complexities by providing that ratification does not prevent a person bringing proceedings on behalf of the company or applying for leave to do so. The court may, however, take ratification into account in deciding what ultimate order it should make: s 239(2).

### *Legal costs*

[24.300] One of the main disincentives facing shareholders who contemplate bringing an action on behalf of a company is that they have to bear at least some of the legal costs of the proceedings while the benefit of any successful action goes to the company. Under the previous law, company funds were generally not available to shareholders to finance the legal costs of their derivative actions.

Section 242 gives the court a broad discretion to make any order it considers appropriate about the legal costs of the applicant, the company or any other party to the proceedings. Such orders can include an order requiring indemnification by the company for the applicant's costs. In deciding whether to order that a company pay the applicant's costs, the court should protect a bona fide shareholder against liability for costs where the company stands to gain considerable benefit if the action is ultimately successful. A costs order may be varied or recalled at a later time where there are good reasons for doing so. There may be good reason for doing so if the applicants pursue claims that they ought to have realised were not in the best interests of the company at the time that the claims were being litigated: *Links Golf Tasmania Pty Ltd v Sattler (No 2)* [2012] FCA 1271.

## **Section 1324 injunctions**

[24.305] Under s 1324(1), the court has a discretion to grant an injunction restraining a person from engaging in conduct that contravenes the *Corporations Act*. In addition, the

court may, if it thinks it is desirable to do so, require that person to do any act or thing. The court may issue an injunction under s 1324 to mark its disapproval of the conduct involved and to deter others from engaging in similar conduct in the future: *ASIC v Storm Financial Ltd (Receivers and Managers Appointed) (in liq) (No 2)* [2011] FCA 858.

Where an application is made under s 1324(1), the court may grant an interim injunction restraining particular conduct, before considering the application: s 1324(4). This means that an applicant may speedily obtain an injunction order with the case to be fully decided at a later hearing.

In addition to granting an injunction under s 1324(1), the court may also order that the person acting in contravention of the *Corporations Act* pay damages to any other person: s 1324(10). There are conflicting views as to whether an order for damages can be made pursuant to s 1324(10) where no injunction is sought. In *Permanent Trustee Australia Ltd v Perpetual Trustee Co Ltd* (1994) 15 ACSR 722, the court gave a broad reading of s 1324 and determined that a damages order under s 1324(10) may be made even if the applicant had not applied for an injunction under s 1324(1). The opposite and perhaps stronger view, that an injunction must be sought, was expressed in *Executor Trustee Australia Ltd v Deloitte Haskins Sells* (1996) 22 ACSR 270.

The question has arisen whether a creditor may seek damages under s 1324(10). In *McCracken v Phoenix Constructions (Qld) Pty Ltd* [2012] QCA 129, a director contravened s 182(1) by acting improperly in using his position to gain an advantage for his wife and thereby causing detriment to the company. The Queensland Court of Appeal held that s 1324(10) did not empower the court to award damages to a creditor following a contravention of a civil penalty provision. Section 1317H deals with compensation for contraventions of civil penalty provisions and it states that only ASIC and the corporation, to the exclusion of any other interested persons, are able to claim for compensation. Civil penalty provisions are discussed at [19.120]–[19.150].

## Contravention of the Corporations Act

**[24.310]** Conduct that constitutes a “contravention” of the *Corporations Act* includes conduct that is regarded as a criminal offence under the *Corporations Act*. For example, as discussed at [7.195], a person who issues a disclosure document that contains a material statement that is misleading or deceptive contravenes s 728, which is a criminal offence. Section 1324 allows the court to grant an injunction to restrain the person from issuing the disclosure document in such circumstances.

A court may also grant an s 1324 injunction to restrain a contravention of a section of the *Corporations Act* that is a designated civil penalty provision. The designated civil penalty provisions include ss 180–183 (statutory duties of officers), s 588G (insolvent trading), s 208 (related party transactions) and the various sections that deal with share capital transactions. As discussed at [19.120]–[19.155], contravention of a civil penalty provision may have both civil and criminal consequences. Contravention may result in the imposition of civil penalty orders under s 1317G and a liability to pay compensation under s 1317H. Criminal proceedings may be brought under s 184. The interaction of s 1324 and the civil penalty provisions in relation to the standing of parties seeking an injunction is discussed at [24.325].

Section 1324 does not apply to conduct that merely contravenes a provision in a company's constitution or the replaceable rules. According to s 135(3), this is not regarded as a contravention of the *Corporations Act*, but may be remedied as a breach of contract under s 140(1).

### Who may apply?

**[24.315]** ASIC or a person whose interests have been affected by the conduct can apply to the court for an s 1324 injunction: s 1324(1). The discussion in this part of the chapter is concerned with actions brought under s 1324 by shareholders whose interests are affected by conduct that constitutes a contravention of the *Corporations Act*. An example of an action brought by ASIC under s 1324 is discussed at [19.153].

#### *Broken Hill Proprietary Co Ltd v Bell Resources Ltd* (1984) 2 ACLC 157

**[24.320]** The range of persons who may apply for an s 1324 injunction was considered in this case. It was held that a broad interpretation should be given consistent with the objects of the legislation when determining who could apply for an injunction under the predecessor of s 1324. It decided that the persons who could apply under s 1324(2)(b) need not show that personal rights of a proprietary or similar nature were or may be affected by the conduct. Further, they need not prove that they suffered any special injury arising from the contravention of the *Corporations Act*. However, applicants must establish that their interests go beyond the mere interests of members of the public.

**[24.325]** There are conflicting cases on the question whether a shareholder or creditor can apply for an s 1324 injunction where the contravention of the *Corporations Act* was a breach of the statutory directors' duties. The *Broken Hill* case seems to suggest that shareholders do have standing under s 1324 because they have an interest that goes beyond that of a member of the public. This approach was followed in *Airpeak Pty Ltd v Jetstream Ltd* (1997) 73 FCR 161, where it was held that shareholders, as well as creditors of a company, had standing to apply for an s 1324 injunction to restrain breaches of duty by directors as their interests could be affected by directors' contraventions of their duties. The court noted that, because it retained the ultimate discretion whether to grant an injunction, giving standing to shareholders and creditors in cases where the civil penalty provisions were contravened would not result in an opening of the floodgates of actions against directors and cause disruption to the proper running of companies.

The problem with giving shareholders standing in cases of breach of directors' duties is that this would constitute an indirect means of bringing proceedings on behalf of a company without following the procedure set out in Pt 2F.1A. This procedure is discussed at [24.285]–[24.300]. It also enables shareholders to seek a remedy where they are excluded from applying for a civil penalty order. Civil penalty orders are discussed in [19.120]–[19.150]. In *Mesenberg v Cord Industrial Recruiters Pty Ltd* (1996) 39 NSWLR 128, the Supreme Court of New South Wales expressed strong doubts that s 1324 was intended to be used to circumvent the restrictions contained in the civil penalty provisions. It held that because shareholders did not have standing to apply for a civil penalty order,

only ASIC could apply for a s 1324 injunction to restrain contraventions of civil penalty provisions.

Standing of creditors and shareholders to apply for an injunction.

*McCracken v Phoenix Constructions (Qld) Pty Ltd* [2012] QCA 129 agreed with the *Mesenberg* approach. It was held that the contraventions of the *Corporations Act* to which s 1324 refers did not include the statutory directors' duties in ss 180–183 and therefore such contraventions could not be used to give creditors standing to apply for an injunction or claim damages under s 1324(10).

A contravention of the *Corporations Act* is taken to affect the interests of a creditor or member of a company if:

- the insolvency of the company is an element of the contravention; or
- the company contravenes the share buy-back, financial assistance or share capital reduction provisions contained in ss 257A, 260A and 256B, respectively: s 1324(1A).

Where it is alleged that these provisions have been contravened by the company or other person, the onus is on the company or other person to prove that no contravention has occurred: s 1324(1B). Sections 1324A and 1324B give the court the power to order persons who contravened the following provisions to publish corrective advertisements at the person's own expense:

- managed investment scheme provisions of Ch 5C;
- continuous disclosure provisions of Ch 6CA;
- fundraising provisions of Ch 6D;
- market misconduct provisions of Pt 7.10; and
- corporate collective investment vehicles provisions of Pt 8B.

## Winding-up

**[24.330]** There are various grounds set out in s 461(1) upon which the court may order the winding-up of a company on the application of a member.

Grounds for court-ordered winding-up of solvent companies.

It is a drastic step to apply for the winding-up of a solvent company and so requires a strong case: *ASIC v ABC Fund Managers (No 2)* [2001] VSC 383. It may have adverse results for the applicant and other members as assets generally realise less than if they are sold as part of a going concern. This is especially the case if no ready buyer can be found for the assets of the company. The court will not make a winding-up order under s 461(1)(e), (f), (g) or (k) if it is of the opinion that the applicants have some other available remedy or that they are acting unreasonably in seeking the winding-up order instead of pursuing that other remedy: s 467(4). It is not unreasonable for applicants to seek a winding-up order if there is uncertainty as to whether another party is able to buy-out the applicant under a buy-out order: *Asia Pacific Joint Mining Pty Ltd v Always Resources Holdings Pty*



*Ltd* [2018] QCA 48. From the applicant's point of view, an order under s 233 is usually preferable to a winding-up and the courts have a wide discretion in the type of order they can make.

*Re Dalkeith Investments Pty Ltd* (1984) 3 ACLC 74

**[24.335]** The facts of this case are discussed at [24.210]. A divorce between two major shareholders resulted in a breakdown in the mutual trust and confidence between members. As this was irreconcilable, the applicant shareholder was entitled to have the company wound up under what is now s 461(1)(k). However, the court held that a remedy under the equivalent of s 232 was less drastic and more appropriate in the circumstances as a winding-up would have been prejudicial to the shareholders other than the applicant. The company was profitable and held considerable net assets and should not unnecessarily be put into liquidation.

### *Directors act in their own interests*

**[24.340]** Under s 461(1)(e), the court may wind up a company if the directors have acted in their own interests rather than in the interests of the members as a whole, or in any other manner that is unfair or unjust to other members.

There have been few cases dealing with this ground for winding-up. The circumstances where s 461(1)(e) applies will normally also give a shareholder a remedy under s 232. They will also usually satisfy the ground for winding-up under s 461(1)(k), the "just and equitable" ground. This is discussed at [24.360].

*Re William Brooks & Co Ltd* [1962] NSWLR 142

**[24.345]** The managing director of a successful company used his position as a director to acquire options to purchase shares that had been issued to the company's employees. This arrangement was entered into to enable him to control the majority of votes at a general meeting of members. The managing director also managed the company's business without consulting the other directors. Further, for a number of years he saw to it that the company paid extravagant bonuses to employees. These payments concealed the fact that the company was in fact very profitable and had the effect of depressing the market price of the shares on the stock exchange. The court held that in these circumstances the managing director had committed serious and persistent breaches of his fiduciary duty. As he acted in his own interests and in a manner that was unfair or unjust to members, the court ordered that the company be wound up under a predecessor to s 461(1)(e).

### *Oppressive and unfair conduct*

**[24.350]** Where the grounds for a remedy under s 232 are established, a member may also apply to have the company wound up under s 461(1)(f) and (g).

*Kokotovich Constructions Pty Ltd v Wallington* (1995) 13 ACLC 1113

[24.355] The court ordered that a company be wound up under s 461(1)(f). The directors breached their fiduciary duties when they issued shares for the improper purpose of manipulating the voting power to the detriment of the minority shareholder. The court noted that even though winding-up a successful and prosperous company was an extreme step, it was appropriate in this case because of the real risk of further oppressive conduct and the limited nature of the company's business activities.

## *Just and equitable ground*

[24.360] Under s 461(1)(k), the court may order the winding-up of a company if it is of the opinion that this would be just and equitable. This ground has been interpreted very broadly so as to give the courts a very wide discretion as to when to order a winding-up and has often been used as a means of resolving a situation where minority shareholders have been harshly treated by the controllers of a company or where the company is unable to properly function. It appears to overlap with s 461(1)(e), (f) and (g), but encompasses a wider range of circumstances. It also overlaps with s 232. Any member has a right to apply for a winding-up on these grounds even if the company is solvent and able to pay its debts.

The courts may wind up a company on the “just and equitable” ground in a number of different circumstances.

The courts have wound up companies on the just and equitable ground in a number of different circumstances. These include situations where there is:

- a breakdown in the mutual trust and confidence of members;
- a deadlock;
- fraud, misconduct or oppression in the conduct and management of the company's affairs;
- a public interest that the company be wound up;
- no director; or
- a failure of substratum.

### **Breakdown of mutual trust and confidence**

[24.365] It is just and equitable to wind up a company that is a “quasi-partnership” if there has been a breakdown in the mutual trust and confidence that should exist among shareholders or there are irreconcilable differences between them. In the case of small companies that have evolved from partnerships or that operate in a similar manner to partnerships, it has been held just and equitable to wind up the company when the relationship between the “partners” breaks down. This power of the court is based upon a similar discretion the court has to order the dissolution of a partnership. The relationship may break down for a variety of reasons.



*Lawrence v Lawrick Motors Ltd* (1948) 2 SA 1029 (WLD)

**[24.370]** A South African company was controlled by two families. The court held that the mutual trust and confidence between the directors broke down when one director had a relationship with the wife of the other. The court ordered that the company be wound up.

*Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360

**[24.375]** One “partner” attempted to “freeze out” another from the management of the company’s business by removing him as a director.

The House of Lords ordered a winding-up of the company on the just and equitable ground. It held that even though the applicable *Companies Act* and articles may allow for a particular course of action, such as the removal of a director, where the company was in substance a “quasi-partnership” the majority shareholders had to act in a way that was consistent with the understanding the shareholders had at the time the company was formed. This understanding involved mutual confidence. It was appropriate in this case to order a winding-up because this understanding had been repudiated. The minority shareholder was excluded from management of the affairs of the company and he lost his right to share in its profits.

**[24.380]** Section 232 also applies in circumstances similar to *Ebrahimi*’s case and provides for more appropriate and flexible remedies than the extreme step of winding-up, especially where the company is solvent.

Indicators of a breakdown of a quasi-partnership that justifies winding-up on just and equitable grounds include misuse of proceeds from the sale of company assets and exclusion of a director from access to the company’s books: *Stapp v Surge Holdings Pty Ltd* (1999) 17 ACLC 896. Further indicators include failure to comply with tax obligations, failure to maintain company records and intermingling of company and personal funds: *Entwisle v Minken Pty Ltd* [2013] VSC 709.

**[24.390]** A court will only make a winding-up order if the breakdown of mutual trust and confidence is of a degree that materially frustrates the commercial viability of the company and any loss of confidence by one of the shareholders is justified: *Tomanovic v Argyle HQ Pty Ltd* [2010] NSWSC 152. The fact that there had been a dispute over respective shareholdings that had since been resolved by the court did not in itself show an irretrievable breakdown of confidence or a deadlock between family members. Mere disagreement is an insufficient basis for a winding-up order.

## Deadlock

**[24.395]** The just and equitable ground is established where the shareholders are deadlocked to the extent that the company is unable to function properly: *Re Yenidje Tobacco Co Ltd* [1916] 2 Ch 426. This is also analogous to the situation in partnership law where a deadlock or dispute between the partners results in an order that the partnership be dissolved. In such cases it is not necessary for the applicant to show that other members

acted oppressively or unjustly. The courts will generally not interfere if the deadlock can be resolved under the articles.

**[24.405]** Another alternative in the case of a deadlock is for the court to convene a general meeting where this is impracticable under the replaceable rules or constitution. In *Re Totex-Adon Pty Ltd* [1980] 1 NSWLR 605, a company had two shareholders, one of whom refused to attend meetings. The articles required a quorum of two. The court convened a general meeting under the equivalent of s 249G and ordered that the presence of one member would constitute a quorum.

### **Fraud, misconduct or oppression**

**[24.410]** The court may wind up a company on the just and equitable ground if there has been fraud, misconduct or oppression. This ground has been largely incorporated into s 232, which allows for a wide range of remedies.

#### *ASIC v Sino Australia Oil & Gas Ltd* [2016] FCA 201

**[24.415]** A winding-up order was made against a company on the just and equitable ground, notwithstanding that it might be solvent. The court found that the company's prospectus contained false and misleading statements in contravention of s 728 (see [7.185]); the company made false and misleading statements to its auditors in contravention of s 1041H (see [26.190]); and breached its continuous disclosure obligations under s 674: see [22.135]–[22.145]. As a result of these contraventions the court concluded that there had been substantial and serious misconduct in the affairs of the company. Further, the evidence indicated that there were also serious reasons to have concern about the competency of the company's management.

### **Public interest**

**[24.420]** Following an investigation into the affairs of a company, s 464(1) gives ASIC standing to apply to the court for the winding-up of the company. ASIC winding-up applications on the just and equitable ground are usually based on the public interest to protect shareholders and creditors.

A company may be wound up on the just and equitable ground on the application of ASIC where the company's directors mismanage its business and repeatedly breach the *Corporations Act* so that there is a real risk to actual and potential investors that such breaches would continue: *ASIC v Stone Assets Management Pty Ltd* [2012] FCA 630. In this case, a company carried on a financial services business without being licensed. The company published statements on its website and among other things misrepresented that it was the holder of an Australian Financial Services Licence. Also it contravened s 201A(1) which requires at least one director to ordinarily reside in Australia.

#### *ASIC v CME Capital Australia Pty Ltd (No 2)* [2016] FCA 544

**[24.421]** The court held that a company may be wound up on just and equitable grounds where there is a justified lack of confidence in the conduct and management

of a company's affairs such as to give rise to a real risk to the public interest that warrants protection. A justified lack of confidence in the conduct and management of a company's affairs would be demonstrated by evidence of the propensity of the company's controllers' failure to comply with legal obligations, including the keeping of books, records and documents, and failure to look after the affairs of the company. A risk to the public interest that warranted protection would be established by evidence that a company had not carried on its business candidly and in a straightforward manner with the public. Winding-up may also be justified to protect and condemn repeated breaches of the law.

**[24.425]** In appropriate circumstances, a minority shareholder may succeed in winding-up a company on just and equitable grounds, on the basis that it was in the public interest to do so. For example, in *Re JSSP Holdings Pty Ltd* [2021] VSC 33, a minority shareholder of a company that conducted a children's indoor play centre, alleged that the play centre's construction did not comply with industry regulations, the company did not maintain public liability insurance and there were electrical safety issues. The court held that it was in the interests of public safety that the operator company be wound up under s 461(1) (k). Even though a winding-up order would adversely affect the interests of the majority shareholders, protecting the public interest was of paramount importance.

#### **No director**

**[24.427]** A winding-up order can be made where a company has not had a director appointed to it for some time who could make corporate decisions on its behalf and who is subject to the responsibilities imposed on an appointed director: *Boyd v Feeney* [2017] NSWSC 1595.

#### **Failure of substratum**

**[24.430]** A company may be wound up on the just and equitable ground where it ceases to carry on the business for which it was formed. This is referred to as "failure of substratum".

#### *Re Tivoli Freeholds Ltd* [1972] VR 445

**[24.435]** A company was formed for the purposes of carrying on the business of theatre proprietor, conducting entertainment and other associated activities. Its main asset was land upon which theatres were built. A fire severely damaged the buildings and the theatrical activities ceased. Tivoli Freeholds Ltd then sold the land with the approval of the general meeting. The board resolved to lend the surplus funds thus obtained to the majority shareholder, repayable at call. A group of minority shareholders, applied to wind up the company on the grounds of oppression and on the just and equitable ground. It was held that it was just and equitable that the company be wound up because the company was acting entirely outside what could fairly be regarded as having been within the general intention and common understanding of the members when they became members. In order to ascertain the commonly understood purposes of the company, it is permissible to look beyond the objects clause to things such as a prospectus, the company's course of conduct and even its name.

## Members' right to inspect books

[24.440] The right of members to inspect their company's books raises two competing considerations. This right enhances the ability of shareholders to hold directors accountable because it gives them the means to enforce the members' remedies discussed at [24.10]–[24.437] through access to company information and records. On the other hand, giving members the right to inspect company books could infringe the legitimate interest of a company to prevent confidential or sensitive information becoming accessible to disgruntled shareholders. Shareholders' rights of inspection were limited to common law rights and under the company's constitution. Section 247D contains the replaceable rule that directors or the company by resolution passed at a general meeting may authorise a member to inspect the books of the company. At common law, the right of members to inspect books was limited to narrow circumstances. A member had to establish that inspection was necessary with reference to a particular dispute. The interest of the shareholder must be a "special interest" greater than that of other shareholders. The rationale for this restrictive approach was that shareholders do not generally have the right to challenge the management decisions of directors.

Access to the company's books can also be achieved through court rules which provide for a discovery procedure where the parties gain access to documents from the other side relevant to the litigation. Once a shareholder commences litigation, they have the right to require the company and other parties to produce relevant documents and answer specific questions dealing with the case.

### Section 247A

[24.450] The common law rights of a member to gain access to the books of a company have been expanded by s 247A. Under that provision a member may apply to the court for an order authorising the member or another person to inspect books of the company. The court may make such an order only if it is satisfied that the member is acting in good faith and the inspection is to be made for a proper purpose: s 247A(1). The rationale behind s 247A is to enable a shareholder who has identified an appropriate case for investigation to determine whether that case has any substance or prospects: *Merim Pty Ltd v Style Ltd* [2009] FCA 314. The applicant must be an actual member at the time of the judgment: *Leadenhall Australia Pty Ltd v Cape Lambert Resources Ltd* [2018] FCA 558.

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|---------------------|
| Meaning of "books". |
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The meaning of "books" extends to documents that would inform the applicant's decision as to whether to bring legal proceedings. In *Merim Pty Ltd v Style Ltd* [2009] FCA 314, the court ordered that the applicant be granted access to directors' and officers' insurance policies. The court also has the discretion to restrict the books to which a shareholder is given access: *Majestic Resources NL v Caveat Pty Ltd* [2004] WASCA 201.

The term "books of the company" for purposes a s 247A does not include proxy forms shareholders have delivered to the company prior to its AGM as they are merely documents the company uses to facilitate its AGM: *Re Cromwell Property Securities Ltd* [2019] NSWSC 1608.

The court may authorise a person other than a member to inspect the books on behalf of a member. This enables a member to seek an order authorising a solicitor, auditor or other appropriate person to obtain certain information to assist the member in the conduct of litigation. A court order is required so as to prevent access to the books in circumstances where the member is not seeking information in the capacity of a member and this is to the detriment or inconvenience of the company. This could arise where the information sought is confidential or is to be used to further the personal interests of the member. The person authorised to inspect the books may make a copy unless the court orders otherwise: s 247A(2).

In *Tinios v French Caledonia Travel Service Pty Ltd* [1994] FCA 1154, a shareholder was able to nominate persons to inspect the company's books solely for the purpose of valuing the shares and not to assist in possible legal action. A person who inspects the books on behalf of a member may only disclose information obtained during the inspection to the member or ASIC: s 247C.

A person who is granted leave to bring proceedings on behalf of a company under s 237 also has the same rights as a member to inspect the company's books: s 247A(3)–(6). Persons other than members who may apply for leave under s 237 include former members, members of a related company and officers or former officers of the company: s 236(1).

In addition to an order authorising inspection of the company's books, the court may make any other orders it considers appropriate. Such orders may limit the use that may be made of information acquired during the inspection or the right to make copies of the books: s 247B.

The right of a member to apply to the court for an order authorising inspection of the company's books is in addition to a right of directors and former directors under s 198F to inspect the company's books for the purposes of legal proceedings. This is discussed at [22.30].

The procedure under s 247A is not intended to bypass legal professional privilege and allow access to documents that are excluded from discovery in court proceedings. This discretionary power of the court was described as “remedial” and a provision of last resort: *Czerwinski v Syrena Royal Pty Ltd* [2000] VSC 125.

### **Good faith and proper purpose**

[24.455] A member who applies for an inspection order must satisfy the court that they are acting in good faith and the inspection is for a proper purpose. The requirements of good faith and proper purpose are a composite notion rather than two distinct requirements: *Knightswood Nominees Pty Ltd v Sherwin Pastoral Company Ltd* (1989) 15 ACLR 151. “Proper purpose” means a purpose connected with the proper exercise of the rights of a shareholder as a shareholder and not as a litigant in proceedings against the company or as a takeover bidder: *Cescastle Pty Ltd v Renak Holdings Ltd* (1991) 6 ACSR 115. Applicants are more likely to satisfy these requirements if they hold a significant shareholding for a considerable period of time: *Quinlan v Vital Technology Australia Ltd* (1987) 5 ACLC 389.

*Unity APA Ltd v Humes Ltd (No 2)* [1987] VR 474

[24.460] Unity APA, a minority shareholder of Humes, made a hostile takeover offer. Humes purchased a steel business, the consideration for which was a placement of shares to the vendor. The effect of this agreement was to dilute Unity APA's shareholding. Unity APA applied for an order under the equivalent of s 247A, authorising an accountant and lawyer to inspect and make copies of books relating to the acquisition of the steel business. Unity APA was concerned that the directors of Humes may have acted in breach of fiduciary duty and argued that access to the company's books was necessary to enable it to ascertain the motives of the directors. Humes argued against Unity APA being given access on the main ground that Unity APA was seeking information to assist its takeover bid and this was not a "proper purpose" within the meaning of s 247A(1).

The court granted the order allowing access. Unity APA may have sought information to assist its takeover offer but this was not its dominant purpose. The dominant purpose was to ascertain whether the directors were in breach of duty and whether the Humes proposal should be opposed. Unity APA's suspicions regarding the proposed acquisition were well founded. The application for a right to inspect was not a simple challenge to a management decision as the proposal involved a significant restructuring and expansion of Humes' activities.

[24.470] Further examples where the court found that the member's application to inspect a company's books satisfied the "proper purpose" test include:

- an investigation of irregularities in the company's financial accounts (*Vinciguerra v MG Corrosion Consultants Pty Ltd* [2007] FCA 503);
- an inspection for the purpose of valuing a member's shares so as to negotiate a fair exit price (*Tinios v French Caledonia Travel Service Pty Ltd* [1994] FCA 1154); and
- an inspection to enable a member to determine the extent of cover directors had under insurance policies which was relevant to the member's decision whether to bring proceedings in the name of the company against the directors (*Merim Pty Ltd v Style Ltd* [2009] FCA 314).

Normally, a shareholder's right to inspect books under s 247A is limited to the books of the company of which they are a member and does not extend to applications to inspect the books of subsidiaries or associated companies. However, in *Intercapital Holdings Ltd v MEH Ltd* (1988) 6 ACLC 1068, it was held that an application may be granted to inspect the books of a holding company where a subsidiary has entered into a transaction that may threaten the value of the shareholder's investment in the parent company.

## Duties of controlling members

[24.475] At common law, there are certain duties owed by majority shareholders to the company that constitute restraints imposed on the general meeting of shareholders. In *Gambotto v WCP Ltd* (1995) 182 CLR 432, the majority of the High Court considered that where a special resolution alters the constitution in a manner that gives rise to a conflict of interest or advantages, the special resolution is valid unless it is beyond any purpose

contemplated by the constitution or is oppressive. This case is discussed at [4.220]. The meaning of “oppressive conduct” is discussed at [24.75]. Where the majority seek to expropriate the shares of a minority shareholder, this may be outside the contemplated objects of the power to amend the company’s constitution. Expropriating shares must be for a proper purpose and be fair. It cannot be for the purpose of benefitting the majority.

While these tests suggest that majority shareholders are under some duty to consider the interests of minority shareholders, the extent and application of this duty have posed some problems. The duties of majority shareholders are quite different from those of directors. As discussed at [13.10], directors and certain other officers stand in a fiduciary position as regards the company. Their fiduciary obligation imposes clear duties on directors to consider the interests of their company ahead of their own interests. Conversely, it is clearly recognised that shareholders have a proprietary interest in their shares that is similar to a proprietary interest in any other property. This enables shareholders to exercise any voting rights attaching to their shares in their own self-interest: *North-West Transportation Co v Beatty* (1887) 12 App Cas 589. Shareholders, in contrast to directors, may even enter into a contract whereby they agree to exercise their voting rights in the future in a particular way.

This right of shareholders to vote in their own interests extends to situations where a director seeks to exercise voting rights as a shareholder at a general meeting called to ratify their actions as a director which are in breach of duty: *Mills v Mills* (1938) 60 CLR 150. Thus where directors control general meetings, they are able to exercise voting rights as shareholders in their own interests. They are then able to have a resolution passed that exonerates them from breaches of duty as directors. However, this may constitute oppressive or unfair conduct and enable shareholders to obtain a remedy under s 232. In some cases, the *Corporations Act* prevents directors and their associates from voting their shares at shareholders’ meetings. For example, under s 224 directors and other related parties of a public company are not permitted to vote at a shareholders’ meeting that considers whether or not to approve the giving of financial benefits to them.

## Enforcement of members’ personal rights

### The rule in *Foss v Harbottle*

[24.480] The common law right of a member to bring a legal action in the name of a company to remedy an internal irregularity or a wrong committed against the company stemmed from the old rule in *Foss v Harbottle* (1843) 2 Hare 461; 67 ER 189 and its exceptions. The Rule in *Foss v Harbottle* presented a considerable obstacle in the path of minority shareholder actions. This rule was based on the approach adopted by the courts that it was generally appropriate for internal disputes to be resolved in accordance with the constitution and vote of the majority. Courts were reluctant to interfere with these processes. Further, if wrongs were committed against the company, such as where directors breached their duties to the company, it was the company that was the proper plaintiff and not a shareholder. In order for a minority shareholder to proceed with a legal action, it was necessary to show that one or more of certain established exceptions applied. These are discussed at [24.485] and [24.490].



The common law rule in *Foss v Harbottle* comprised two aspects:

- the internal management rule; and
- the proper plaintiff rule.

### *Internal management rule*

[24.485] The internal management rule was based on the broad idea that the will of the majority prevails and the courts were reluctant to interfere with internal irregularities that were capable of later being ratified by ordinary resolution of a general meeting of members. An example of an internal irregularity is a refusal to recognise the voting rights of a shareholder. This aspect of the rule in *Foss v Harbottle* was rationalised on the basis that it would be futile to allow minority members standing to bring legal actions against the company or its directors if the general meeting could afterwards ratify the irregularity. A refusal to recognise the voting rights of a member or other contraventions of the company's constitution could constitute an infringement of a member's personal rights which was an exception to the Rule in *Foss v Harbottle*.

Procedural irregularities are now governed by s 1322 which provides that irregularities are not invalidated unless the court finds that the irregularity has caused substantial injustice which may not otherwise be remedied by the court. This is discussed at [21.200]. Further, as discussed at [20.05], the general meeting has wide powers to ratify breaches of directors' duties as well as other irregularities. Accordingly, the internal management rule also extends to such ratifications.

### *Proper plaintiff rule*

[24.490] The proper plaintiff rule recognises that a company is a separate legal entity. Where a wrong is done to the company, it is the proper plaintiff in any legal proceedings which seeks a remedy. The proper plaintiff rule applies whether the wrong against the company is caused by the directors, the controlling members or outsiders. Where directors breach their duties to the company, it is unlikely that the board will bring an action against its directors. This is more likely to occur where there has been a change of control of the company or a liquidator has been appointed. The *Corporations Act* provides for members to bring legal proceedings on behalf of a company under ss 233(1)(g) and 236. These provisions are discussed at [24.285]–[24.300].

## **Exceptions to the rule in *Foss v Harbottle***

[24.500] There were a number of exceptions to the rule in *Foss v Harbottle*. If a member was able to establish standing under one of these exceptions to the rule, they could bring an action against the company, its directors or other members.

The exceptions to the rule in *Foss v Harbottle* are now only of significance in relation to the enforcement of personal rights by members in their capacity as members. Such rights could be conferred by the *Corporations Act* or the company's constitution.



## What are personal rights?

### *The Corporations Act and constitution*

**[24.510]** Personal rights may be conferred by the *Corporations Act*, the company's constitution or a separate contract. An example of personal rights conferred by the *Corporations Act* is provided by s 246D. This provision confers a right on holders of classes of shares to bring an action to prevent the majority from altering the constitution so as to vary class rights otherwise than in accordance with the procedure laid down in the *Corporations Act* or constitution. This is discussed at [8.155]–[8.195].

Personal rights may also be conferred on a member by the replaceable rules or constitution. Under s 140, a company's constitution and any applicable replaceable rules have the effect of a contract between the company and each member and between a member and each other member. Where this is the case, a member has a personal right to oblige the company or other members to comply with the provisions of the constitution and any replaceable rules. This is discussed at [4.80]–[4.140].

### *Expropriation of shares*

**[24.515]** Majority shareholders may use their voting power so as to deprive a member of their shares in the company. An expropriation of a member's property is a wrong that is committed against the minority member. One way shares can be expropriated is by modifying or repealing the company's constitution under s 136(2). However, the power to alter the constitution so as to allow for an expropriation of a member's shares is severely restricted.

A member has a personal right to prevent the company altering its constitution to expropriate their shares if the expropriation is not for a proper purpose or is unfair: *Gambotto v WCP Ltd* (1995) 182 CLR 432. Expropriation of shares is discussed at [4.215]–[4.235].

**[24.530]** The property of the minority that is expropriated may also be the voting rights attaching to a member's shares. The majority in such cases may commit a fraud on the minority even if it believes that to do so is in the best interests of the company: *Eastmanco (Kilner House) Ltd v Greater London Council* [1982] 1 All ER 437.

The principles stated in *Gambotto's* case are not applicable where the *Corporations Act* provides protection to minority shareholders and sets out prescribed procedures in cases such as selective reductions of capital or compulsory acquisitions: *Winpar Holdings Ltd v Goldfields Kalgoorlie Ltd* [2001] NSWCA 427. Reductions of capital are discussed at [8.230]–[8.265].

### *Voting rights*

**[24.535]** A member has a personal right to have their votes at general meetings counted: *Pender v Lushington* (1877) 6 Ch D 70. Where a general meeting attempts to pass an ordinary resolution and the *Corporations Act* or the company's constitution requires a special resolution, this could be a procedural irregularity that may be invalid if it causes a substantial injustice under s 1322(2).

## Conduct of meetings

[24.550] In *Efstathis v Greek Orthodox Community of St George* [1989] 1 Qd R 146, some members sought a declaration that a motion purporting to dissolve the council was invalid on the ground that proper notice had not been given. The motion was held to be invalid and the rule in *Foss v Harbottle* did not prevent the members receiving proper notice and bringing the action. They were seeking to enforce their rights as members to prevent the duly elected council being dismissed by an invalid action. This is similar to a member bringing an action to enforce personal rights under the constitution or replaceable rules to have an election of directors properly conducted.

## Improper share issue

[24.555] A shareholder has a personal right to bring an action where it is alleged that an issue of shares was made for an improper purpose: *Residues Treatment & Trading Co Ltd v Southern Resources Ltd* (1988) 51 SASR 177. In that case the court suggested that there was a clear trend in the cases to indicate that shareholders had a personal right, grounded upon equitable principles, to have the voting power of their shares undiminished by improper actions of directors.

## Ultra vires acts

[24.560] Individual shareholders could bring an action at common law complaining that the company was acting or intending to act on some matter that was *ultra vires*. In this sense, *ultra vires* refers not only to acts that were beyond the objects and powers set out in the memorandum but also to illegal acts of the company. In the case of companies that have objects or restrictions on the exercise of powers set out in their constitutions, acts that are outside these objects or restrictions are treated in the same way as any other breaches of the company's constitution. This is discussed at [4.75].

## Special majority

[24.565] As discussed at [24.480]–[24.580], the rule in *Foss v Harbottle* prevented a shareholder from bringing an action where the general meeting was able to ratify the misconduct or irregularity by ordinary resolution. Where this ratification required more than a simple majority and this was not obtained, a member could bring an action.

Under the *Corporations Act*, a company can only do certain things by special resolution of the general meeting. Provisions in the company's constitution may also provide for special majorities.

This exception prevents a company from doing by bare majority that which the *Corporations Act* or constitution require to be done by special majority.

## Fraud on the minority

[24.575] A shareholder was entitled to sue at common law if the actions of the majority constituted a fraud on the minority. This exception to the rule in *Foss v Harbottle* was an application of a broader principle developed by the courts of equity which

prevented the holders of various types of powers from exercising their powers improperly. In the company law context, the majority must use its voting power for a purpose contemplated by the replaceable rules or company's constitution and not oppressively. If the vote involves an expropriation of a minority member's shares, the vote must be for a proper purpose and fair in all the circumstances: *Gambotto v WCP Ltd* (1995) 182 CLR 432. If the majority breaches this duty, it is regarded as having committed a fraud on the minority. The types of situations that came within the fraud on the minority exception now mostly come within the oppression remedy or the statutory derivative procedure under Pt 2F.1A. These are discussed at [24.15] onwards and [24.285] onwards.

## Personal and representative actions

[24.580] Personal and representative actions may arise when the company deprives a member of a personal right. A personal action, as opposed to a representative action, is appropriate to enforce a right conferred on a member individually. A representative action is appropriate to enforce personal rights conferred on members generally. This is sometimes referred to as a "class action". In a representative action a shareholder sues on behalf of herself or himself and the other shareholders whose rights are being infringed. In such an action all the shareholders must have some common interest in the right being enforced. They have such an interest to enforce compliance with the replaceable rules or the company's constitution by virtue of the contract created by s 140(1). Thus, the rights conferred by the replaceable rules or the company's constitution may be enforced either as a personal or representative action.

A shareholder's personal or representative action generally seeks an injunction to restrain a breach of the replaceable rules or company's constitution or a declaration that the actions contemplated by the company are invalid. The plaintiff normally cannot claim damages to enforce the s 140(1) contract created by the replaceable rules or the company's constitution because an injunction or declaration is usually the appropriate remedy.

## Tutorial questions

1. Lily and Morris are the directors and shareholders of Zap Graphics Pty Ltd. Recently, the company began to suffer cash flow problems and needed additional capital. Lily persuaded Rodney to invest \$100,000 in Zap Graphics Pty Ltd. Lily and Morris held a directors' meeting and decided to issue Rodney with two shares in the company. A general meeting of shareholders also appointed Rodney as a director of the company. At the shareholders' meeting Rodney said that he would not be attending board meetings and wanted to be treated as a "silent partner".

The company's financial position improved as a result of Rodney's \$100,000 investment, as well as the considerable efforts of Lily and Morris. Despite the company's increased profits Lily and Morris decided not to declare a dividend for the current year. Instead, they gave themselves pay rises and arranged for the company to lease two new Mercedes-Benz cars for their personal use.

Rodney began to attend directors' meetings and made a number of suggestions to improve the profitability of the business. He also questioned Lily and Morris about their pay rises. Lily and Morris resented these questions and took the following actions:

- They formed another company, Lily, Morris & Carol Graphics Pty Ltd, in which Rodney was not involved, and diverted a valuable government design contract that they had been negotiating to their new company.
- They also called a shareholders' meeting at which it was resolved that Rodney would be removed from his position as a director. The meeting also approved the diversion of the government design contract to Lily, Morris & Carol Graphics Pty Ltd. Lily and Morris made sure that Rodney did not receive notice of this shareholders' meeting.

Advise Rodney what legal remedies he has in these circumstances.

2. Street Motors Ltd, a listed company, is an importer and retailer of Mercedes-Benz cars and trucks. The directors and their associates own about 35 per cent of the company's issued shares, Asset Redeployment Ltd (ARL) owns nine per cent of the shares. The remainder is held by a large group of other shareholders.

At a recent board meeting, attended by all the directors, it was decided that Street Motors Ltd would sell all the company's showroom sites to White Knight Investments Pty Ltd. Unknown to the other directors, White Knight Investments Pty Ltd was the family company of Frank Street, chairman of Street Motors Ltd. One of the terms of the sale was that Street Motors Ltd would lease back all the showroom sites from White Knight Investments Pty Ltd. Because no independent real estate valuations had been obtained, the Street Motors Ltd directors were unaware that the sale price was considerably less than market prices and that the agreed lease-back rent was very high.

Assume that Frank has breached his duty to act in good faith and in the best interests of the company and his duty to avoid a conflict of interest and that the other directors have breached their duty of care in relation to the sale and lease back of the showroom site. What rights does Asset Redeployment Ltd have under the *Corporations Act* if the company refuses to take action against the directors for breach of duty?

3. Freddie Ball and Thor Mountainsson established World's Strongest Man Enterprises Pty Ltd (WSM), carrying on a business of strength coaching and selling fitness supplements. The company has no constitution. At the time of formation of the company, Ball and Mountainsson were the directors and shareholders of WSM, with each being issued 200 ordinary shares. Both had large social media followings and frequently posted about their strength exploits.

WSM's profit is heavily dependent on maintaining large social media followings to generate income through product sales and advertising revenue. From 2010 to 2016, WSM generated healthy and increasing levels of profit; Ball and Mountainsson participated in running the business and shared equally in the profits.

In May, after five straight years of eating 15,000 calories per day, Ball suffered a heart attack and informed Mountainsson that he intended to move to Hawaii to recuperate. Mountainsson assumed sole responsibility for running the business.

Subsequently, Mountainsson broke Ball's deadlift world record by 1 kg, leading to a falling out between the two men. Since then Ball will not communicate directly with Mountainsson, and will not respond to Mountainsson's phone calls and emails, but has resorted to posting negative comments about Mountainsson on Instagram. Public interest in this weakens, and Ball's social media following declines sharply. As a result, WSM remains profitable, but its revenue begins to fall. Mountainsson offered to buy Ball's shares in 2018 but Ball refused, arguing that the price offered by Mountainsson was too low. Ball resigned as a director of WSM not long ago and no longer actively contributes to the running of the company.

Concerned about the decreasing levels of profit, since 2018 Mountainsson has invested significant effort in boosting the company's revenue and profitability, launching a YouTube channel, posting daily on Instagram, and attending many competitions and events in order to raise the company's profile. As a result, by the end of 2020 WSM's revenue was greater than it had ever been, and its profit continued to climb in the following years.

Mountainsson is frustrated that he is doing all the work to maintain the company's profitability, and Ball continues to receive dividends without contributing to the company's business.

In early 2021, Mountainsson passed a director's resolution to issue himself 10,000 partly paid cumulative preference shares at an issue price of \$1 per share, paid to only 1 cent per share. The cumulative preference shares carry the right to be paid an annual dividend of such amount per share as the board determines, payable as soon as practicable after the end of each financial year, with such dividends to be paid prior to the payment of any dividend to ordinary shareholders. He also increases his monthly director stipend to \$30,000 plus expenses. In June 2021, Mountainsson passed a director's resolution declaring a dividend of \$100 per preference share and \$100 per ordinary share. There are no concerns about WSM's solvency.

What remedies, if any, are available to Ball under the *Corporations Act*?

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.
- For further corporations law links and material, please refer to the Understanding Company Law website at <http://www.uclaw.com.au>.

## Chapter 25

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# Takeovers

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## Key points

- The takeover provisions of the *Corporations Act* seek to strike a balance between facilitating an informed and efficient market to determine the success or failure of a bid and protecting the interests of all target company shareholders.
- A general prohibition prevents a person from acquiring more than 20 per cent of the shares in a target company. The main exceptions to this prohibition arise where the bidder makes an off-market bid; a market takeover bid or acquires up to three per cent of the shares in a six-month period.
- Off-market and market bids require disclosure of the information specified in the bidder's statement and target's statement in response to the bid.
- A compulsory acquisition procedure enables a bidder to acquire outstanding shares after the 90 per cent threshold has been exceeded. Also, the minority shareholders may require a bidder holding more than 90 per cent of shares to buy out their holdings.
- The liability provisions applicable to takeover documents are similar to those applicable to fundraising disclosure documents. Misleading and deceptive statements are prohibited and contravention is an offence that allows for recovery of loss or damage.
- Directors of target companies who adopt defensive strategies and tactics that aim to prevent hostile takeovers may breach their fiduciary duties.
- The Takeovers Panel is the main forum for resolving disputes that arise during a takeover bid. The Panel has wide powers where it believes unacceptable circumstances have occurred.



## What is a takeover?

**[25.05]** A takeover involves a change of control of a target company. This occurs when the target's shareholders sell sufficient shares to a bidder so as to give the bidder control of the voting power attaching to the target company's shares. This will clearly be the case where a bidder acquires over 50 per cent of the voting shares in the target company. Effective control may also be achieved with a lesser shareholding, depending on the nature of the target company's shareholding structure. In the case of large companies with many thousands of shareholders, most typically do not vote at general meetings, so that a shareholding well below 50 per cent may allow de facto control.

The consideration for an acquisition of shares sufficient to gain control of a target company may involve a cash payment or it may comprise shares in the bidder company or a mixture of cash and shares.

## Sources of law

**[25.10]** Since takeovers essentially involve the purchase and sale of shares, the basis of the transaction is governed by the law of contract. In addition, Ch 6 of the *Corporations Act* sets out detailed rules regulating takeovers that aim to ensure that they take place in an efficient and informed market and all shareholders of target companies are fairly treated. The objectives of the legislation are discussed at [25.20]. Takeovers may also be affected by other legislation, such as Ch 7 of the *Corporations Act*, dealing with financial services and markets, the competition provisions of the *Competition and Consumer Act 2010* (Cth) and the *Foreign Acquisitions and Takeovers Act 1975* (Cth), which deals with significant proposals that result in a change of control involving a foreign person acquiring interests in securities, assets or Australian companies.

## Policy issues

**[25.15]** The regulation of takeovers raises several policy issues, and so it is useful to see the takeover legislation in the context of the economic and social functions performed by takeovers and how they may affect target company shareholders.

Equal opportunity principle and premium for control.

Takeovers serve an important economic function by providing a mechanism whereby a target company's assets come under the control of a bidder, which believes it can utilise the assets more efficiently than the target company's existing board and management. The bidder for the target company's shares must generally be prepared to pay a higher price for the shares than the prevailing market price because acquisitions of shares that can result in a change in control of the target generally command a higher price than acquisitions of smaller shareholdings that do not affect control. The payment of this

“premium for control” will usually be justified only if the bidder is able to utilise the target company’s assets more productively than the existing board of directors. This may occur because the bidder is a more efficient business manager or it may be in a related industry where economies of scale or integration of the bidder’s and target’s businesses may arise.

In addition to the economic efficiency gains arising from takeovers, the threat of a takeover may also provide a strong incentive to the management of a potential target company to utilise their company’s assets as efficiently as possible and to consider the interests of shareholders. The most vulnerable takeover targets are often inefficient asset-rich companies that generate relatively low profits. This results in a discounted market price for the company’s shares relative to the value of its assets. Such companies may also fail to consider the interests of shareholders by, for example, pursuing a conservative dividends policy, which may cause shareholders to more favourably consider takeover offers. Therefore, the threat of a takeover may encourage directors to act in ways that engender increased shareholder loyalty.

## Purposes of the takeovers provisions

[25.20] The purposes of the takeovers provisions of Ch 6 of the *Corporations Act* are set out in s 602. They seek to ensure that:

- the acquisition of control over voting shares in a listed company, or an unlisted company with more than 50 members, takes place in an efficient, competitive and informed market (s 602(a));
- the shareholders and directors of a target company:
  - know the identity of any person who proposes to acquire a substantial interest in the company;
  - have a reasonable time to consider the proposal; and
  - are given enough information to enable them to assess the merits of the proposal (s 602(b));
- as far as practicable, shareholders all have a reasonable and equal opportunity to participate in any benefits accruing to the holders through any proposal under which a person would acquire a substantial interest in the company (s 602(c)); and
- an appropriate procedure is followed as a preliminary to compulsory acquisition of voting shares or other kinds of securities (s 602(d)).

The s 602 purposes also apply to acquisitions of relevant interests in:

- voting shares in listed companies or unlisted companies with more than 50 members (s 606(1)(a));
- listed bodies other than companies (s 603); and
- voting interests in listed registered managed investment schemes. Listed registered managed investment schemes are treated as if they were listed companies (s 604). Managed investment schemes are discussed in Chapter 27.

The meaning of “relevant interest” is discussed at [25.50].

## Role of ASIC

**[25.25]** ASIC has a particularly significant role in the operation of the takeover legislation. Its powers include obtaining information as to who owns beneficial ownership of shares (discussed at [25.40]) and exempting compliance with, or modifying the operation of, the legislation, which is further discussed at [25.235]. Various notices and documents such as bidder's statements and notices to compulsorily acquire securities must be lodged with ASIC. ASIC must consent to the withdrawal of unaccepted offers under a takeover bid. It also releases regulatory guides setting out how it will interpret the legislation and exercise its discretions. The general powers of ASIC are also applicable to takeovers, and these are discussed in Chapter 28.

## Disclosure of ownership of shares

**[25.30]** One of the purposes of the takeover provisions is to ensure that shareholders and directors know the identity of a person who acquires a substantial interest in a company: s 602(b)(i). This is implemented by the substantial holding provisions of Pt 6C.1 and the tracing of beneficial ownership of shares provisions of Pt 6C.2 of the *Corporations Act*. These disclosure requirements also apply to holders of interests in listed registered managed investment schemes.

Mandatory disclosure of large shareholdings.

The substantial holding provisions in Pt 6C.1 (ss 671B and 671C) oblige shareholders who have a relevant interest in not less than five per cent of the voting shares of a listed company to disclose to the company full particulars of their relevant interest in the shares. Disclosure of substantial holding information is often the first indication of an impending takeover bid. The definition of "relevant interest" is complex and is discussed at [25.50].

Part 6C.2 (ss 672A–672F) complements the substantial holding information provisions by enabling both the company and ASIC to obtain information as to the identity of persons who control or have a beneficial ownership in voting shares. The nature and extent of such interests and the identity of any other persons who have an interest must also be disclosed.

## Substantial holding provisions

**[25.35]** The purpose of the substantial holding provisions of Pt 6C.1 is to enable listed companies, and the market generally, to ascertain the identity of holders of large parcels of shares and the extent of their shareholdings. This is particularly important where a person is acquiring shares with the intention of eventually launching a takeover bid. Disclosure that a person has acquired a substantial holding in a listed company is often the first public indication that the company may be a potential takeover target. It may also be of interest to directors and shareholders to know if a particular shareholder is in a position to exert influence over the board.

A person who acquires a substantial holding in a listed company or listed registered managed investment scheme must give prescribed information to the company or responsible entity and the relevant market operator, such as the ASX: s 671B(1). Information must also be given if the person ceases to have a substantial holding or there is a movement of at least one per cent in their holding, or the person makes a takeover bid for securities of the company or scheme.

“Substantial holding” of more than five per cent.

“Substantial holding” is defined in s 9. Under that definition, a person has a substantial holding in a body corporate if that person or their associates have relevant interests in five per cent or more of the total number of votes attached to voting shares in a body corporate. A person also has a substantial holding if they have made a takeover bid for voting shares in a body and the bid period has started and not yet ended.

Details of the information required to be given are set out in s 671B(3). Required information includes:

- details of relevant interest in voting shares;
- details of any relevant agreement through which a relevant interest in voting shares is acquired;
- the name and details of each associate who has a relevant interest (including the nature of the association); and
- the size and date of any movement in the holding of at least one per cent.

This information must be given in the prescribed form and must be accompanied by a copy of any document setting out the terms of any relevant agreement or a statement setting out details of any relevant contract, scheme or arrangement: s 671B(4). The document or statement need not accompany the information if a holding was acquired or disposed of on a prescribed financial market: s 671B(5). The required information must be given within two business days after the person became aware of the information: s 671B(6).

A person who contravenes s 671B is liable to compensate a person who suffers loss or damage as a result of the contravention: s 671C(1).

## Tracing beneficial ownership

[25.40] Part 6C.2 provides a mechanism for tracing the person who has the ultimate beneficial ownership of shares in a listed company or interests in a listed registered managed investment scheme. The aim of the Pt 6C.2 tracing provisions is to promote an informed market for shares in listed companies and to prevent substantial transactions on an uninformed market: *Re North Broken Hill Holdings Ltd* (1986) 4 ACLC 131.

Part 6C.2 is not limited to companies involved in takeovers but is of general application: *Brunswick NL v Blossomtree Pty Ltd* (1992) 7 WAR 226.

ASIC, the company itself or the responsible entity for a listed managed investment scheme may direct a registered shareholder or scheme member to disclose the information required by s 672B. A shareholder may also request ASIC to give such direction, in which

case ASIC must exercise its power unless it considers that it would be unreasonable to do so: s 672A(2).

Directed shareholder to disclose beneficial interest.

Where information is disclosed in response to a direction that another person has a relevant interest in any of the shares, that other person may also be directed to disclose information required by s 672B.

A person who is given a direction to make disclosure under s 672B must disclose the following:

- full details of their own relevant interest and the circumstances that gave rise to that interest;
- details of other persons who have a relevant interest in any of the shares or interests and the nature and extent of the interest and how it arose; and
- persons who have given instructions about the acquisition or disposal of the shares or interests or voting rights or other matters in relation to them.

The direction to make disclosure may impose obligations on foreign corporations, even where performance would result in a breach of foreign law. In *ASC v Bank Leumi Le-Israel (Switzerland)* (1996) 69 FCR 531, a Swiss company was obliged to disclose information under the predecessor of Pt 6C.2 even though to do so would infringe Swiss law protecting private and commercial confidences.

Disclosure must be made within two business days after a person receives a direction under s 672A: s 672B(2). ASIC may pass on information received in response to a direction under s 672A to the company, responsible entity or the shareholder who requested ASIC to give the direction: s 672C.

A person who contravenes s 672B is liable to compensate a person for any loss or damage arising from the contravention: s 672F(1).

## Prohibited acquisitions: s 606

### Twenty per cent threshold

**[25.45]** The takeovers provisions aim to regulate acquisitions of relevant interests in voting shares of a target company that may have the potential to effect a change in its control.

Prohibition on exceeding the 20 per cent threshold limit.

This is done by prohibiting any person from acquiring a relevant interest in voting shares above a threshold limit of 20 per cent of the shares in a target company. The threshold is set at 20 per cent by s 606(1)(c) on the assumption that persons who hold less than this percentage are unlikely to be able to control the affairs of a target company. To lower the threshold would extend the operation of the legislation to situations where a takeover may only be a remote possibility and regulation would be inappropriate.

Section 606 is the key provision of the takeovers legislation. It sets out prohibitions on acquisitions of relevant interests in voting shares in a company that would increase a person's voting power in the company to more than the prescribed percentage of 20 per cent of the voting share capital: s 606(1)(c)(i). Acquisitions by a person who already possesses over 20 per cent but less than 90 per cent of voting shares are also prohibited: s 606(1)(c)(ii). Under s 606(2), a person is prohibited from acquiring a legal or equitable interest in securities if, because of the acquisition, another person acquires a relevant interest in issued voting shares and that person's voting power increases beyond the 20 per cent threshold.

The prohibitions in s 606 are subject to a number of exemptions that are discussed at [25.65]. These exemptions permit regulated takeovers and certain other acquisitions that do not infringe the objectives of the takeover provisions.

## Relevant interest in securities

**[25.50]** The s 606 prohibitions refer to acquisitions of “a relevant interest” in issued voting shares. The term “relevant interest” is also a key component of the substantial holding information provisions and the tracing beneficial ownership provisions in Pts 6C.1 and 6C.2.

The term “relevant interest” has a complex definition. Section 608(1) sets out the basic rule which provides that persons have a relevant interest in securities if they:

- are the holder of the securities; or
- have the power to exercise, or to control the exercise of, voting rights attached to the securities; or
- have the power to dispose of, or control the exercise of a power to dispose of, the securities.

“Power or control” may be indirect or by means of a trust, agreement or practice, whether or not enforceable. It does not matter whether the power or control is express or implied, formal or informal or exercisable jointly with someone else. It need not be related to a particular security: s 608(2). A person is taken to have a relevant interest in securities that are held through an interposed body corporate in which the person's voting power is above 20 per cent: s 608(3).

The concept of relevant interest extends to situations where a person who already has a relevant interest enters into an agreement, gives or receives an enforceable right or grants or is granted an option with respect to the securities. The other party is also taken to have a relevant interest in the securities: s 608(8). The operation of s 608 may result in a body corporate having a relevant interest in its own securities: s 608(9).

Situations that do not give rise to a relevant interest are listed in s 609. These include a range of transactions that do not involve a takeover context.

## Associates

**[25.55]** In order to prevent shareholders acting collectively to improperly obtain a substantial stake in or gain control of a target entity, a person's voting power for the

purposes of the s 606 prohibition comprises the aggregate votes of the person and any associates taken as a percentage of the total votes in the body corporate: s 610.

Section 12 defines the word “associate” in very wide and complex terms for the purposes of the provisions dealing with takeovers, substantial holding information, tracing beneficial ownership and compulsory acquisitions and buyouts. For example, under s 12(2)(a), a body corporate (the second person) is regarded as an associate of another body corporate (the primary person) if the primary person either controls the second person or is controlled by the second person. The primary person and the second person are also associates if they act in concert in relation to the affairs of another body corporate: s 12(2)(c). Two or more parties “act in concert” where there is an understanding between them as to a common purpose or object. This understanding may arise even in the absence of direct communications between the parties. Consensus may be inferred where each of the parties “embarked on conduct of which each was aware or understood the other was engaging in, to achieve their mutual objectives”: *Aurora Funds Management Ltd v Australian Government Takeovers Panel* [2020] FCA 496.

Sometimes, institutional investors and other substantial shareholders may wish to act collectively in order to engage with a company’s directors to promote good corporate governance. While such collective conduct may come within the broad meaning of acting in concert and the investors may be “associates” within the definition in s 12, ASIC Regulatory Guide RG 128 *Collective Action by Investors* permits collective action that has the purpose of promoting corporate governance improvements.

## Breach of prohibition

**[25.60]** A transaction is not invalid merely because it involves a contravention of s 606: s 607. However, contravention of the prohibitions in either s 606(1) or (2) is an offence of absolute liability: s 606(4A). It is a defence to a prosecution for breach of s 606 if it is proved that the contravention was due to inadvertence, mistake or lack of awareness: s 606(5). This defence is necessary because the wide operation of s 606 may affect remote interests that have no implications for takeovers. Inadvertence or mistake does not include ignorance of a matter of law.

The s 606 prohibitions are supplemented by the broad discretionary powers of the Takeovers Panel to make declarations of unacceptable circumstances under s 657A. These declarations may be made where the policy of the *Corporations Act*, as set out in s 602, has not been adhered to, even though specific provisions may not have been breached or a suspected breach may be difficult to prove. Declarations under s 657A are discussed at [25.245].

## Exemptions

**[25.65]** Section 611 sets out certain exemptions from the general prohibition in s 606. For example, a person does not breach the section if an acquisition:

- resulted from acceptance of an offer under a takeover bid;
- resulted from an on-market transaction where the acquisition is by a takeover bidder during the bid period;

- was previously approved by a resolution of the general meeting of the target company;
- was by creeping takeover whereby the acquirer held voting power in the company of at least 19 per cent and no more than three per cent was acquired in the previous six months;
- occurred as a result of an allotment by the company to all shareholders on a pro-rata basis; or
- resulted from a dividend reinvestment plan available to all shareholders.

These exemptions are based on the assumption that it would not further the objectives of the takeovers legislation to require compliance in those situations.

## Takeover procedure

**[25.70]** There are two types of takeover bids:

- off-market bids (for quoted or unquoted securities); and
- market bids (only available for quoted securities).

|                         |
|-------------------------|
| Types of takeover bids. |
|-------------------------|

These types of takeovers are the main permissible methods by which a person may acquire a relevant interest in voting shares beyond the 20 per cent threshold in the target company. “Creeping takeovers” of no more than three per cent of a target company’s voting shares in a six-month period are also permitted under the s 611 exceptions to the s 606 prohibition. The procedures applicable to off-market and market bids are largely similar: see [25.75] and [25.80], respectively.

### Off-market bids

**[25.75]** An off-market bid is an offer to buy all or a specified proportion of all the securities in the bid class: s 618(1). All offers must be the same although they may include alternative forms of consideration of cash and securities: ss 619(1) and 621(1). Where the consideration is cash only, the price must be at least the highest price paid by the bidder or an associate for securities in the bid class in the four months prior to the date of the bid: s 621(4). Each offer must state that, unless withdrawn, it will remain open until the end of the offer period: s 620(1)(c). The offer period must be of at least one month and up to 12 months: s 624. The offer must also state how and when the bidder is to satisfy its obligations: s 620(1)(d). Section 632 contains a diagram that illustrates the steps involved in an off-market bid.

### Market bids

**[25.80]** A market bid must relate to securities in a class of quoted securities (the bid class): s 617(3). An offer of securities under a market bid must be an offer to buy all the securities in the bid class: s 618(3). A market bid commences with an announcement of the bid to the relevant financial market. By their nature, market bids must be made for



cash only: s 621(3). As with off-market bids, the amount of consideration must be at least equal to the maximum price that the bidder or an associate provided for the bid class security in the four-month period prior to the date of the bid: s 621(4). Market bids must be unconditional: s 625(1). The offer period also must last at least one month and not more than 12 months: s 624(1). Section 634 contains a diagram that illustrates the steps involved in a market bid.

## Bidder's statement

**[25.85]** A takeover bidder must prepare a bidder's statement disclosing the information prescribed by s 636. A copy of the bidder's statement (together with offer documents) must be lodged with ASIC and sent to the target and to the shareholders in the bid class. The information that must be disclosed in a bidder's statement is similar in some ways to the information that must be disclosed under the fundraising provisions.

The content requirements of a bidder's statement are the same whether the bid is an off-market or market bid. Information required under s 636 to be contained in a bidder's statement includes:

- the identity of the bidder;
- details of the bidder's intentions regarding any changes to the target company's business, future employment of present employees and continuation of its business;
- details of how cash consideration will be paid;
- where consideration is in the form of securities, information required for a prospectus for an offer of those securities;
- price of purchases paid by bidder of securities in the bid class in the previous four months and any benefits given to induce a person to accept an offer under the bid;
- for an off-market bid, the bidder's voting power; and
- any other information that is material to the making of the decision by a holder of bid class securities whether to accept an offer under the bid.

Under s 643, if a bidder becomes aware of:

- a misleading or deceptive statement in the bidder's statement;
- an omission of required information; or
- a new circumstance that would have been required to be included had it arisen before the bidder's statement was lodged;

the bidder must prepare a supplementary bidder's statement that remedies this defect where the defect is material from the point of view of a holder of bid class securities.

## Target's statement

**[25.90]** The target's statement is the response of the target to the takeover bid and bidder's statement. Its contents are the same, irrespective of whether the takeover bid is an off-market or market bid.

A target's statement must include all the information that holders of bid class securities and their professional advisers would reasonably require to make an informed assessment

whether to accept the offer under the bid: s 638(1). This information must be included to the extent to which it is reasonable for investors and their professional advisers to expect to find the information in the statement and only if the information is known to any of the directors of the target: s 638(1A).

A target's statement must contain a recommendation by each of the target's directors that the offers under the bid be accepted or not accepted and reasons for the recommendation: s 638(3). A person whose statement is included in the target's statement must give consent to its inclusion: s 638(5).

An expert's report must accompany the target's statement if the bidder's voting power in the target is 30 per cent or greater, or a director of the bidder is a director of the target: s 640(1). The expert's report must state whether, in the expert's opinion, the takeover offers are fair and reasonable and reasons for this opinion. Expert's reports are discussed at [25.170]–[25.180].

If a target becomes aware of:

- a misleading or deceptive statement in the target's statement;
- an omission of required information; or
- a new circumstance that would have been required to be included had it arisen before the target's statement was lodged;

a supplementary target's statement that remedies this defect must be prepared where the defect is material from the point of view of a holder of bid class securities: s 644.

## Variation of offers

**[25.100]** Generally, a bidder cannot vary a takeover offer except to increase the consideration or extend the offer period: ss 649A and 650A. ASIC may exercise its power under s 655A to exempt a person from a provision or modify the legislation to allow other variations.

## Withdrawal of offers

**[25.105]** Unaccepted offers under a takeover bid can only be withdrawn with the consent of ASIC or if an event specified in s 652C occurs and the bidder's voting power in the target is less than 50 per cent. The specified events mainly involve significant changes to the share capital or assets of the target. A takeover bid may also be withdrawn if either the target or a subsidiary resolves to wind itself up.

## Conditional offers

**[25.110]** Offers under a market bid must be unconditional: s 625(1). This is not the case with off-market bids, which may be subject to conditions. However, certain types of conditions are not permitted. A bidder may wish to attach conditions to its offer to ensure the takeover only proceeds in circumstances that are favourable to it. From the point of view of a target company's shareholders, conditions have the effect of creating uncertainty. If shareholders accept a conditional offer, they commit themselves to selling, but they cannot be certain that the sale will be completed because a conditional event

may occur that allows the bidder to avoid completing the transaction. To strengthen the position of shareholders of a target company, the takeover provisions regulate the use of conditions in off-market bids. Some types of conditions are prohibited, while other types, known as defeating conditions, are permitted only if they meet certain requirements.

## Prohibited conditions

**[25.115]** The following types of conditions are prohibited in off-market bids:

- maximum acceptance conditions (s 626). These provide that the offers will terminate if the number of securities for which the bidder receives acceptances exceeds a particular number;
- discriminatory conditions (s 627). These allow the bidder to acquire securities from some, but not all, of the people who accept the offers;
- a condition that payments or other benefits to officers of the target as compensation for loss of office be approved by the offerees (s 628); and
- a defeating condition that depends on the bidder's opinion or belief or the occurrence of an event that is within the sole control of the bidder or an associate (s 629). Defeating conditions are discussed at [25.120]–[25.122].

## Defeating conditions

**[25.120]** Certain “defeating conditions” are permitted in off-market takeover bids. A defeating condition is defined in s 9 as a condition that entitles a bidder to rescind a takeover contract in the circumstances referred to in the condition or prevents a binding takeover contract resulting from an acceptance of the offer unless or until the condition is fulfilled.

A defeating condition is permitted where the offer specifies a date between 14 days and seven days before the end of the offer period for giving a notice on the status of the condition: s 630(1). In particular, the bidder must state whether the offers are free of the condition, whether the condition was fulfilled and the bidder's voting power in the target: s 630(3).

Notice of status of the condition must be given to:

- the target; and
- for quoted bid class securities – the relevant market operator; or
- for unquoted bid class securities – ASIC.

In some cases, directors of a target company have entered into transactions or arrangements that are intended to trigger a defeating condition in the hope of preventing a hostile takeover bid from proceeding.

*Re Pinnacle VRB Ltd (No 8) (2001) 19 ACLC 1252*

**[25.122]** The Takeovers Panel set the following guidelines for directors of target companies which enter into transactions that trigger a bid condition. The Panel decided that, in general, a transaction or conduct by a target board which

has the effect of triggering a bid condition that is likely to lead to the defeat of the bid must be submitted to the target's shareholders for approval. This followed from s 602(c), which requires that shareholders have a reasonable and equal opportunity to participate in any benefits from the bid proposal. However, a target board cannot act to defeat or delay a takeover by entering into transactions of dubious benefit by the simple expedient of putting matters to shareholders. This may constitute a breach of directors' duties or unacceptable circumstances. There could also be exceptional circumstances where shareholder approval would be unnecessary despite an action triggering a bid condition. For example, target directors may enter into a transaction which was clearly for the commercial advantage of the company and was so motivated. Shareholder approval would also be unnecessary where a defeating condition was so far-reaching and constraining that it exceeds what would be commercially reasonable in the circumstances, with the result that perfectly legitimate transactions would trigger the bid condition.

## Partial takeovers

**[25.125]** Bidders may not always want to acquire all the shares of the target company, but may seek to acquire only a sufficient proportion of the target company's shares to enable them to gain control; for example, bidders may seek to acquire only 51 per cent or a lesser percentage of shares. This type of bid is called a "partial takeover". From the bidder's point of view, a partial takeover presents an important advantage in that the bidder gains control of the target company while having to outlay an amount considerably less than would be the case with a full takeover for all the shares in a target.

Partial takeovers perform a legitimate economic function and may be beneficial to investors. They provide a means by which control of a target company's assets may pass to more efficient managers without the need for the bidder to acquire all the shares. On the other hand, by their nature, partial bids may prevent target company shareholders having the opportunity to participate equally in the bid without coercion to participate in the bid.

Partial bids and the equal opportunity principle.

Takeovers generally require a bidder to pay a premium for the privilege of control. The existence of this premium for control can be observed in the price increase of the target company's shares when a takeover occurs or is anticipated. A fundamental objective of takeover regulation is achievement of equality of opportunity between shareholders to share in the premium for control. In a successful partial bid, the control premium will have been paid only to those shareholders who decided to accept the bid. This may place coercive pressure on shareholders to accept the partial bid because if they do not, they may miss out on participating in the premium for control. If the partial bid is successful, the share price of the target company will usually fall.

While partial takeovers are permitted, they are regulated under Ch 6 of the *Corporations Act*. A partial takeover can only occur by way of an off-market bid. This is because under a market bid, the bidder is obliged to take all securities in the bid class tendered by holders who accept the bid.

## Proportional bids

**[25.130]** Partial takeovers must take the form of proportional bids: s 618(1). A proportional bid involves an offer for the same proportion of each shareholder's holding in the target company. For example, if the bidder holds 19 per cent of the target company's shares, it may bid for 50 per cent of every other shareholding. If the holders of all outstanding shares accept the offer, the bidder would end up holding 59.5 per cent of the total shares. In practice, it would be unusual for all shareholders to accept a proportional bid. Some shareholders may oppose the bid, while others may not be contactable or interested in responding. Therefore, a bidder may have to pitch a proportional bid at such a level that takes into account non-acceptances in order to attain the shareholding it hopes to acquire.

Pro-rata bids prohibited.

The other type of bid is a pro-rata bid, where the bidder offers to buy a specified percentage of the target company's shares. If the bidder receives acceptances for a greater number of shares than specified in the offer, each acceptance is pro-rated to the same proportion and the excess is returned to shareholders.

Pro-rata bids are prohibited because they exert coercive pressure on shareholders and cause uncertainty as to the number of shares ultimately sold. The effect of the prohibition on pro-rata bids is that the uncertainty around how many shares will be accepted, passes to bidders. This applies the policy that under the takeovers legislation, considerations of equity or fairness as between shareholders are more important than potential cost savings for bidders and even general price efficiency.

Proportional bids do not exert the same degree of coercive pressure as pro-rata bids. A failure to accept a proportional bid does not result in an increased proportion of the premium for control passing to accepting shareholders. In addition, accepting shareholders have greater certainty as to the number of their shares that may be acquired and are still able to deal with the remainder.

## Shareholder approval of partial takeovers

**[25.135]** The constitution of a company may contain a requirement that shareholders approve a partial takeover of securities of the company. Under s 648D(1)(a), the constitution may provide that registration of a transfer giving effect to a takeover contract for the bid is prohibited unless and until an approving resolution is passed. Such provisions are colloquially referred to as "shark repellents" because, in effect, a majority of a target's shareholders can prevent a partial takeover bid being successful even though the bidder may not want to acquire a majority of the shares.

A company's proportional takeover approval provisions generally cease to apply after three years: s 648G(1). The constitution may specify a lesser period. The company may renew the provisions in the same way as they were originally adopted.

## Compulsory acquisitions

**[25.140]** The *Corporations Act* enables a bidder, who has acquired at least a 90 per cent majority of shares in a company, to compulsorily acquire the outstanding shares and thereby receive the economic, administrative, taxation and other benefits of full ownership of the company. At the same time, the compulsory acquisition provisions also seek to protect the rights of minority shareholders from the potential dangers of being locked in by enabling them to require their shares to be bought by the bidder.

A bidder who wishes to acquire all the securities of a target company may compulsorily acquire the securities of dissenting minority shareholders in the circumstances set out in Pt 6A.1. There is further power to compulsorily acquire securities at any time and not just after a takeover bid: s 664A(3). The interests of minority shareholders to keep their shares are outweighed by the benefits accruing to the bidder. The necessary high acceptance levels are taken as indicating the fairness of the offers. In the light of the High Court's decision in *Gambotto v WCP Ltd* (1995) 182 CLR 432, it is difficult to compulsorily acquire minority shareholdings outside the statutory procedures contained in ss 414, 661A and 664A. This case is discussed at [4.215]–[4.235].

### Ninety per cent threshold

**[25.145]** A bidder, under a takeover bid, may compulsorily acquire any securities in the bid class if, during or at the end of the offer period, the bidder and associates have relevant interests in at least 90 per cent of the bid class securities and the bidder and associates have acquired at least 75 per cent of the securities that the bidder offered to acquire under the bid: s 661A(1)(b). The court may allow compulsory acquisition even if the thresholds have not been reached: s 661A(3). This discretionary power of the court may be exercised where the bidder falls marginally short of the 90 per cent threshold or where there are late acceptances which would have taken the bidder's relevant interest over the threshold had they been received in time: *Re Sylvania Resources Ltd* [2009] FCA 955.

### Notice

**[25.150]** In order to compulsorily acquire securities, a bidder must give a notice to holders of securities in the bid class informing them that the bidder is entitled to acquire their securities and of their right to apply to the court for an order preventing the compulsory acquisition: s 661B(1). This notice must be lodged with ASIC and a copy given to each relevant market operator. Notice must be dispatched during the offer period or within one month after it ends. The notices cannot be withdrawn: s 661B(2).

### Terms of acquisition

**[25.155]** The terms of a compulsory acquisition must be the same as those under the takeover bid: s 661C.

## Preventing compulsory acquisition

**[25.160]** The holder of securities covered by a compulsory acquisition notice may apply to the court for an order that the securities not be compulsorily acquired: s 661E.

Court may order that the securities not be compulsorily acquired.

The application must generally be made within one month after the notice of acquisition was given. The court may order that the securities not be compulsorily acquired if it is satisfied that the consideration is not fair value for the securities: s 661E(2).

Section 667C sets out how fair value for securities is to be determined:

- assess the value of the company as a whole;
- allocate that value among the classes of issued securities taking into account class rights and financial risk;
- allocate the value of each class on a pro-rata basis among securities of the class; and
- consider the price paid for the securities in that class over the previous six months.

The onus is on the dissenting shareholder to establish that an offer is unfair. This is to be considered in relation to the general body of shareholders, rather than whether it is fair to the particular shareholder.

A high level of acceptances will generally indicate that an offer is fair. The court will be reluctant to impose its views of fairness in opposition to the attitude taken by the great majority of those who are directly concerned with the scheme. It is not sufficient for the dissenting shareholder to show that the offer is open to some criticism or could have been improved upon. A failure to comply with legislative requirements is relevant to the question of fairness.

The mere fact that a compulsory acquisition would make a company worth more to the majority shareholder than to a third party does not mean that the additional value should be wholly attributed to the minority shareholders: *Pauls Ltd v Dwyer* [2001] QSC 67. The amount of consideration offered is not the only matter to be examined. It may be relevant to consider the conduct of the bidder in the period prior to the making of the offer.

In considering whether a price is fair, the fact that it is considerably higher than the market price before the takeover bid is more significant than an expert's report stating that the offer price was unfair and did not reflect the target company's true value: *Elkington v Shell Australia Ltd* (1993) 32 NSWLR 11.

## Compulsory buy-out

**[25.165]** A bidder and its associates who have relevant interests in at least 90 per cent of the bid class securities must offer to buy out the remaining holders of the securities: s 662A. Upon attaining 90 per cent, the bidder must give a notice to each holder of securities in the bid class. The notice must state that the bidder has exceeded the 90 per cent threshold, inform the holders of their right to be bought out and set out the terms on

which the holder may be bought out: s 662B. The notice must be lodged with ASIC and given to each relevant market operator.

Within one month after this notice is given, the holder of securities may give written notice requiring the bidder to acquire the securities: s 662C(1). The notice by the holder gives rise to a contract between the holder and the bidder for the sale of the securities on the terms applicable before the end of the offer period: s 662C(2). The right to require the bidder to buy out securities also extends to the holders of securities that are convertible into bid class securities: s 663A.

These provisions enable minority shareholders holding any class of shares, option holders or convertible note holders to prevent themselves being locked in after control has overwhelmingly passed. The market price for the shares may fall to reflect the dominance of the major shareholder. The takeover offer may not have been addressed to them; however, their securities may be delisted because, for example, the target company's spread of shareholders is insufficient for the purposes of ASX Listing Rules.

## Experts' reports

**[25.170]** There are a number of provisions in the takeovers legislation and ASX Listing Rules that require the report of an independent expert to provide shareholders with objective information to enable them to assess the merits of a takeover proposal or proposed acquisition. The definition of "expert" in s 9 provides that experts must have a professional reputation that gives authority to a statement made by the expert.

As discussed at [25.90], under s 640, a target's statement must be accompanied by an expert's report in cases where the bidder's voting power in the target is 30 per cent or more or where the bidder and target company have common directors. An expert's report is also required in situations of compulsory acquisitions and buy-outs: ss 663B, 664C and 665B. An expert may be liable for false and deceptive statements and omissions under ss 670A and 670B. This is further discussed at [25.205].

## Fair and reasonable

**[25.175]** Under s 640, the expert must report whether, in their opinion, the takeover offer is fair and reasonable and must give reasons for that opinion. In the case of a compulsory acquisition or buy-out, an expert's report must state whether a fair value is proposed for the securities concerned: s 667A. In determining whether an offer or value is fair and reasonable, the expert should follow the guidelines on how an expert can help security-holders make informed decisions about transactions set out in ASIC Regulatory Guide RG 111 *Content of Expert Reports*.

The concept of "fair and reasonable" is different from a recommendation as to whether an offer or proposal should be accepted. An offer is fair if the value of consideration is equal to or greater than the value of the securities concerned. An offer may be reasonable if, after considering significant factors, shareholders should accept the offer or proposal in the absence of a higher price. Some relevant considerations include the bidder's voting power in the target, market liquidity for the target's securities and the value to an alternative bidder.



To determine fair value, the expert should adopt the process set out in s 667C. This requires an assessment of the value of the company as a whole, an allocation of this value among the classes of issued securities and then a pro-rata allocation among those securities.

## Independence of expert

**[25.180]** Under s 648A, the expert who prepares the report is also required to set out details of the expert's business relationship with the bidder, the target company or their associates, together with details of any financial or other interest the expert has that could be reasonably regarded as affecting the expert's ability to give an unbiased opinion. This is to enable shareholders in the target company, when reading the expert's opinion, to take into account any factor that may have influenced the expert's independence.

The expert is not regarded as independent if the expert is an "associate" of the bidder or target within the meaning of s 11 or s 15. In addition, ASIC Regulatory Guide RG 112 *Independence of Experts* sets out ASIC's view on how previous and existing relationships with commissioning and other interested parties may affect the independence of an expert and how an expert should deal with the commissioning party and other interested parties to maintain its independence.

## Prohibited conduct

### Disposal of securities by bidder

**[25.185]** The bidder must not dispose of any securities in the bid class during the bid period: s 654A(1). This prohibition does not apply if someone else who is not an associate of the bidder makes a takeover bid for securities in the bid class after the bidder's statement is given to the target. The bidder may then dispose of the securities after the later offer is made or the consideration is improved: s 654A(2).

### Escalation agreements

**[25.190]** Prospective bidders are prohibited from entering into arrangements with selected shareholders whereby their shares are to be acquired in the six-month period before the bid is made with additional benefits attributable to the acquisition: s 622(1). Such an agreement is void to the extent of the benefit: s 622(3). These arrangements are prohibited because they confer an advantage on some shareholders – usually large institutional investors. Such shareholders could dispose of their shares at a prevailing market price, knowing that when a takeover bid is later made, they will receive the benefit of any better price subsequently offered. The effect of such arrangements is contrary to the principle that all shareholders have the opportunity to share in any premium for control.

### Collateral benefits

**[25.195]** A bidder is prohibited from giving a benefit to a person during the offer period if the benefit is likely to induce the person to accept the bid offer and is not offered to all

holders of securities in the bid class: s 623. As with escalation agreements, this type of arrangement seeks to advantage some holders of securities over others.

## “Bluffing” bids

**[25.200]** A person who publicly proposes to make a takeover bid for securities must make offers for the securities within two months of the proposal. The terms of the bid must be the same or not substantially less favourable as those in the public proposal: s 631(1). It is an offence for a person to publicly propose to make a takeover bid if the person knows the bid will not be made or is reckless as to whether it will be made. This is known as a “bluffing bid”. It is also an offence if the person is reckless as to whether they will be able to fund their obligations under the bid if a substantial proportion of the offers under the bid are accepted: s 631(2). A person who enters into a transaction relating to securities in reliance on the public proposal for a takeover bid may recover any loss suffered as a result from the persons who contravened s 631: s 670E.

Section 631 is contravened where a person has no genuine intention to ultimately make a bid. However, a bidder does not necessarily need to have in place certain, guaranteed or unconditional funding at the time the bid is announced nor does the bidder need to show that there are reasonable grounds to believe that it will be able to perform its obligations if a substantial proportion of offers under the bid are accepted: *ASIC v Mariner Corporation Ltd* [2015] FCA 589.

Defences to this liability may arise if the person was unaware of particular circumstances or if the circumstances changed: s 670F.

If a bidder contravenes s 631 by failing to make offers under the bid within time, s 1325B gives the court, on an application by ASIC, the power to order the bidder to send out offers to the target’s shareholders.

## Misleading or deceptive statements

**[25.205]** Chapter 6B of the *Corporations Act* contains the liability provisions for misleading and deceptive statements in relation to takeover activity. These provisions are consistent with the liability regime applicable to fundraising. This is discussed at [7.195]. Criminal liability is imposed by s 670A(3). A person who suffers loss or damage as a result of a contravention of s 670A(1) may recover the amount of loss or damage from the persons who are liable under s 670B.

## Section 670A prohibition

**[25.210]** Section 670A(1) applies to bidder’s and target’s statements, takeover offer documents and compulsory acquisition and buy-out notices. It provides that a person must not include a misleading or deceptive statement or make an omission of required information in these documents. This section also requires disclosure of any new circumstance in a bidder’s or target’s statement.

A statement about a future matter, such as a profit forecast, or future act may be misleading if it is made without reasonable grounds: s 670A(2).

Misleading or deceptive statements or omissions in takeover documents.

A contravention of s 670A(1) is an offence if the misleading or deceptive statement or omission is materially adverse from the point of view of the holder of securities to whom the document is given: s 670A(3).

A person who suffers loss or damage that results from a contravention of s 670A(1) may recover the amount of the loss or damage from the people referred to in s 670B. Civil liability may arise even if the person did not commit and was not involved in a contravention of s 670A(1).

## Who may be liable?

**[25.215]** People who may be liable under s 670B(1) for loss or damage include:

- the bidder and its directors;
- the target and its directors;
- a person giving a compulsory acquisition or buy-out notice; and
- a person who consented to have a statement included in a takeover document or on which a statement made in the document is based. This includes experts.

Directors are generally not liable if they can prove that they were not present when the resolution to adopt the document or statement was passed or they voted against the resolution. This defence is not available in relation to non-cash consideration bids and notices of variation of takeover offer.

## Notification of deficiencies

**[25.220]** Those who may be liable on a takeover or compulsory acquisition document under s 670B(1) must notify the issuer of the document as soon as possible after becoming aware of the misleading or deceptive statement or omission or that a material new circumstance has arisen: s 670C.

An expert is under corresponding obligations to notify the bidder and target where there has been a significant change affecting information included in the report accompanying a bidder's or target's statement: s 670C(2) and (3).

## Defences

**[25.225]** The defences set out in s 670D apply to both prosecutions for an offence under s 670A(3) and civil actions brought under s 670B. The defences include:

- proof of lack of knowledge that a statement was misleading or deceptive or that there was an omission;

- proof of reasonable reliance on information given by someone else;
- withdrawal of consent by a person named in a document as making a statement; and
- where a new circumstance has arisen of which the person was unaware.

## Other liability for false and misleading statements

**[25.230]** Conduct in relation to takeover activity other than the content of takeover and compulsory acquisition documents is subject to s 1041H. This section prohibits misleading and deceptive conduct in relation to financial products or financial services and gives rise to civil liability. This is discussed at [26.190].

Criminal liability is also imposed on an officer of a corporation who makes available or furnishes information that relates to the affairs of the corporation and is to the knowledge of the officer false or misleading: s 1309(1). This section encompasses information provided to a wide range of persons including other directors, the company auditor, members and debenture-holders. It also includes information provided to a stock exchange. This may arise during a takeover where a response is made by a company to a stock exchange query.

ASIC Regulatory Guide RG 25 *Takeovers: False and Misleading Statements* considered that an offeror who states that the offer price will not be increased will generally be expected to honour this representation. A subsequent increase in the offer price may result in a misleading statement and attract civil liability or an application may be made to the Takeovers Panel for a declaration of unacceptable circumstances.

## ASIC powers to exempt or modify

**[25.235]** ASIC has wide powers to exempt compliance with, and modify the operation of, the takeover provisions: s 655A. These discretionary powers are not intended to be used retrospectively where the *Corporations Act* has already been breached. Where a breach has occurred, application may be made to the Takeovers Panel or the court.

In exercising its powers under s 655A, ASIC must take into account the underlying principles of the takeovers legislation as set out in s 602: s 655A(2).

The exemption may apply unconditionally or subject to specified conditions. ASIC may apply to the court for an order that a person comply with a condition: s 655A(4). ASIC is required to take reasonable steps to give each person whose interests are affected by an exemption or modification notice of the decision and of the person's right to have the decision reviewed by the Panel: s 655B(1).

The Takeovers Panel may review a decision of ASIC to exempt or modify under s 655A: s 656A(1)(a). An application to the Panel may be made by any person whose interests are affected by the decision: s 656A(2).

## Takeovers Panel

**[25.240]** The Takeovers Panel was established under the *Australian Securities and Investments Commission Act 2001* (Cth) with the powers and functions conferred on it under the

*Corporations Act*. While its main functions are in relation to takeover bids, the Takeovers Panel's powers also apply to non-takeover situations, such as rights issues, buy-backs, reductions of capital and other acquisitions of shares that may involve the control of a company or an acquisition of a substantial interest in a company.

The Understanding Company Law website at <http://www.uclaw.com.au/resources/> has a link to the Takeovers Panel's website, which contains information about the Panel, its guidance notes, media releases, decisions and rules.

The Takeovers Panel is the main forum for resolving disputes during the bid period.

The Takeovers Panel takes the place of the courts as the main forum for resolving disputes arising from a takeover during the bid period: s 659AA. This enables takeover disputes to be resolved quickly and efficiently by a specialist body comprised of takeover experts attuned to the commercial realities and aware of market practices. This role of the Panel aims to prevent the practice of target companies in particular resorting to court litigation as a tactic to prevent or slow down a takeover bid: *Metalicity Ltd v Allen* [2022] WASC 291.

The Takeovers Panel power to make declarations of unacceptable circumstances.

The most important power the Panel has is the power to make declarations of unacceptable circumstances in relation to the affairs of a company under s 657A. A declaration of unacceptable circumstances may be made whether or not the circumstances involve a contravention of s 657A(1) of the *Corporations Act*. A declaration that circumstances are unacceptable can only be made if it appears to the Panel that:

- the circumstances are unacceptable having regard to the effect of the circumstances on the control or potential control of the company or the acquisition or proposed acquisition of a substantial interest in the company; or
- they are otherwise unacceptable having regard to the purposes of Ch 6 of the *Corporations Act*, as set out in s 602; or
- they constitute or are likely to constitute, or give rise to, a contravention of the takeovers provisions: s 657A(2).

The purposes of the takeover provisions are described in [25.20].

If the Panel makes a declaration of unacceptable circumstances, s 657D gives it the power to make any order (including remedial orders) to protect the rights or interests of affected persons or ensure a bid proceeds as if the unacceptable circumstances had not occurred. The power of the Panel to make orders requires a nexus between the harm addressed by the order and the effect of the circumstances on control or the acquisition of a substantial interest in the target. It is not sufficient that a person merely suffers harm as a result of the unacceptable circumstances: *Glencore International AG v Takeovers Panel* [2006] FCA 274.

Remedial orders.

Under s 9, remedial orders include orders that:

- restrain the exercise of voting or other rights attached to securities;
- restrain an acquisition of securities;
- direct a person to dispose or not dispose of securities;
- direct the payment of profits from a disposal of securities;
- vest securities in ASIC;
- direct a body corporate not to register a transfer of securities;
- cancel securities issued as consideration for offers under a takeover bid;
- cancel or declare voidable an agreement relating to a takeover bid or acquisition of securities;
- direct a person to disclose information to the holders of securities;
- direct a body corporate to amend its constitution; and
- direct a person to comply with a requirement of the legislation.

Before making an order, the Panel must give affected persons an opportunity to make submissions and it must be satisfied that the order would not unfairly prejudice any person: s 657D(1).

The Panel may make interim orders even if there is no declaration that circumstances are unacceptable or no application has been made for a declaration: s 657E. Interim orders may have effect for up to two months.

Section 657A(3) provides that in deciding whether to make a declaration of unacceptable circumstances the Panel must have regard to:

- the purposes of the takeover provisions as set out in s 602;
- the other provisions in Ch 6 of the *Corporations Act*;
- the Panel's rules made under s 658C; and
- any other matter it considers relevant.

The Panel must also take into account the actions of the directors of the target, including actions that caused the acquisition of shares not to proceed or contributed to it not proceeding: s 657A(3). This indicates that defensive tactics and strategies may be considered by the Panel. In Takeovers Panel Guidance Note 4 – *Remedies General* the Panel provides background to its power to make remedial orders.

[2] If the Panel makes a declaration of unacceptable circumstances, it may make orders:

- a. to protect rights or interests affected by the unacceptable circumstances or
- b. to ensure (as far as possible) that a bid proceeds as if the unacceptable circumstances had not occurred.

[5] The Panel does not seek to punish when deciding on a remedy. But the remedy may adversely affect a person, provided it is not unfairly prejudicial. In addition, a declaration, orders or other statement (for example, reasons) may expressly or impliedly involve a reprimand of a party or adviser.

Applications for Panel declarations or orders can be made by the bidder, target, ASIC or any other person whose interests are affected by the relevant circumstances: s 657C(2). The application must be brought within two months after the circumstances occurred or such longer period determined by the Panel: s 657C(3).

The Panel must give each person to whom a proposed declaration relates, each party to the proceedings and ASIC an opportunity to make submissions: s 657A(4). A declaration must be made within three months after the circumstances occur or one month after the application for the declaration was made. These time limits can only be extended by the court on application by the Panel: s 657B. In deciding whether to extend the time for the Panel to make a declaration under s 657B, the court will consider whether the statutory purposes set out in s 602 could be achieved if the time is extended and whether the Panel is the appropriate forum for considering the issues: *Palmer Leisure Cooloom Pty Ltd v Takeovers Panel* [2015] FCA 1498. The purposes of the takeovers legislation are discussed at [25.20].

The Panel is required to provide reasons for making a declaration to each person to whom the declaration relates: s 657A(6). This is because of the public nature of the declaration and the fact that it may affect the reputations of the parties concerned, the need to ensure that a consistent body of principles is developed and the need to ensure that the market is informed about particular securities. The Panel is required to set out its findings on material questions of fact and refer to the evidence on which those findings were based; however, it need only make general findings in respect of the issues before it: *Queensland North Australia Pty Ltd v Takeovers Panel* [2015] FCAFC 68.

ASIC or a party to proceedings in which the Panel made a decision may apply to the Panel for a review of the decision: s 657EA. The court may also refer a decision of the Panel to it for review: s 657EB.

Orders of the Panel may be enforced by the court: s 657G.

The Panel has power to make rules to clarify or supplement the operation of the takeovers legislation: s 658C. The rules must take account of the purposes of the legislation as set out in s 602. The court may give directions for compliance with a rule to a company that contravenes a rule and its directors.

The powers of the Panel have been considered in two cases involving Glencore International AG: *Glencore International AG v Takeovers Panel* [2005] FCA 1290 and *Glencore International AG v Takeovers Panel* [2006] FCA 274. These cases stemmed from a declaration of unacceptable circumstances and orders of the Takeovers Panel against Glencore made during a takeover bid by Centennial Coal for Austral Coal. The Panel stated that equity derivatives held by Glencore in the form of equity swaps in relation to shares of Austral Coal gave Glencore “a degree of de facto control” over the underlying parcel of shares which were held by investment banks, who were counterparties to the equity swaps, for the purposes of protecting their financial positions. The failure of Glencore to disclose its interest in these shares resulted in the market being uninformed about the full extent of Glencore’s interest in Austral Coal. The Panel made a declaration of unacceptable circumstances on the basis that Glencore acquired a substantial interest in Austral Coal within the meaning of s 657A(2)(a).

It was held that the equity swaps did not confer on Glencore a sufficient degree of control over Austral Coal shares to give rise to it acquiring a substantial interest in Austral Coal. It did not control the disposal of the hedged shares and it did not have a “relevant interest” within the meaning of s 608. This definition is discussed at [25.50].

The *Glencore* cases raised concerns that the statutory powers of the Panel were too narrow to enable it to effectively perform its role as the main forum for resolving disputes arising from a takeover during the bid period. Amendments were introduced in 2007 to overcome the restrictions on the Panel’s powers which were evident in the *Glencore* cases:

- the definition of “substantial interest” in s 602A was broadened to encompass new and evolving finance practices and developments in takeovers to deter avoidance of the policies of the takeovers law;
- circumstances may be declared unacceptable if the Panel is satisfied under s 657A(2)(c) as to its likely effect in the future before any effect has actually occurred;
- the Panel may have regard to the broad purposes of the takeovers law and the s 602 objectives, rather than be limited to circumstances which either involve contraventions of the legislation or meet the requirements of s 657A(2)(a) and (b). The purposes of the takeover provisions are discussed at [25.20]; and
- orders may be made which protect the interests of parties indirectly affected by the circumstances.

## Unacceptable circumstances

[25.245] The *Corporations Act* does not define the term “unacceptable circumstances”. Section 657A directs the Panel to take into account the s 602 objectives and the detailed requirements of Chs 6, 6A, 6B and 6C of the *Corporations Act*. The purposes of the takeover provisions as set out in s 602 are described at [25.20]. The Panel therefore has very broad powers to make declarations of unacceptable circumstances without having to establish a contravention of the takeover provisions. A declaration can be made to give effect to the spirit of the legislation.

In *Attorney-General of the Commonwealth of Australia v Alinta Ltd* [2008] HCA 2, Crennan and Kiefel JJ stated:

... The declaration [of unacceptable circumstances] is a statement of the Panel’s conclusion that, having regard to the circumstances created by the contravention and to the public interest, it considers that something needs to be done about those circumstances. They are “unacceptable” in the sense that they cannot remain as they are and that they require consideration to be given to the orders that may be made under s 657D.

## Defensive strategies and tactics

[25.250] Directors of a target company often engage in various defensive tactics and strategies to frustrate hostile takeover bids. “Tactics” are measures adopted to combat a hostile bid that has been made or is thought imminent. “Strategies” are intended to discourage bids being made at all. While the *Corporations Act* and the common law do not expressly prohibit the



directors of a target company from engaging in such frustrating action, directors must, of course, comply with their fiduciary and statutory duties, particularly their duties to act in good faith, in the best interests of the company and for proper purposes.

In Guidance Note 12: *Frustrating Action*, para 12 the Takeovers Panel provided some examples of frustrating actions that could give rise to unacceptable circumstances. These included issuing a significant number of new shares, acquiring or disposing of a major asset, undertaking significant liabilities, declaring an abnormally large dividend and entering into a joint venture.

Defensive strategies and tactics were also examined in a report by the NCSC, *Defensive Schemes and the Duties of Directors* (1986). This report outlined the common defensive schemes and examined whether the duties of directors may be breached in the implementation of the schemes. The NCSC report may be accessed on the Takeovers Panel website and is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## Powers of the court

**[25.330]** As discussed at [25.240], the Takeovers Panel is the main forum for resolving disputes about a takeover bid before the bid period has ended. This is stated by s 659AA.

Prior to the end of the bid period, only ASIC or another public authority may commence court proceedings in relation to a takeover bid: s 659B(1).

The court may stay proceedings that have already commenced until after the end of the bid period: s 659B(2).

### *Glencore International AG v Takeovers Panel* [2005] FCA 1290

**[25.332]** The court held that even though s 659B prohibited a party subject to Panel proceedings from seeking a court review of the Panel's decision, court proceedings were possible if the Panel made a jurisdictional error. In that case the Panel made a declaration of unacceptable circumstances in relation to Glencore's failure to disclose its interest in a target company acquired through an equity swap. One effect of Glencore's equity swap was that the takeover bidder would not be able to acquire 90 per cent of the shares in the target and then be able to compulsorily acquire the remaining shares because the counterparties to the equity swaps held parcels of shares in the target company as a hedge against adverse share price movements in relation to the share swaps.

The court held that in considering whether to make a declaration of unacceptable circumstances, the Panel is required to engage in a balancing exercise. It must weigh the object of protecting rights or interests of any person affected by the relevant circumstances against the prejudice to any person that would flow from the making of an order. In Glencore's case, the Panel made a jurisdictional error because it did not identify the particular interests or rights that were affected by the non-disclosure that were intended to be the subject of protection in order to balance those rights and interests against the prejudice that would be suffered by Glencore.

**[25.333]** The Panel may refer a question of law arising in proceedings before it to the court for decision: s 659A.

After the end of the bid period, the court may make certain orders where the Panel has refused to make a declaration under s 657A that particular conduct amounts to unacceptable circumstances: s 659C. If the court finds that the conduct contravenes the legislation, it may determine whether a person is guilty of an offence and impose a penalty. It may also order the person to pay money to another by way of damages, account of profits or pecuniary penalty. The court cannot make other kinds of remedial orders: s 659C(2).

## Other legislation

**[25.335]** The *Competition and Consumer Act 2010* (Cth) prohibits a corporation from acquiring shares or assets of a body corporate if the acquisition will have the effect of substantially lessening competition in a market: s 50. An acquisition that has the effect of substantially lessening competition in breach of s 50 may be authorised by the ACCC. Authorisation will be given if the ACCC is satisfied that the acquisition will create a benefit to the public.

The *Foreign Acquisitions and Takeovers Act 1975* (Cth) empowers the Federal Treasurer to prevent the acquisition by a foreign person of shares in an Australian company where the acquisition would result in control passing to the foreigner, and this would be contrary to the national interest. A foreign corporation is defined as a corporation in which 15 per cent of its voting capital is held by a foreigner or where two or more foreigners hold at least 40 per cent of the issued capital.

Certain industries are regulated by specific legislation that restricts the acquisition of shares in companies engaged in the industry; for example, the *Broadcasting Services Act 1992* (Cth) seeks to prevent undesirable concentrations of ownership in the television and other media industries.

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.
- For further corporations law links and material please refer to the Understanding Company Law website at <http://www.uclaw.com.au>.

## Chapter 26

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# Financial services and markets

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## Key points

- Chapter 7 of the *Corporations Act* regulates a wide range of financial products, financial services and financial markets under a single regulatory regime.
- The Australian Securities and Investments Commission (ASIC) is responsible for the supervision and enforcement of laws dealing with Australian licensed financial markets and their participants. The Australian Securities Exchange (ASX) also has a regulatory role in the operation of the market including monitoring and enforcing compliance with its market and listing rules which have contractual effect and statutory force.
- Financial services providers must be licensed and are under obligations to ensure that financial services are provided efficiently, honestly and fairly and that conflicts of interest are suitably managed.
- Financial services licensees and their representatives must provide retail clients and other consumers of financial products and services with prescribed disclosure documents.
- Certain types of market misconduct are prohibited. These include insider trading, short selling, market manipulation, false trading and making false or misleading statements. The more serious types of market misconduct are designated as financial services civil penalty provisions and may result in the imposition of a pecuniary penalty, compensation order or criminal liability.

## Introduction

[26.05] The regulation of financial markets is necessary because, by their nature, financial products such as shares and other securities often do not have a readily ascertainable value as may be the case with tangible property. The value of securities depends on complex factors such as the financial position, risk profile and the future prospects of the issuing corporation. The provision of quality financial advice is of great importance to financial product consumers. For this reason, Ch 7 of the *Corporations Act* contains a regulatory framework that, among other things, requires disclosure of information regarding financial products; the provision of knowledgeable, unbiased financial advice; the maintenance of efficient and honest markets for financial products; licensing requirements for financial service providers; and various other investor protection provisions.

[26.10] The regulatory regime dealing with financial services and markets in the *Corporations Act* largely developed in response to the recommendations of a number of inquiries and reviews. The first of these was the *Financial System Inquiry* (1997) (the Wallis Report), which undertook a comprehensive stocktake of the Australian financial system structure and regulation. It considered the forces driving change at the time and raised some key issues in regulatory reform. The Wallis Report is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

The 2009 *Inquiry into Financial Products and Services in Australia* by the Parliamentary Joint Committee on Corporations and Financial Services (the PJC Inquiry) issued a report that addressed a number of issues associated with the corporate collapses of several financial service providers that occurred in the aftermath of the global financial crisis. The Government's response to the PJC Inquiry was the introduction of two significant tranches of legislative reforms in 2012, known as the Future of Financial Advice (FOFA) reforms that focused on the framework for the provision of financial advice. These reforms are discussed at [26.105]–[26.107]. The PJC's *Inquiry into Financial Products and Services in Australia*, 2009, is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

The *Financial System Inquiry Final Report* 2014 (also known as the Murray Report) made recommendations regarding the financial advice industry, in particular that the professional standards required of financial advisers were inadequate and should be strengthened. It recommended that a framework should be established to raise the professional, ethical and educational standards of financial advisers. The legislative amendments that implement these recommendations are discussed at [26.76]–[26.78]. The Murray Report also recommended various measures to better regulate financial services licensees and protect retail clients. The legislative adoption of these recommendation is discussed at [26.75]. The *Financial System Inquiry – Final Report* 2014 is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

The 2019 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (the Hayne Royal Commission) made a number of recommendations affecting the financial services industry, especially financial advice

providers. These included the banning of the widespread practice of payment of conflicted remuneration for financial advice, introducing a single disciplinary process to strengthen the oversight of the financial services industry, and strengthening and simplifying the ongoing arrangements for fees to minimise the risk of such arrangements resulting in fees for no service conduct. These recommendations were adopted and are discussed at [26.107], [26.75] and [26.106] respectively.

*The Quality of Advice Review Final Report*, December 2022, arose from the Hayne Royal Commission. It recommended that the process of giving advice should be simplified and made more efficient so as to reduce costs to consumers by reducing the volume of documentation. This review made many recommendations “to ensure Australians have access to high quality, accessible and affordable financial advice ... for retail clients (consumers)”. The government issued its response to this review in June 2023, accepting most of its recommendations. These included streamlining statements of advice and other documentation requirements, enabling superannuation funds to provide more information to consumers and replacing the best interests of client duty with a new duty to provide “good advice”. It is expected that legislation adopting some of these recommendations will be introduced in late 2023 or early 2024. *The Quality of Advice Review Final Report* is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources>.

In 2020, the Australian Law Reform Commission (ALRC) was asked to inquire into the potential simplification of the laws regulating financial services. In 2023, the ALRC released *Financial Services Legislation: Interim Report C (ALRC Report 140)* containing recommendations, proposals and questions in relation to the reform of the legislation. The ALRC’s proposals seek to restructure and reframe provisions of Ch 7 of the *Corporations Act* so that they are easier to navigate and understand.

ALRC Report 140 is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources>.

## Overview of the legislation

**[26.15]** Chapter 7 of the *Corporations Act* regulates financial products, financial services, advisers and financial markets. The regulatory framework has wide application, regulating diverse financial products such as:

- securities;
- derivatives;
- general and life insurance;
- superannuation;
- deposit accounts; and
- means of payment facilities such as smart cards.

This chapter is primarily concerned with market dealings in shares and other securities on the ASX and the regulation of financial and related licensed investment advisers. The other products listed above fall outside the scope of this book even though they are regulated by the *Corporations Act*.



According to s 760A, the main objects of Ch 7 of the *Corporations Act* are to promote:

- confident and informed decision making by consumers of financial products and services while facilitating efficiency, flexibility and innovation in the provision of those products and services;
- fairness, honesty and professionalism by those who provide financial services;
- fair, orderly and transparent markets for financial products; and
- the reduction of systemic risk and the provision of fair and effective services by clearing and settlement facilities.

Financial service providers are regulated under a single licensing regime. There are various requirements, such as education and training standards, that must be met in order to obtain a financial service provider's licence. These requirements are aimed at ensuring clients are protected as far as possible with additional obligations applicable where services are offered to retail clients.

Further protection for clients is afforded by various conduct and disclosure obligations imposed upon financial service licensees such as provision of a Financial Services Guide (FSG), an obligation to act in their client's best interests, maintenance of separation of funds held on a client's behalf and various reporting and accounting requirements in relation to the financial services business carried on by the licensee.

Financial product disclosure is required throughout the life of a financial product – from its point of sale by means of a Product Disclosure Statement (PDS) to ongoing disclosure and periodic reporting requirements.

A general prohibition applies to misleading and deceptive conduct in relation to dealings in financial products and provision of financial services. Chapter 7 of the *Corporations Act* also contains various market misconduct and insider trading provisions, contravention of which attract criminal sanctions as well as the financial services civil penalty provisions contained in Pt 9.4B of the *Corporations Act*.

## Key concepts

**[26.20]** The three key elements of the regulatory system are:

- financial product disclosure;
- licensing and conduct of financial services providers; and
- licensing of financial markets and clearing and settlement facilities.

Thus, the two important concepts around which Ch 7 of the *Corporations Act* is based are the terms “financial product” and “financial services”.

## Financial products

**[26.25]** The term “financial product” has a complex definition that consists of a general definition as well as specific inclusions and exclusions. Under the general definition contained in s 763A(1), a financial product is a facility through which, or through the acquisition of which, a person:

- makes a financial investment;
- manages financial risk; or
- makes a non-cash payment.

An investor makes a financial investment where money (a contribution) is given to a person to generate a financial return or other benefit for the investor and the investor does not have day-to-day control over the use of the contribution to generate the return or benefit: s 763B. “Making a financial investment” includes investing in shares, debentures and interests in managed investment schemes.

“Managing financial risk” is defined in s 763C and includes taking out insurance and hedging a liability by acquiring a futures contract or entering into a currency swap. “Non-cash payments” include cheque facilities and electronic payment systems: s 763D.

In determining whether a facility is a financial product, the intention or purpose of a particular person is not relevant. A facility is a financial product if it is of a kind through which people commonly make financial investments, manage risk or make non-cash payments: s 763A(2).

In addition to the general definition contained in s 763A(1), there are specific inclusions and exclusions. Under s 764A, inclusions include securities such as shares and debentures, an interest in a registered managed investment scheme, a derivative, various contracts of insurance and a margin lending facility which is defined in s 761EA. Various exclusions are listed in s 765A. In order to ensure that evolving financial products may be regulated without legislative amendment, the *Corporations Regulations* can specifically include or exclude products from being financial products: ss 764A(1)(m) and 765A(1)(y). ASIC may also exclude a facility: s 765A(2).

The most important financial products with which this book is concerned are securities and particularly shares. It was noted at [8.10] that a share is a chose in action. This means that a share is intangible property constituted by a bundle of legally enforceable rights and obligations. Other examples of choses in action that are types of financial products are debentures, government bonds and interests in a managed investment scheme. Collectively, all these come within the definition of “securities” under ss 92(1) and 761A.

## Financial services

[26.30] Chapter 7 of the *Corporations Act* regulates the provision of “financial services” and those who provide such services. Under s 766A, a person provides a financial service if they:

- provide financial product advice (defined in s 766B) meaning a recommendation or a statement of opinion that is intended, or could reasonably be regarded as being intended, to influence a person to make a decision in relation to a particular financial product;
- deal in a financial product (defined in s 766C);
- make a market for a financial product (defined in s 766D);
- operate a registered managed investment scheme (managed investments are discussed in Chapter 27);

- provide a custodial or depository service (defined in s 766E);
- provide a crowd-funding service (defined in s 766F). Crowd-sourced funding is discussed at [7.210]–[7.215];
- engage in conduct of a kind prescribed by regulations; or
- provide traditional trustee services: s 766A(1)–(1A).

A person who provides financial services must obtain an Australian financial services licence or other authorisation. This is discussed at [26.75]. There are various obligations that must be met in providing financial services and making disclosure regarding financial products. These are discussed at [26.80]–[26.98]. Financial advisers are under various duties and obligations when providing advice to clients. These are discussed at [26.99]–[26.110].

Apart from Ch 7, other provisions of the *Corporations Act* also regulate various matters concerning securities and other financial products. For example, Ch 6 regulates trading in shares during a takeover. Takeovers are discussed in Chapter 25. Chapter 6D of the *Corporations Act* regulates fundraising and is discussed in Chapter 7. In addition, Chs 2L and 5C of the *Corporations Act* regulate debentures and managed investment schemes. These are discussed in Chapters 11 and 27.

## Regulation of financial markets

[26.35] Several financial markets operate in Australia. The most important financial markets are conducted by the ASX, which is licensed to operate Australia's main securities (shares and bonds) market and derivatives (futures and options) market. Other financial markets include Cboe Australia and the National Stock Exchange of Australia (NSX).

### Role of ASIC

[26.40] ASIC has wide powers to regulate financial markets and financial service providers. ASIC is responsible for the supervision and enforcement of laws dealing with misconduct on financial markets: s 798F. As part of its supervisory role, ASIC has specific powers to make and enforce “market integrity rules” that deal with the activities or conduct of market operators and participants in relation to market activity and financial products traded on licensed markets: s 798G(1). Regulatory Guide 265 explains how ASIC expects market participants to comply with its market integrity rules.

A breach of market integrity rules constitutes a breach of s 798H(1), a civil penalty provision: s 1317E(3). Where damage has resulted from a breach of the market integrity rules, the court may make a compensation order against a person other than a market operator who has contravened the market integrity rules: s 1317HB. Civil penalty provisions are discussed in Chapter 19.

There are a number of alternatives to civil penalty proceedings available to ASIC for enforcing the market integrity rules without the need to pursue the matter in court. These alternative actions enable ASIC to act quickly in issuing infringement notices, imposing penalties or requiring a person who has contravened the rules to undertake remedial measures or enter into a legally enforceable undertaking: s 798K(1).

ASIC also has the power to issue enforceable directions, such as one requiring an entity to suspend dealings in a financial product, where it is of the opinion that it is necessary, or in the public interest, to protect people dealing in that financial product: s 798J. Where ASIC decides to deal with a breach of the market integrity rules by issuing an infringement notice or accepting an enforceable undertaking, this is done by the Markets Disciplinary Panel, an independent peer review body established by ASIC.

## The ASX

**[26.45]** The ASX conducts the main securities market in Australia. The predecessor of the ASX was established in 1987 when it effected a reorganisation of the major Australian securities exchanges, then based in the various State capital cities, into a single national securities exchange. In 1998, the ASX demutualised and converted from a company limited by guarantee to a company limited by shares and shares in the ASX were listed on its own exchange.

The obligations of the ASX, as stated on its website, include:

- to do all things reasonably practicable to ensure that its markets are fair, orderly and transparent;
- to do all things reasonably practicable to ensure that the services of its clearing and settlement facilities are provided in a fair and effective way;
- to have adequate arrangements for monitoring and enforcing compliance with its Listing Rules; and
- to have adequate arrangements for monitoring and enforcing compliance with its other Operating Rules.

The ASX website contains valuable information about the securities market and ASX-listed companies and is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

Trading in ASX-listed securities is conducted electronically under the CHESS system. CHESS is discussed at [9.225]–[9.245].

The ASX operates a number of financial markets apart from its market in securities. It also operates markets in options, futures, derivatives and interest rate securities.

### *ASX operating and listing rules*

**[26.50]** Operating rules of a financial market are defined in s 761A to mean any rules, including listing rules, that are made by the market operator, such as the ASX, and that deal with the activities or conduct of the market or of persons in relation to the market. The operating rules regulate the relationships between market participants (stockbrokers), their clients and the ASX. The ASX website sets out the Operating Rules. The ASX website is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>. The listing rules are any rules made by the market operator (the ASX) that deal with admitting entities to, or removing them from, the market's official list or deal with the activities or conduct of listed entities: s 761A.

The operating rules (other than listing rules) have effect as a contract under seal between the market licensee and each participant in the market and as between a participant and each other participant: s 793B.

An important way in which the ASX carries out its role is by requiring compliance with its listing rules. The Listing Rules seek to further the interests of listed entities by setting suitable standards of conduct, maintain investor protection and protect the reputation of the market. The principles upon which the listing rules are based are set out in the Introduction to the ASX Listing Rules. The listing rules are binding as a contract under which an entity is admitted to the Official List. Further, the listing rules are enforceable under the *Corporations Act*. This is discussed at [26.60].

The rules impose strict requirements on companies, which, if not complied with, render them liable to removal from the official list.

Section 792D(1) requires a market licensee such as the ASX to provide such assistance to ASIC, as ASIC reasonably requires, for the performance of its functions. In addition, if a market licensee believes a person has committed, is committing or is about to commit a significant contravention of the market's operating rules or the *Corporations Act*, the market licensee must as soon as practicable notify ASIC in writing: s 792B(2)(c).

## *Applications for listing*

**[26.55]** In line with the policy of allowing financial markets to be substantially self-regulating, the ASX is given the discretion of accepting or rejecting applications for listing. This also applies to decisions whether to remove a company from listing. These discretions are part of the general duty of financial markets to maintain fair markets.

The ASX Listing Rules set out a number of prerequisites for admission to the official list. To be eligible to list on the ASX, a company must satisfy two minimum admission criteria relating to the number of shareholders and company size. The minimum number of shareholders require a company to have at least 300 non-affiliated investors each of whom holds a parcel with a value of at least \$2,000 (Listing Rule 1.1):

An entity must satisfy either the profits test in Listing Rule 1.2 or the assets test in Listing Rule 1.3.

The profits test requires an entity seeking listing to have:

- aggregated profit from continuing operations for the last three full financial years of at least \$1 million; and
- consolidated profit from continuing operations for the 12 months prior to applying for listing exceeding \$500,000.

To meet the assets test at the time of admission the entity must have net tangible assets of at least \$4 million after deducting the cost of fund raising or a market capitalisation of at least \$15 million.

The listing rules also set out requirements for continuation of listing. The continuing listing rules supplement the disclosure requirements of the *Corporations Act*. A company whose securities are listed on the ASX is regarded as a “listed disclosing entity”: s 111AL.

Listed disclosing entities are required by Ch 6CA (ss 674–678) to comply with the ASX's continuous disclosure requirements which are set out in Listing Rule 3. For example, under Listing Rule 3.1 a listed disclosing entity must immediately disclose to the ASX, on a continuing basis, information that may have a material effect on the price or value of its securities. The ASX then makes that information available to the market. Under s 674(2), a listed disclosing entity commits an offence if it fails to notify the ASX of information that is not generally available and that a reasonable person would expect, if it were generally available, to have a material effect on the price or value of the entity's securities. Continuous disclosure is further discussed at [22.135]–[22.144].

The ASX website sets out the Listing Rules and Guidance Notes. The ASX website is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## Enforcement of operating rules

**[26.60]** The ASX's operating rules are given statutory force by s 793C. This section enables an application to be made by ASIC, a market licensee or an aggrieved person to the court for an order that the operating rules of the market be complied with or enforced. A holder of financial products of the entity that are tradable on the market is taken to be a person aggrieved by a failure to comply with the operating rules: s 793C(5).

Section 1101B enables the court to make a wide range of orders to ensure compliance with the provisions of Ch 7 of the *Corporations Act*, the operating rules and the other requirements relating to dealing in financial products, providing financial services or operating a licensed market. An application for a court order may be brought by ASIC, a market licensee or a person aggrieved by a contravention of the operating rules. In exercising its discretion, the court should consider the purpose of the legislation, which is to ensure that share acquisitions occur in an efficient, competitive and informed market. This will usually require the court to return all parties to the positions they were in before the share acquisitions occurred: *Gjergja v Cooper* [1987] VR 167.

The court may also make orders that prevent unfair prejudice to vendors. In *NCSC v Monarch Petroleum NL* [1984] VR 733, the NCSC (a predecessor of ASIC) successfully obtained orders under a predecessor of s 1101B to restrain a company from registering any transfers of shares and a declaration that certain transactions were void. This case arose when unknown persons circulated to the Perth Stock Exchange a forged letter purporting to be from the company, the effect of which was to increase the market price for its shares. This constituted a contravention of predecessors of ss 1041E and 1041F which prohibit the making of false or misleading statements and false or reckless statements. These prohibitions are discussed at [26.165].

## National Guarantee Fund

**[26.65]** A licensed market must have in place a scheme for compensation arrangements where the market participants, such as stockbrokers, provide financial services for retail clients and, in doing so, accept money or other property from their clients. In the case of the ASX and Cboe stock exchanges, compensation arrangements are made through the National Guarantee Fund (NGF). The NGF is a compensation fund available to meet

various types of claims made by clients of market participants of the ASX or Cboe which are set out in Div 4 of Pt 7.5 of the *Corporations Act*. Operators of financial markets other than the ASX must have compensation arrangements approved in accordance with Div 3 of Pt 7.5.

The NGF provides a compensation regime administered by the Securities Exchange Guarantee Corporation (SEGC) as the trustee of the NGF. The SEGC is a subsidiary of the ASX although it operates autonomously.

The types of claims which can be made to the NGF include:

- where there has been default by a market participant in the completion of securities transactions entered into on ASX or Cboe markets which are required or permitted to be reported by the participant to the ASX;
- where a market participant transfers securities without authority; and
- where loss arises from a market participant's insolvency.

The NGF provides compensation in relation to exchange-traded options but does not cover trading losses or losses caused by poor investment advice. There are separate compensation funds applicable to ASX futures markets.

## Futures markets

**[26.70]** Futures trading and futures markets are regulated in the same way as share trading and stock markets. Prior to 2006, the Sydney Futures Exchange (SFE) conducted the main futures market in Australia. The SFE and the ASX merged in 2006 and the merged entity operates Australia's main futures markets.

A futures contract is a type of derivative which is defined in s 761D. In *Sydney Futures Exchange Ltd v Australian Stock Exchange Ltd* (1995) 56 FCR 236, Lockhart J described the nature of the futures market:

A futures market is a market in which people buy and sell things for future delivery. A futures contract generally involves an agreement to buy and sell a specified quantity of something at a specified future delivery date. The price is the variable, determined competitively by "open outcry" on the trading floor or through a computer-based market place. Futures markets perform the economic function of managing the price risk associated with holding the underlying commodity or having a future requirement to hold it. The futures market is a risk transfer mechanism whereby those exposed to risks shift them to someone else; the other party may be someone with an opposite physical market risk or a speculator ... Futures markets along with options and other similar markets are often described as "derivative markets" in the sense that they are derived from the underlying instrument (for example, the cash securities market).

There are basically two types of users of the futures market: "hedgers" and "speculators". Hedgers typically deal in the physical commodity and use futures to manage price risks. Hedgers transfer risk to speculators. The futures market performs a price-setting function, allowing hedgers to know in advance the price at which they will buy or sell and to plan for known costs and returns. The futures market achieves its purpose of setting a price in advance by providing profits or losses that balance losses and gains in the



physical market, respectively. The ASX operates markets in a range of futures and options contracts such as equities, energy, grain and interest rates.

## Financial services licensees

### Obligation to hold an Australian financial services licence

**[26.75]** A person who carries on a financial services business in Australia must hold an Australian financial services (AFS) licence: s 911A(1). A person carries on a financial services business where that person gives financial product advice within the meaning of s 766B(1). This includes making a recommendation or providing a statement of opinion that is intended to influence a person to make a decision in relation to a financial product.

In *ASIC v Scholz (No 2)* [2022] FCA 1542, Scholz conducted a business in which he published posts on an Instagram account where he described himself as “ASX Wolf”. Some of these posts contained favourable commentary of certain companies in which Scholz claimed to have purchased shares. These posts were intended to encourage his Instagram followers to purchase the shares and so increase their share price. Scholz also sold share recommendations and conducted seminars. It was held that Scholz contravened s 911A by carrying on a financial services business, as the posting of stories constituted financial product advice within the meaning of s 766B, even though the stories did not contain overt advice to buy shares. It was enough that they presented a positive view of the company’s prospects and were intended to influence readers to make decisions about particular company shares. Scholz also gave financial product advice by making statements during seminars which expressed opinions on certain companies that were also intended to influence persons to invest in their shares.

It is an offence for a person to hold out that they possess a licence when this is not the case: s 911C.

A person may apply for a licence by lodging an application with ASIC. The application must include the information required by reg 7.6.03 of the *Corporations Regulations*. ASIC must grant the application if the requirements of s 913B are met. In particular, ASIC must be satisfied that there is no reason to believe that the applicant or the responsible officers of the applicant are not of good fame and character.

A financial services licensee may authorise a person to be a representative and provide financial services on its behalf by giving the person a written notice. An authorised representative may provide financial services on behalf of a licensee without being licensed: s 911A(2). Directors and employees of a licensed entity are representatives of a licensee and do not need to be appointed as authorised representatives: s 911B(1)(a). Representatives may be authorised to provide all or some of the services covered in the principal’s licence: s 916A. As a general rule, a financial services licensee is prohibited from acting as the authorised representative of another financial services licensee: s 916D.



## Obligation to provide financial services efficiently, honestly and fairly

**[26.76]** An AFS licensee who provides financial services must meet the general obligations set out in s 912A. These obligations include ensuring financial services are provided efficiently, honestly and fairly: s 912A(1)(a). The words “efficiently, honestly and fairly” signify a policy that requires licensees to meet social and commercial norms or standards of behaviour: *ASIC v Westpac Securities Administration Ltd* [2019] FCAFC 187. This includes the requirement of competence in providing advice and in complying with statutory obligations as well as sound ethical values. The provision of efficient financial services means the person is adequate in performance, produces the desired effect and is capable, competent and adequate. Inefficiency may be demonstrated where the performance of a licensee’s functions fall short of the reasonable standard of performance that the public is entitled to expect. To act dishonestly may include conduct that, while not necessarily criminal, is morally wrong in a commercial sense: *ASIC v Cassimatis (No 8)* [2016] FCA 1023.

The obligation to provide financial services efficiently, honestly and fairly appears to impose three separate standalone obligations: *Paciocco v Australia and New Zealand Banking Group Ltd* [2015] FCAFC 50. In *ASIC v National Australia Bank Ltd* [2022] FCA 1324, National Australia Bank (NAB) charged periodic payment fees to customers when it knew that it was not entitled to charge these fees. This conduct was misleading and deceptive under s 12DA of the *Australian Securities and Investments Commission Act 2001* (Cth) (*ASIC Act*), and because NAB knew that it was not entitled to the fees charged, it also constituted unconscionable conduct under s 12CB(1) of the *ASIC Act*. This unconscionable conduct meant that NAB had not done all things necessary to provide financial services efficiently, honestly and fairly to its charged customers.

The duties set out in s 912A require compliance with financial services laws (s 912A(1)(c)), taking reasonable steps to ensure representatives of AFS licensees comply with the financial services laws and ensuring representatives are adequately trained and competent to provide financial services, including complying with the continuing professional development (CPD) obligation in s 921D: s 912A(1)(ca) and (f).

In *ASIC v Commonwealth Bank of Australia* [2018] FCA 941, bank employees engaged in market manipulation and unconscionable conduct in relation to the bank bill market. Among other matters the court held that the employees’ conduct meant that the bank contravened s 912A(a) and (f) because the bank’s systems failed to ensure efficiency and fairness in the provision of financial services.

The obligation to act efficiently, honestly and fairly may be breached where a licensee fails to have adequate controls and risk management systems in place to manage cybersecurity risks and cyber resilience. This involves the ability of an organization to protect and defend the use of cyberspace from attacks: *ASIC v RI Advice Group Pty Ltd* [2022] FCA 496.

## Other applicable regulatory provisions

### Client money trust accounts.

[26.77] AFS licensees are required to keep client money in designated “client money accounts” to which a statutory trust applies which imposes a duty on the AFS licensee to hold the money in that account on trust for the benefit of the client entitled to the money: s 981B. This applies to both wholesale and retail clients where money is paid to an AFS licensee in connection with a financial service or product and held on behalf of the client. It does not include remuneration or payment for that service or product.

### Arrangements for managing conflicts of interest.

A financial services licensee must have in place adequate arrangements for managing conflicts of interest that may arise in relation to activities the licensee undertakes in the provision of financial services: s 912A(1)(aa). The management of conflicts of interest may involve the use of “Chinese walls”: *ASIC v Citicorp Global Markets Australia Pty Ltd (No 4)* [2007] FCA 963. Chinese walls are discussed at [26.310]. There are further obligations to ensure representatives of a licensee are adequately trained and adequate risk management systems are in place. There are additional obligations set out in ss 912B–912F, including having arrangements in place to compensate retail clients for certain losses and notifying ASIC of breaches of these obligations.

Financial services licensees are responsible for the conduct of their employees, directors and authorised representatives where financial services are provided on which a client could reasonably be expected to rely and on which the client relied in good faith: s 917A. Licensees are liable for any loss or damage suffered by a client as a result of the conduct of representatives: s 917E.

### Bans and disqualification.

ASIC may ban a person from providing financial services on several grounds including a failure by the person to comply with the obligations set out in s 912A, where the person was convicted of fraud or ASIC has reason to believe the person is not a fit and proper person to provide financial services: s 920A(1). Various criteria are set out in s 913BB for determining whether a person is fit and proper to provide financial services. The banning order may be permanent or for a specified period: s 920B(2). A banning order must be accompanied by a statement of reasons for the order: s 920F.

ASIC may also apply to the court for orders disqualifying a person against whom ASIC has made a permanent banning order. The disqualification order of the court may be subject to conditions or as the court considers appropriate: s 921A.

ASIC maintains a register of financial services licensees and authorised representatives which is available for public inspection without charge: ss 922A and 922B. The register provides a central record of the competency, employment history and any misconduct

of individual financial advisers. The register assists ASIC in its compliance activities and ability to respond to problem advisers.

#### Restricted words.

There are restrictions on the use of certain words and expressions by financial service providers which could create a misleading impression. It is an offence for a person to use the words “independent”, “impartial” or “unbiased” or similar words unless the financial service provider does not receive commissions, volume bonuses or gifts or benefits from product issuers and there are no conflicts of interest which may reasonably be expected to influence the person: s 923A. It is also an offence for persons to describe themselves as a type of broker, including a stockbroker, unless authorised by ASIC under the conditions on their licence: s 923B.

Various protections are afforded to clients who enter into agreements with unlicensed financial service providers where the service provider should be licensed. The client may rescind the agreement (ss 925A–925D), the agreement is unenforceable against the client (s 925E) and the unlicensed person cannot recover commission from the client: s 925F. However, the client can recover any commission paid to the unlicensed person: s 925H. The client retains any other rights and remedies in addition to these statutory rights: s 925I.

#### Establishment of a single disciplinary system.

The Hayne Royal Commission in its final report found that while sanctions against financial service providers are available to ASIC, the lack of less serious sanctions meant that ASIC generally focused only on the most serious cases of misconduct. For this reason, the Hayne Royal Commission recommended the establishment of a single disciplinary body for financial advisers and that all financial advisers who provide personal financial advice to retail clients be registered.

This recommendation was adopted by the *Financial Sector Reform (Hayne Royal Commission Response – Better Advice) Act 2021* (Cth), usually called the “Better Advice Act”. It established the Financial Services and Credit Panel as a part of ASIC, to which ASIC may refer complaints on matters such as where it believes an adviser has breached the *Corporations Act*, is not a fit and proper person to advise retail clients or has not met the required education and training standards. The Panel may apply various penalties including warnings, infringement notices and banning orders and make recommendations to ASIC that it bring a civil action where a civil penalty provision has been breached. Decisions of the Panel and details relating to disciplinary actions may be published on the Financial Advisers Register. Financial advisers, referred to as “relevant providers”, must be registered by ASIC in the Register of Relevant Providers under s 922Q.

## Professional standards for financial advisers

**[26.78]** Amendments introduced in 2017 aimed to raise the education, training and ethical standards of “relevant providers” who provide personal advice to retail clients on

financial products. This was seen as necessary after numerous cases where inappropriate financial advice had a negative impact on consumer confidence in the financial services industry resulting in a reluctance of consumers to seek financial advice.

The term “relevant provider” is defined in s 910A as an individual who is a financial services licensee, or an authorised representative or employee of a financial services licensee or a related body corporate who is authorised to provide personal advice to retail clients as the licensee or on behalf of the licensee, in relation to relevant financial products. “Relevant financial products” is also defined in s 910A to exclude basic banking products, general insurance products and consumer credit insurance or a combination of any of those products. “Personal advice” is defined in s 766B(3) and is discussed at [26.100] and the distinction between retail and wholesale clients is discussed at [26.80].

Education and training standards.

Division 8A of Pt 7.6 requires a financial advice provider to meet the education and training standards set out in s 921B and comply with the Code of Ethics made under s 921E.

Section 921B sets out four education and training standards for financial advisers:

- completion of a bachelor or higher degree or equivalent qualification;
- passing of an exam administered by ASIC;
- completion of at least one year of work and training that meets certain requirements; and
- meeting requirements for prescribed continuing professional development.

ASIC can only issue an Australian financial services licence that covers the provision of personal advice to retail clients in relation to financial products, if the applicant has met the first three of the four education and training standards: s 921C(1). A provider of financial advice who is a financial services licensee, or otherwise authorised, must not provide advice to retail clients unless registered: s 921Y.

The requirement that existing financial advisers must complete a degree course or an approved equivalent has resulted in large numbers of experienced financial advisers who do not possess degrees leaving the industry and creating a shortage of advisers. The Treasury Laws Amendment (2023 Measures No 3) Bill 2023 (Cth), introduced in June 2023, seeks to address this issue by removing the approved qualification standard for financial advisers who have provided personal advice to retail clients for more than 10 years and have a clean disciplinary record. These exempted financial advisers must still pass the required exam and meet the continuing professional development standards.

An individual may be authorised as a provisional relevant provider where they have met the qualification and exam conditions but are still in the course of their professional year. A provisional relevant provider must be appropriately supervised by a relevant provider who must disclose to the client the provisional status of the relevant provider: s 921F.

Terms such as “financial adviser” and “financial planner” can only be used by individuals who are relevant providers: s 923C(1) and (2). Those who are provisional relevant providers are not permitted to use these titles. These restrictions enable clients to easily ascertain whether someone is authorised to provide personal advice on relevant financial products to retail clients. Persons who provide advice to wholesale clients are permitted to use the restricted terms where they do not give advice to retail clients: s 923C(3)–(6).

#### Ethical standards.

A relevant provider must comply with the *Financial Planners and Advisers Code of Ethics 2019*: s 921E(3). The Code sets out ethical obligations that go beyond legal requirements and encourage higher standards of behaviour and professionalism in the financial services industry. The Code’s ethical standards include acting in the interests of clients, avoiding conflicts of interest, ensuring clients give informed consent and understand the advice they receive, and maintaining a high level of knowledge and skills.

#### Register of Relevant Providers.

ASIC must enter details about AFS licensees, representatives and other relevant providers in a Register of Relevant Providers: s 922Q. Relevant providers are required to notify ASIC of prescribed information: s 922L. Information which licensees must notify ASIC include the relevant provider’s principal place of business, the licensee, the year the relevant provider started giving personal advice and recent advising history, educational qualifications and the name of the scheme that covers the relevant provider: ss 922D–922G. ASIC must be notified of any changes to this information: ss 922H, 922J and 922K.

## Providing financial services and product disclosure

**[26.80]** One of the main aims of Ch 7 of the *Corporations Act* is to ensure that consumers of financial products and services receive adequate information about those products and services. Important obligations are imposed on financial services licensees and authorised representatives to provide prescribed disclosure documents to retail clients. The main disclosure documents are the “Financial Services Guide”, “Statement of Advice” and “Product Disclosure Statement”. Licensees and their representatives are also under various additional obligations where personal advice and financial services are provided to retail clients.

A distinction is made in the legislation between “retail” and “wholesale” clients. Greater disclosure, conduct requirements and other protections are imposed on licensees and representatives where financial services are provided to retail clients. A client is a wholesale client (and therefore not a retail client) where that person meets a wealth test or is a professional investor within the tests set out in s 761G(7).

## Financial Services Guide

### *When is an FSG required?*

**[26.85]** A financial services licensee or authorised representative who provides a financial service to a retail client must give the client an FSG: ss 941A and 941B. The requirement to provide an FSG aims to ensure that retail clients receive key information about the type of financial services they are being offered. An FSG is not required in the situations set out in s 941C such as where the client already possesses the information or where the transaction is regulated by other legislation.

### *Prescribed contents of an FSG*

**[26.95]** Sections 942B and 942C set out the prescribed contents of an FSG. These content requirements ensure that retail clients receive key information required to make informed decisions about whether to acquire the financial service that is offered while at the same time providing flexibility for the industry in determining the level of information that should be included.

The level of information about a matter that is required to be specified in an FSG is such as a person would reasonably require for the purpose of making a decision whether to acquire financial services from the providing entity as a retail client: ss 942B(3) and 942C(3).

Sections 942B and 942C, which deal with the contents of an FSG, require a financial services licensee or authorised representative that is not independent, to include a statement in the FSG to that effect.

## Financial product disclosure

**[26.98]** Part 7.9 of the *Corporations Act* deals with the various disclosures that must be made throughout the life of a financial product from point of sale disclosure through to ongoing disclosure and periodic reporting requirements.

In general, the financial product disclosure requirements of Pt 7.9 apply to all financial products other than shares and debentures and stocks or bonds issued or proposed to be issued by a government. In particular, the Pt 7.9 requirements apply to issues of interests in registered managed investment schemes. These are discussed in Chapter 20.

One of the main requirements of Pt 7.9 is the obligation to give retail clients a PDS at the point of sale of a financial product. Sections 1012A–1012C set out the various circumstances where a PDS must be given to a client. The broad objective of this requirement is to provide consumers with sufficient information to make informed decisions in relation to the acquisition of financial products, including the ability to compare a range of products.

## Financial product advice to retail clients

**[26.99]** There are two types of financial product advice to retail clients – personal advice and general advice: s 766B(2). The disclosure obligations on financial product advisers

differ depending on whether personal advice or general advice is provided. The main requirements applicable to the provision of personal advice are for a written statement of advice to be given (see [26.100]) and an obligation to act in the best interests of the retail client.

Fewer requirements are imposed where general advice is given to a retail client. Under s 949A(2) the main obligation on the adviser is to provide a general advice warning that the advice has been prepared without taking into account the client's objectives, financial situation or needs and because of that, the client, before acting on the advice, considers the appropriateness of the advice, having regard to the client's objectives, financial situation and needs.

Providers of personal advice to retail clients are subject to a number of statutory obligations and restrictions aimed at protecting retail clients. The adviser's obligations include a requirement to provide a statement of advice (see [26.100]), to act in the best interests of the client (see [26.105]) and to prioritise the client's interests where a conflict of interest arises. Certain types of remuneration that raise issues of conflicts of interest are banned. Margin loans are also subject to regulation and investor protection provisions.

## *Statement of advice*

**[26.100]** Where a retail client is given personal advice, the provider must give the client a "Statement of Advice". "Personal advice" is defined in s 766B(3) as financial product advice that is given to a person in circumstances where the provider of advice has considered one or more of the person's objectives, financial situation and needs or a reasonable person would expect the provider to have considered one or more of these matters.

### *Westpac Securities Administration Ltd v ASIC [2021] HCA 3*

**[26.102]** In this case the High Court considered the meaning of "personal advice" for purposes of s 766B(3). Westpac began a campaign directed at existing members of various Westpac superannuation funds encouraging them to roll over their non-Westpac superannuation funds to their respective Westpac superannuation accounts. The main objective of the campaign was to increase Westpac's funds under management. Each member was sent written communications from a Westpac employee in which Westpac offered to search whether members had external superannuation accounts, and if they had such accounts, Westpac offered to roll them over to their Westpac superannuation accounts. Westpac indicated that combining the superannuation accounts into one could save on administration fees and the convenience of having all super in one place. Westpac followed up the written communications with a telephone call from a Westpac adviser who warned that the member was being given general advice that would not take into account a member's personal financial needs.

The court held that Westpac provided personal advice to the members because a reasonable super fund member might expect that the personal objectives such as saving on fees and improving manageability were relevant and that Westpac advisers would consider these matters before providing financial product advice.



The court also held that Westpac's general advice warning was ineffective because the telephone calls involved advice specifically about the members' situation.

A Statement of Advice does not need to be provided when personal advice is given in relation to financial investments of less than the threshold amount of \$15,000 (s 946AA), there is no recommendation in relation to a particular financial product and no remuneration or benefit is received: s 946B(7).

#### Content of statement.

The level of detail of information required in the Statement of Advice is that which a person would reasonably require for the purpose of making a decision whether to act on the advice provided: ss 947B(3) and 947C(3). There are specific content requirements contained in ss 947B(2) and 947C(2), including a statement setting out the advice, information about the basis on which the advice was given and any remuneration received or other factors which might reasonably be expected to be capable of influencing the advice provider in providing advice.

*The Quality of Advice Review Final Report*, December 2022, recommended that the process of giving advice should be simplified and made more efficient so as to reduce costs to consumers by reducing the volume of documentation. Part of this was the recommendation that statements of advice should be replaced with an advice record that is more fit for purpose, flexible and less prescriptive. In its response to the Review, the government indicated it would adopt this recommendation.

### *Obligation to act in best interests of client*

**[26.105]** The FOFA reforms imposed a general duty on individuals who are providers of personal advice to retail clients to act in the best interests of their client in relation to that advice: s 961B(1). What would be regarded as being in the best interests of the client is determined objectively with reference to whether a person with a reasonable level of expertise in the subject matter of the advice, exercising care and objectively assessing the client's circumstances, would regard a step as being in the best interests of the client: s 961E.

#### Duty to act in best interests of client satisfied in specified circumstances.

According to s 961B(2), providers satisfy the duty to act in the best interests of their client if they can prove that they properly researched and considered a number of specified relevant matters and took steps such as:

- identified the objectives, financial situation and needs of the client as disclosed to the provider through the client's instructions;
- identified the subject matter of the advice sought by the client;
- identified the objectives, financial situation and needs that would reasonably be considered as relevant to the subject matter of the advice;



- made further inquiries where appropriate to obtain complete and accurate information about the client;
- conducted a reasonable investigation into the financial product that might achieve the objectives and meet the needs of the client;
- based all judgments in advising the client on the client's relevant circumstances and on what would reasonably be regarded as being in the best interests of the client.

In *ASIC v NSG Services Pty Ltd* [2017] FCA 345, it was held that at least the key “safe harbour” provisions in s 961B(2) would have to be satisfied in order for a licensed service provider to satisfy their duty to act in the best interests of their client. These include the need for thorough investigation of the client's needs and a reasonable investigation of financial products available before recommending suitable products for a client.

The provider must only provide the advice to the client that it would be reasonable to conclude is appropriate to the client had the provider satisfied the duty under s 961B(1) to act in the best interests of the client: s 961G.

Priority of client's interests where conflict of interest arises.

Section 961J(1) deals with situations where there may be a conflict between a client's interests and those of the provider. That provision requires the provider to give priority to the interests of the client in situations where the provider knows, or reasonably ought to know, there is a conflict between the interests of the client and the interests of the provider or an associate of the provider as specified in s 961J(1). This obligation may be breached where, for example, the provider gives priority to maximising non-client remuneration, such as commissions from a financial product provider, over the interests of the client. Prohibitions on certain forms of remuneration received by providers are discussed at [26.107].

Financial services licensees are required to take reasonable steps to ensure that their representatives comply with their obligations to act in the client's interest (s 961B), give appropriate advice (s 961G), warn clients where the provider has based advice on incomplete or inaccurate information (s 961H) and give priority to the interests of the client (s 961J): s 961L.

In *ASIC v NSG Services Pty Ltd* [2017] FCA 345, it was held that NSG as a licensee had failed to take reasonable steps to ensure its representatives had adequately discharged their duties to act in the best interests of their clients and provide appropriate advice. NSG was aware that the content and form of its policies were deficient and its response to rectify them was substantially inadequate. Despite a number of warnings from external advisers and auditors, NSG failed to disseminate key information as to representatives' duties, written statements of advice were hastily prepared without opportunity for review by clients, training of representatives and commission-based salary structures were focussed on sales effectiveness rather than statutory duties and responsibilities, systems for monitoring and supervision were inadequate and registers of breaches by and complaints against representatives were poorly maintained.

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| Consequences of contravention. |
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A financial services licensee contravenes ss 961B, 961G, 961H and 961J if a representative, other than an authorised representative breaches those provisions: s 961K. A financial services licensee must take reasonable steps to ensure that representatives of the licensee comply with the provisions set out in s 961K: s 961L. Sections 961K and 961L are included within the s 9 definition of “Part 7.7A civil penalty provision”. Authorised representatives of a licensee who contravene these sections are also subject to the civil penalty provisions: s 961Q(1). The civil penalty provisions are discussed at [19.120]–[19.150]. An authorised representative of a licensee who contravenes these sections will not be subject to the civil penalty provisions where they were provided with information or instructions by a licensee about compliance with the requirements in relation to the giving of personal advice and the failure to comply with the civil penalty provisions occurred because the representative acted in reliance on that information or those instructions and it was reasonable to do so: s 961Q(2).

Where a client suffers loss or damage as a result of a contravention of ss 961B, 961G, 961H or 961J, the court may order that compensation be paid by the licensee irrespective of whether the licensee has been the subject of a civil penalty order or been convicted of a criminal offence: s 961M. Licensees are therefore accountable for the advice given by their representatives as they are also under an obligation to have arrangements in place for compensating retail clients for loss or damage arising from breaches of the legislation caused by the licensee or its representatives: s 912B.

*The Quality of Advice Review Final Report*, December 2022, recommended that the duty to act in the best interests of the client should be replaced by a duty imposed on a financial adviser to give “good advice”. The review chose this terminology because it describes simply, clearly and directly what consumers want and the law should require. It defined “good advice” as personal advice that, among other things, is fit for purpose and considers the scope, content and nature of the advice and the likely relevant circumstances of the client. It is expected that legislation adopting this recommendation will be introduced in late 2023 or early 2024. *The Quality of Advice Review Final Report* is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources>.

## Ongoing fees for financial services

**[26.106]** Financial advisers are often paid ongoing fees by their clients based upon a percentage of the value of assets under management, or a flat annual fee, often covering a range of financial services available to the client which may or may not be used. In many cases, clients who paid an ongoing fee for financial advice received little or no service. Clients were often unaware of the magnitude of the fees they paid or they continued to pay fees after disengaging from their relationship with their adviser. A number of provisions seek to prevent these situations arising.

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| Fee disclosure statement. |
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Where a financial services licensee or representative, described as a “fee recipient” gives personal advice to a retail client and an ongoing fee arrangement is entered into that provides that a fee is to be paid during a period of more than 12 months, the fee recipient is required to provide the client with a fee disclosure statement: s 962G. This statement must contain specified fee information set out in s 962H(2) to assist the client in ascertaining whether they are receiving a service from their fee recipient commensurate with the ongoing fee that they are paying or whether to renew the ongoing fee arrangement. If the fee recipient fails to provide the fee disclosure statement within the specified time, the client is not liable to pay the ongoing fee: s 962F(1).

Recommendations of the Hayne Royal Commission in relation to ongoing fee arrangements were adopted so as to reduce the likelihood of ongoing fee arrangements giving rise to “fee for no service” issues. The changes include that the client:

- is required to opt-in to an ongoing fee arrangement annually;
- should receive a forward-looking summary of the services they are entitled to receive and the fees payable for those services; and
- should provide express written authority prior to the deduction of fees from the client’s accounts, and this authority must be renewed annually.

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| Renewal notice. |
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If an ongoing fee arrangement is in place for a period of more than 24 months, the fee recipient is required to provide the client with a renewal notice: s 962K(1). This notice must contain information indicating that the client may elect to renew or not renew the ongoing fee arrangement. If the client elects not to renew the fee arrangement or if they do not respond to the renewal notice, the arrangement, including the provision of advice and the ongoing fee, terminates. If the fee recipient does not provide the required renewal notice within the specified time, the client is not liable to continue paying the ongoing fee: s 962F(1). After termination of an ongoing fee arrangement, the recipient is prohibited from charging an ongoing fee: s 962P.

## *Banned remuneration*

**[26.107]** The legislation bans the payment and receipt of “conflicted remuneration” and certain other payments made by product issuers which have the potential to affect the quality of the advice provided to retail clients and often results in financial advisers failing to act in the best interests of their clients.

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| Conflicted remuneration. |
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The ban on conflicted remuneration addressed a particular problem identified as stemming from the once common practice of financial advisers receiving ongoing or “trailing” commissions from product providers for placing their financial products with clients. This practice put financial advisers in a conflict of interest situation as it encouraged them to promote products that maximised their commissions rather than acting in the best interests of their client.

Licensees and their representatives are prohibited from accepting conflicted remuneration: ss 963E, 963G and 963H. The prohibition does not apply to authorised representatives where the authorised representative received the benefit after reasonably relying on information from their licensee that the benefit was not conflicted remuneration: s 963G(2). A licensee must take reasonable steps to ensure that its representatives do not accept conflicted remuneration: s 963F. An employer of a licensee or a representative must not give employees conflicted remuneration: s 963J. Employees cannot accept conflicted remuneration from third parties: s 963H. Similarly, an issuer or seller of a financial product must not give conflicted remuneration to a financial services licensee or their representatives: s 963K.

“Conflicted remuneration” is defined in s 963A as 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. The concept of conflicted remuneration covers a broad range of monetary and non-monetary benefits, covering both traditional product commissions, volume payments from platform operators, financial advice dealer groups and “soft-dollar” (non-monetary) benefits. Benefits that are related to the volume of financial products recommended or funds invested are presumed to be conflicted remuneration unless the contrary is proved: s 963L. Volume-based benefits are inherently conflicted because they provide a strong financial incentive to an adviser to maximise the value of the payments even where the product may not be suitable for the client.

In *ASIC v Select AFSL Pty Ltd (No 2)* [2022] FCA 786, a company that retailed life insurance products established a competitive, sales-driven culture. Sales agents were remunerated according to the number of sales they made and were paid commissions and other incentives and non-financial benefits such as travel vouchers and various goods. It was held that these benefits were conflicted remuneration within the meaning of s 963A. Factors that are relevant in determining whether a benefit could reasonably be expected to influence financial advice include the significance of the benefit in the total remuneration of the recipient, how direct the link is between the benefit and the value of financial products recommended, and the environment in which the benefit is given.

In *ASIC v Commonwealth Bank of Australia* [2023] FCAFC 135, ASIC alleged that CBA and its wholly-owned subsidiary Colonial reached an agreement under which Colonial gave benefits to CBA in relation to the distribution of a superannuation product that, among other features, provided the convenience of online access and the ability of customers to choose their preferred investment mix. It was held that while benefits were given by Colonial to CBA, ASIC had failed to prove that financial product advice was given, so the benefit did not influence the financial product advice given to retail clients as required by s 963A. This case also held that the conflicted remuneration provisions apply where only one financial product is offered to retail clients.

Various monetary and non-monetary benefits are excluded from the definition of conflicted remuneration by ss 963B and 963C. These include fee for service arrangements where the client pays the adviser in relation to the issue or sale of a financial product or financial product advice and benefits provided by third parties that have a genuine education or training purpose relevant to the provision of financial advice.

Volume-based shelf-space fees and asset-based fees on borrowed amounts.

Volume-based shelf-space fees and asset-based fees on borrowed amounts are also banned forms of remuneration: ss 964A, 964C and 964E. “Volume-based shelf-space fees” are payments made by product issuers or funds managers to platform operators in order to obtain shelf space or preferential positions on administration platforms. Platform operators offer to provide custodial arrangements whereby the client may instruct the platform to acquire certain financial products which are then held on trust for the client. An “asset-based fee” is a fee for providing financial product advice that is dependent upon the amount of funds to be used to acquire financial products. Retail clients must not be charged such fees on borrowed amounts where it is reasonably apparent that the money used by the client to purchase the financial product has been borrowed.

The prohibitions dealing with conflicted and other banned remuneration are included in the s 9 definition of “Part 7.7A civil penalty provision” and are discussed at [26.345].

### *Regulation of margin lending*

**[26.110]** A margin loan facility allows an investor to borrow money in order to invest in shares and other financial products. The loan is usually secured by the acquired investments. The investor may also provide further assets as security for the loan. Where the market price of the investment falls below an agreed level, the lender can require payment of a margin call to restore the loan-to-value ratio back to an agreed level. This requirement can be met by payment of cash to reduce the amount outstanding under the loan, selling some of the secured assets or providing further security.

A margin lending facility is a financial product.

The term “margin lending facility” is defined in s 761EA and included within the definition of a financial product so that providers of financial services that include margin loans are subject to the licensing, conduct and disclosure requirements of Ch 7 of the *Corporations Act* and ASIC supervision. These requirements are discussed at [26.75]–[26.107]. There are also specific investor protection provisions applicable to margin loans.

Unsuitable proposed margin loans.

Lenders are required to assess whether a proposed margin loan is unsuitable for a particular retail client: s 985E. In making this assessment, the lender is required to make reasonable inquiries about the client’s situation: s 985F. A margin lending facility must be assessed as unsuitable for the retail client where it is likely that if a margin call was made, the client would be unable to comply with the obligations under the margin lending facility or could comply only with substantial hardship: s 985G(1). If a loan is assessed as unsuitable it must not be provided to the client: s 985J(1). A factor in assessing unsuitability is where a client has engaged in “double gearing” which occurs where the client borrows funds to finance their equity contribution to the margin loan.

Lenders must take reasonable steps to notify the retail client when a margin call is made, unless the client has agreed to being notified by a financial planner: s 985L.

## Prohibited market misconduct

**[26.120]** Certain improper market practices are prohibited because they create false markets for securities and other financial products and enable some persons to derive unfair advantages.

The prohibited market misconduct practices are:

- short selling;
- market manipulation;
- false trading and market rigging;
- dissemination of information about illegal transactions;
- false or misleading statements;
- misleading or deceptive conduct; and
- contravention of provisions dealing with unsolicited off-market offers.

### Short selling

**[26.125]** Short selling is the practice of selling securities or other financial products that are not owned by the seller at the time of the sale. Short sellers sell securities that they do not possess, at current prices, in the expectation that their price will fall. They hope to buy similar securities, or “cover” their positions at a lower price before they are obliged to honour the contract of sale and deliver the securities. Short selling therefore enables the seller to make a profit because of the time lag between entering the actual contract and its eventual settlement. It is usually practised in markets where prices fluctuate significantly or there is an expectation that prices will fall.

Short selling is not absolutely prohibited but must be disclosed to the market. Under s 1020B(2), a person can only sell securities and other products specified in s 1020B(1) if at the time of sale, the person has a presently exercisable and unconditional right to vest the products in the buyer or the person has reasonable grounds for believing they have such a right.

“Covered” short selling.

A “covered” short sale occurs where a short seller borrows the securities from an owner under a securities lending agreement and uses the borrowed securities to settle the short sale. The short seller subsequently buys the same securities on the market and then returns the borrowed securities to the lender at an agreed later date. Covered short selling involving a securities lending agreement as defined in s 1020AA is required to be disclosed by the seller to the acting broker. This requirement aims to keep the market informed of the extent of short selling taking place.

Under s 1020AE, AFS licensees, usually the executing broker, must ask the seller if a sale is a short sale and report the disclosed covered short sale to the relevant market operator who in turn, must disclose aggregate short sale information to the market. These disclosures must be made whether sales are on- or off-market crossings and whether the seller is inside or outside Australia. Failure to comply with these disclosure requirements is an offence: ss 1020AB(3), 1020AC(2) and 1020AE.

“Naked” short selling.

The other form of short selling is known as “naked” short selling, where the seller has no prior interest in the shares which are short sold and has not made arrangements at the time of sale to borrow the shares. Naked short selling is now prohibited as it raises the risk that the seller will be unable to provide the securities at settlement. This type of short selling is also seen as more likely to undermine the integrity of financial markets as it increases price volatility and potentially facilitates market manipulation.

ASIC exemptions and modifications.

ASIC has various powers under s 1020F(1) to exempt compliance with the legislation and to make declarations to omit, modify or vary certain parts of the *Corporations Act* in relation to short selling and transactions which have substantially similar market effects. This is usually done by issuing Class Orders. ASIC’s power to make declarations under s 1020F(1)(c) includes suspending, prohibiting or limiting these transactions and varying, removing or adding applicable requirements: s 1020F(8).

## Market manipulation

**[26.130]** A person is prohibited from taking part in or carrying out a transaction that is likely to have the effect of creating an artificial price for trading in financial products on a financial market: s 1041A.

*DPP v JM* [2013] HCA 30

**[26.131]** JM and his family entered into various transactions involving shares in X Ltd, a listed company on the ASX. It was alleged that an entity associated with JM had borrowed money to exercise a large number of call options in X Ltd and his daughter purchased shares in the company for the purpose of maintaining X Ltd’s share price above the threshold that would have entitled a lender to make a margin call on a loan made to JM. The High Court held that the price of a share which has been created or maintained by a transaction on the ASX that was carried out for the sole or dominant purpose of creating or maintaining a particular price for that share is an “artificial price” for the purposes of s 1041A. Section 1041A is not confined in its application to the creation or maintenance of an artificial price by a dominant market participant exercising that participant’s market power.



*ASIC v Soust* [2010] FCA 68

[26.135] Soust was the managing director and CEO of Select Vaccines Ltd (SVL). He had entered into a contract of employment with SVL which provided for the payment of a bonus if the company's share price outperformed a particular share price index at the end of a calendar year. Just before the end of a year, Soust purchased SVL shares and as a result of that trade the share price increased so that the bonus became payable and was later paid to Soust. Goldberg J described the meaning of the term "artificial price" used in s 1041A. "I consider that the expression 'artificial price' connotes a price created not for the purpose of implementing or consummating a transaction between genuine parties wishing to buy and sell securities, but rather for a purpose unrelated to achieving the outcome of the interplay of genuine market forces of supply and demand". Soust was not a genuine buyer because his purpose was to increase the market price of the shares so he could obtain his bonus. This conduct also contravened s 1041B which is discussed at [26.145] and the directors duties contained in ss 181 and 182. See [15.235] and [16.120].

[26.140] An improper practice that occurred in the past was for a group of investors to form a pool to which each contributed funds used to buy and sell shares. Acquired shares were sold successively from one member of the pool to another in order to increase turnover and price and therefore give a misleading impression of the desirability of the shares. This induced some members of the public to buy the shares. The members of the pool then sold their shares at the increased price. This practice is prohibited by s 1041A which is designated as a financial services civil penalty provision: s 1317E(1). The consequences of a contravention of these provisions are discussed at [26.345].

## False trading and market rigging

[26.145] A person is prohibited from doing or omitting to do something that has or is likely to have the effect of creating a false or misleading appearance of:

- active trading; or
- the price for trading in financial products on a financial market: s 1041B(1).

A person is taken to have created a false or misleading appearance of active trading if the person enters into transactions of acquisition or disposal that do not involve a change of beneficial ownership of the financial products. It may also arise where a person makes an offer to acquire or dispose of financial products at a specified price knowing that a matching transaction at substantially the same price will be made: s 1041B(2). Criminal liability for a breach of s 1041B requires an intention to do a particular act such as entering into a transaction as well as the requisite intention, knowledge or recklessness with respect to creating a false or misleading appearance: s 1041B(1A).

A natural person who breaches s 1041B is guilty of a criminal offence punishable by a penalty of the greater of 4,500 penalty units or three times the value of the profit gained or loss avoided as a result of the contravention. The court can also order imprisonment for up to 10 years: s 1311 and Sch 3. The maximum penalty for a body corporate guilty



of breaching s 1041B is 45,000 penalty units or three times the value of the profit gained or loss avoided as a result of the contravention or 10 per cent of the body corporate's annual turnover: s 1311 and Sch 3.

A person is also prohibited from entering into fictitious or artificial transactions if that results in an artificial price for trading in a financial product or causes the price to fluctuate: s 1041C.

Sections 1041B and 1041C prohibit the practice of “churning”. This involves the placing of buying and selling orders for shares with the object of artificially increasing the market turnover and price of those securities.

*ASC v Nomura International PLC (1999) 89 FCR 301*

**[26.150]** Nomura was a stock index arbitrageur. It sold large parcels of shares, which sparked a fall in share prices and the futures index. This allowed Nomura to repurchase, at a lower price, the futures contracts it had previously sold. It was held that the intention of the transactions was to self-trade at depressed prices that did not reflect the market but were unilaterally determined by Nomura, and speculative profits were thereby gained. The court held that Nomura contravened a predecessor of s 1041B(1). It also contravened the misleading and deceptive conduct provisions now contained in s 1041H.

**[26.155]** Sections 1041B(1) and 1041C(1) are designated as financial services civil penalty provisions: s 1317E(1). The consequences of a contravention of these provisions are discussed at [26.345].

## Dissemination of information about illegal transactions

**[26.160]** A person is prohibited from disseminating any information to the effect that the trading price of a financial product will be affected by a transaction or conduct which constitutes a contravention of the market misconduct provisions where the person or an associate has entered into the transaction or engaged in the conduct or has received a benefit from disseminating the information: s 1041D. This provision is designated as a financial services civil penalty provision: s 1317E(1). The consequences of a contravention of these provisions are discussed at [26.345].

## False or misleading statements

**[26.165]** Section 1041E(1) prohibits the making of a statement or the dissemination of information if the statement or information is false in a material particular or is materially misleading and it is likely to induce persons to apply for, dispose of or acquire financial products or have an effect on the market price of a financial product. The prohibition requires that when a person makes the statement or disseminates the information, the person does not care whether the statement or information is true or false, or knows or ought reasonably to have known, that the statement or information is false or misleading in a material respect.

The term “likely to induce” means that there is a real and not remote chance. A statement can be “likely to induce” a person to acquire a financial product even if the statement is only one of several statements which are likely to induce an investor to make an acquisition. It is also relevant whether the person who made the statement intended that the statement induce an investor: *James Hardie Industries NV v ASIC* [2010] NSWCA 332. A statement may still be likely to induce an investor to purchase a financial product even though the investor may not have relied upon or even read the statement. In *ASIC v Cassimatis (No 8)* [2016] FCA 1023, the court took into account several matters that indicated statements were likely to induce investors to acquire a financial product. These included that the statements were prominently displayed in the provided material, they were intended to induce investors to invest who were relatively unsophisticated with few assets and limited income and investors signed every page of the documents containing the statements.

Section 1041F prohibits the making of false or reckless statements to induce another person to deal in financial products.

#### *ASC v McLeod* [2000] WASCA 101

**[26.175]** A consulting geologist prepared a report for a mining company on the results of its exploration. The report claimed that, based on samples, a particular annual profit would be made. In fact, the exploration results did not bear this out and the sample was too small to draw such a conclusion. The geologist contravened s 1041E as the likely effect of the statement would have been to induce a reader to purchase shares in the belief that the company had a basis for predicting the profitability of the venture.

#### *James Hardie Industries NV v ASIC* [2010] NSWCA 332

**[26.180]** The facts of this case are outlined at [17.145]. One aspect of a restructure of the James Hardie group of companies was the establishment of a Medical Research and Compensation Foundation (the Foundation) to pay future asbestos-related claims. The chief executive officer of the holding company, James Hardie Industries NV (JHINV), made statements at “roadshow” presentations to institutional investors that the Foundation was fully funded to meet its present and future asbestos claims and there would be no future liabilities within the James Hardie group of companies. The slides used at these presentations were later lodged with the ASX and made publicly available.

The New South Wales Court of Appeal held that by releasing the statements through the ASX, JHINV contravened s 1041E. The statements were misleading because they were important and were expressed in an emphatic way that was likely to convey to a reasonable member of the public that there was a proper and supportive basis for making the statements when this was in fact not the case. These statements were likely to affect market behaviour by inducing people to acquire

shares in JHINV and so result in the maintaining or stabilising of its share price. In relation to statements made in oral presentations to roadshow audiences, they were “select and sophisticated” people who were expected to engage in further research and analysis before acting on the statements. These audiences were therefore unlikely to be persuaded to acquire shares solely on the basis of a presentation and so were unlikely to have been misled or deceived by statements made at a roadshow presentation.

## Dishonest conduct

**[26.185]** A person carrying on a financial services business must not engage in dishonest conduct in relation to a financial product or financial service: s 1041G. “Dishonest” is determined according to the standards of ordinary people: s 9.

## Misleading or deceptive conduct

**[26.190]** There is a general prohibition on a person engaging in conduct in relation to a financial product or a financial service that is misleading or deceptive or likely to mislead or deceive: s 1041H(1). Engaging in conduct in relation to a financial product is widely defined to include dealing, issuing, publishing a notice, making or evaluating an offer under a takeover bid or any related carrying on negotiations or making arrangements: s 1041H(2). Where the misleading and deceptive conduct involves a contravention of the continuous disclosure provisions, the listed entity and its officers will not be liable under s 1041(1) unless the requisite mental elements of knowledge, recklessness or negligence have been proven. This brings s 1041 in line with recent changes to the continuous disclosure requirements which imposes civil penalty liability only in situations where fault can be proven: s 1041(4). These changes to the continuous disclosure provisions are discussed at [22.144].

Conduct is misleading or deceptive or likely to mislead or deceive if it tends to induce error: *Australian Competition and Consumer Commission v TPG Internet Pty Ltd* [2013] HCA 54. It is not necessary to prove that the defendant intended to mislead or deceive or that the plaintiff was actually misled or deceived as the relevant question is whether, viewed objectively, the conduct was misleading or deceptive or likely to mislead or deceive: *Parkdale Custom Built Furniture Pty Ltd v Puxu Pty Ltd* [1982] HCA 44. Conduct is likely to mislead or deceive if there is a real and not remote chance or possibility that a person is likely to be misled or deceived, and this is the case even though the possibility of that occurring may be less than 50 per cent: *Butcher v Lachlan Elder Realty Pty Ltd* [2004] HCA 60. The question whether someone had engaged in misleading or deceptive conduct does not depend upon whether they had a genuine and reasonable basis for making the relevant statement. It is the effect of the statement on the intended audience that is relevant and not the state of mind of the person making the statement: *Forrest v ASIC* [2012] HCA 39.

**[26.205]** The concept of misleading or deceptive conduct is given a broad meaning so that conduct may be misleading or deceptive in relation to shares even though the conduct does not refer directly to the shares concerned but relates to the company itself.

*ASIC v Narain* [2008] FCAFC 120

**[26.210]** A company released an announcement to the ASX that it had developed a product that among other things could provide a global solution to the spread of the HIV virus. The Full Court of the Federal Court held that the announcement was misleading or deceptive in relation to the company's shares even though the announcement did not refer directly to or deal with the company's shares. The majority came to this conclusion after considering the examples of conduct in relation to financial products listed in s 1041H(2). These include carrying on negotiations, or making arrangements, or doing any other act in any way related to publishing a notice in relation to a financial product. The CEO of the company had engaged in conduct that was misleading or deceptive because he had directed the company secretary to release the announcement to the ASX.

**[26.215]** In determining whether conduct is misleading or deceptive, it is relevant to ascertain the target audience to whom the statement is directed and how would such an audience have understood the statement.

*Forrest v ASIC* [2012] HCA 39

**[26.216]** ASIC alleged that Fortescue Metals Group Ltd and Forrest, its chair and CEO, engaged in misleading or deceptive conduct in relation to Fortescue shares by publishing notices to the ASX and making statements in the media regarding a particular iron ore project. Fortescue and Forrest made announcements that claimed that Fortescue had entered into binding contracts with large Chinese corporations to build, finance and transfer a mine, railway and port. ASIC claimed that the agreements were not binding and the announcements claiming that they were, constituted misleading or deceptive conduct. The majority of the High Court held that the announcements were not misleading and deceptive as the target audiences were investors who would most likely have understood the statement as something the parties had done and intended would happen in the future. They would not have asked the lawyer's question of whether the agreement would be legally enforceable.

*Re HIH Insurance Ltd* [2016] NSWSC 482

**[26.217]** HIH was an ASX-listed company that went into liquidation in 2001. Some shareholders claimed that the group financial statements of HIH including two of its subsidiaries, FAI and C&G, released just prior to the liquidation were misleading and deceptive in contravention of a predecessor of s 1041H in that they wrongly accounted for certain reinsurance arrangements resulting in an overstatement of operating profits. It was held that FAI and C&G were liable under s 79 as accessories

as they had actual knowledge of the facts that comprised a contravention of s 1041H and participated in, assisted or encouraged the contravention. The subsidiaries were parties to the reinsurance arrangements and the misleading information was included in their financial statements. The knowledge of the essential matters that constituted the contravention was attributed to the subsidiaries from the knowledge of their directors, one of whom was highly experienced and authorised the publication of the subsidiaries' accounts and knew they would be reflected in the consolidated accounts of HIH.

Even though there was no direct reliance on the misleading accounts released to the market, the market was deceived by the creation of the mistaken belief that HIH was trading more profitably than was in fact the case. As a result, HIH shares traded at a higher price that reflected the misleading results released to the market and investors purchased their shares at an inflated price and thereby suffered loss. In this way, "market-based causation" established that the contravention of s 1041H materially contributed to the plaintiff shareholders' loss. The measure of damages was the difference between the price paid for the shares and the price that would have been paid had the contravening conduct not occurred.

**[26.218]** Where a provision in Pt 7.10, including s 1041H, has been contravened, the court has a broad power under s 1325 to make a wide range of further orders including setting aside a contract or refusing to enforce any of its provisions. The court may make such an order, which is similar to rescission, where a person entered into a contract in reliance on another party's misrepresentation and it is just and fair to set aside the contract in order to prevent the party who made the misrepresentation obtaining the benefit of the contract at the expense of the innocent party.

**[26.220]** Actions for misleading or deceptive conduct and false or misleading representations in relation to financial services may also be brought under ss 12DA and 12DB of the *ASIC Act*.

In *ASIC v Australia and New Zealand Banking Group Ltd* [2022] FCA 1251, ANZ offered its customers a package loan whereby customers paid an annual fee and received fee waivers and various interest rate discounts on various loans and products. ANZ failed to provide some of these benefits and ASIC brought an action arguing that ANZ contravened s 12DA by making a representation that constituted misleading or deceptive conduct and s 12DB(1)(e) by making a false or misleading representation concerning the benefits of services. In offering the benefits under the package loan, ANZ had made implied representations that it had adequate systems and processes in place to administer the benefits. In fact, it did not have such systems and processes in place, nor reasonable grounds for saying it did. The court ordered ANZ to pay a penalty of \$25 million and publish an adverse publicity notice.

The breaches of the *ASIC Act* had the effect that ANZ breached its obligations as an Australian financial services licence holder to ensure financial services are provided efficiently, honestly and fairly under s 912A(1)(a) and to comply with financial services law under s 912A(1)(c). The obligations of AFS licensees are discussed at [26.75].

## Unsolicited off-market offers

**[26.225]** Unsolicited offers to purchase shares and other financial products off-market are regulated by Div 5A, Pt 7.9 of the *Corporations Act*: ss 1019C–1019K. Sellers who have accepted unsolicited offers to purchase their shares off-market have the right to refuse to transfer their shares to the buyer if the offer documentation either did not comply with the Div 5A requirements or contained a misleading or deceptive statement: s 1019K. The ss 1019C–1019K requirements are discussed at [9.220].

## Liability for contravention

**[26.230]** A person who contravenes ss 1041E (false or misleading statements), 1041F (inducing a person to deal), 1041G (dishonest conduct) or 1041H (misleading or deceptive conduct) commits an offence. In addition, a person who suffers loss or damage by conduct of another person that was engaged in the contravention of these sections may recover the amount of loss or damage by action against any person who was involved in the contravention whether or not there has been a conviction in respect of the contravention: s 1041I(1). The phrase “by conduct of” indicates that the loss or damage had to have been caused by the contravening conduct.

These provisions are not civil penalty provisions and hence civil pecuniary penalties cannot be imposed where they have been contravened. Where proceedings are brought under s 1041I, the court may relieve a publisher wholly or partly from liability if it appears to the court that the publisher received an advertisement in the ordinary course of its business and did not know and had no reason to believe that publication would amount to an offence: s 1044A(2).

## Insider trading

**[26.235]** Insider trading is prohibited under Div 3 of Pt 7.10 of the *Corporations Act*. Insider trading occurs where a person trades in shares or other financial products while in possession of price-sensitive information that is not generally available.

The insider trading provisions cover shares as well as a wider range of financial products, including derivatives, superannuation products and other financial products able to be traded on a financial market. These are referred to in the legislation as “Division 3 financial products”. The person with whom the “insider” dealt is also entitled to recover compensation, and contraventions of the insider trading prohibitions can constitute a crime or attract the civil penalty provisions.

The continuous disclosure provisions of Ch 6CA (ss 674–678) of the *Corporations Act* complement the insider trading provisions. The continuous disclosure provisions require disclosing entities, such as listed companies, to disclose price-sensitive information that is not generally available: ss 674 and 675. Timely disclosure of such information reduces the opportunities for insider trading. The continuous disclosure requirements are discussed at [22.135]–[22.144].

## Why prohibit insider trading?

**[26.240]** The Griffiths Committee report, *Fair Shares for All: Insider Trading in Australia* (1989), sets out various theories that have been put forward as a basis for prohibiting insider trading:

- fairness: market participants should have equal access to the relevant information from the company which issues the securities as this enhances investor confidence;
- fiduciary duty: a person who holds a position of trust should not make a personal profit from that position without the informed consent of the beneficiaries;
- economic efficiency: insider trading is damaging to the integrity of the financial market; and
- corporate injury: insider trading injures the company which issued the securities, the shareholders in the company and investors who deal with insiders.

The Griffiths Report recommended that insider trading should remain a criminal offence and rejected theories that suggest insider trading should be decriminalised as it serves a useful purpose because it enhances the efficiency of the securities market through the faster dissemination of information.

## The insider trading prohibitions

**[26.245]** Section 1043A(1) contains the primary prohibitions against insider trading. Under s 1043A(1)(c), an insider must not apply for, acquire or dispose of, or enter into an agreement to apply for, acquire or dispose of relevant “Division 3 financial products”. Section 1042A defines “Division 3 financial products” to include securities, derivatives, managed investment products, superannuation products and any other financial products which can be traded on a financial market. In *Joffe v The Queen* [2012] NSWCCA 277, it was held that contracts for difference, a form of derivative, were a Div 3 financial product because they were a “financial product” under the definition contained in s 761A and were therefore subject to the insider trading prohibitions.

Section 1043A(1)(d) also specifies that an insider must not procure another person to apply for, acquire or dispose of, or to enter into an agreement to apply for, acquire or dispose of, any securities or other Div 3 financial products. An insider is taken to “procure” the act or omission of another person if the insider incites, induces or encourages an act or omission by another person: s 1042F. These prohibitions apply whether the insider trades as principal or agent.

Section 1043A(2) prohibits an insider communicating or tipping inside information to another person. This prohibition applies only to financial products which can be traded on a financial market operated in Australia.

An 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:



- apply for, acquire or dispose of, or enter into an agreement to apply for, acquire or dispose of, any such tradable financial products; or
- procure a third person to apply for, acquire or dispose of, or enter into an agreement to apply for, acquire or dispose of, any such tradable financial securities.

To establish a breach of s 1043A(2), it is not necessary to prove that there was an association or arrangement between the insider and the tippee (the person receiving the tip) with a view to dealing in the particular financial product. It is only necessary to show a communication of inside information to the tippee.

## *Who is an insider?*

**[26.250]** A person is an “insider” for the purposes of the s 1043A prohibitions if:

- the person possesses “inside information” (defined in s 1042A); and
- the insider knows or ought reasonably to know that the matters specified in the s 1042A definition of “inside information” are satisfied in relation to the information.

The concept of inside information is further discussed at [26.265]–[26.300].

It is important to note that despite the use of the word “insider”, the s 1043A prohibitions do not focus on whether the person has a connection with a company. The insider trading prohibitions can apply to someone who may not have a business or employment relationship with the company whose securities are traded.

The insider trading prohibitions focus on the *possession* of inside information.

The prohibitions focus on the possession of inside information. For example, a person who overhears a conversation in a lift or on the street is regarded as an insider if that person knows, or ought to know, that the overheard conversation is inside information. Because of this broad definition of “insider”, the expression “insider trading” is not a strictly correct description because the legislation extends beyond those persons who have a connection with the company concerned. It is more accurate to describe the insider trading provisions as dealing with the “misuse of non-public information”.

*R v Rivkin* [2003] NSWSC 447

**[26.255]** McGowan was the CEO and major shareholder of Impulse Airlines. During 2000 and 2001, Impulse Airlines was involved in a price war with Qantas, which had an adverse impact on both companies. Impulse Airlines suffered disastrous losses as a result. In addition, both Qantas’ share price and profitability were significantly affected. At the end of April 2001, McGowan concluded confidential negotiations to sell his Impulse Airlines shares to Qantas conditional on obtaining ACCC approval. A few days before the public announcement of the sale to Qantas, McGowan expressed interest in buying Rivkin’s house. McGowan told Rivkin about



the confidential Impulse Airlines and Qantas agreement because he wanted to make the house purchase conditional on the ACCC's approval. McGowan also advised Rivkin that he should not trade in Qantas shares. Within hours of Rivkin agreeing to the conditional sale of his house, Rivkin arranged for his family company to acquire a small parcel of shares in Qantas. Rivkin sold the shares for a small profit several days after the public announcement of the Impulse Airlines and Qantas transaction.

Rivkin was convicted of breaching the predecessor of s 1043A(1) and sentenced to nine months' periodic detention and fined. It was held that Rivkin was an insider in relation to Qantas and arranged for his company to acquire Qantas shares. The court was satisfied beyond reasonable doubt that Rivkin was an insider because he possessed information that was not generally available. This information was the confidential sale of Impulse Airlines' business to Qantas as well as McGowan's assertion that the ACCC approval would be forthcoming. The court was also satisfied that had the information been generally available, it might have a material effect on the price of Qantas' shares.

**[26.260]** An insider can be an officer or employee of a company. A company may also be an insider. For example, under s 1042G, a body corporate is taken to possess and know information which an officer possesses and which came into the officer's possession in the course of performance of their duties as an officer.

### *What is inside information?*

**[26.265]** "Inside information" is defined in s 1042A as meaning information that:

- is not generally available; and
- if it were generally available, a reasonable person would expect it to have a material effect on the price or value of particular Div 3 financial products.

"Information" includes matters of supposition and other matters that are insufficiently definite to warrant being made known to the public and matters that relate to the intentions or likely intentions of a person: s 1042A. This extended definition of information is not confined to specific information and includes factual knowledge acquired by means of hints and veiled suggestions from which the recipient may infer other knowledge: *ASIC v Citicorp Global Markets Australia Pty Ltd (No 4)* [2007] FCA 963.

"Information" may be false or partly false: *Mansfield v The Queen* [2012] HCA 49. In this case, the majority of the High Court said:

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".

## Information not generally available

**[26.270]** To establish a contravention of the prohibitions in s 1043A, it is necessary for the prosecution to prove that a person possessed information that is not generally available. Section 1042C explains when information is generally available.

Readily observable matter.

Under s 1042C(1)(a), information is generally available if it consists of readily observable matter.

*R v Firms* [2001] NSWCCA 191

**[26.275]** The defendant's father was a director of a listed public company engaged in gold exploration in Papua New Guinea (PNG). A subsidiary of the company successfully challenged the validity of a government regulation in a PNG court which had restricted its exploration rights. As a result of the court's decision, it could be expected that the company's share price would increase. The defendant purchased parcels of shares in the names of his wife and a friend after hearing of the outcome of the case. The ASX was notified of the PNG court's decision three days later. The question arose whether the PNG court judgment was generally available before the ASX was notified. It was held that the judgment was readily observable and therefore generally available because it was available, understandable and accessible to a significant number of the public. Information may be readily observable even if no-one observed it.

**[26.280]** Under s 1042C(1)(b), information that previously was not generally available becomes generally available if:

- 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 Div 3 financial products of a kind whose price might be affected by the information; and
- since it was so made known, a reasonable period for it to be disseminated among such persons has elapsed.

Information referred to in s 1042C(1)(b) includes financial information in a company's annual report, corporate information contained in media releases and continuous disclosure announcements to the ASX.

"Trading windows, trading black outs".

Many listed companies have share-trading policies specifying when directors and other officers are permitted to buy or sell their company's shares. These are called "trading windows". Usually, officers are permitted to trade during a short period after the company has released its annual report. In most instances, trading during this period will not contravene the insider trading provisions because after an annual report is made

public, price-sensitive information about the company's shares would become generally available.

Instead of “trading windows”, some listed companies have policies that prohibit their officers or employees trading its shares during specified periods of time immediately prior to the publication of their annual reports. These are called “black outs”. The ASX corporate governance listing rule, Listing Rule 4.10, requires the annual report of a listed company to disclose the company's policy on the trading of its securities by directors and employees including the use of trading windows and black outs.

Information does not become generally available for purposes of s 1042C(1)(b)(i) if it is merely released to a small sector of investors who commonly invest in the particular financial product. The information must be made known to a cross-section of the investors who commonly invest in the financial product. Further, s 1042C(1)(b)(ii) ensures that there is an embargo on trading by insiders who are aware of information prior to its release. They can trade only after a reasonable period for the dissemination of the information has elapsed.

Information is also generally available if it consists of deductions, conclusions or inferences made or drawn from either or both of the types of information referred to in s 1042C(1)(a) and (b)(i). This means that a financial analyst's deductions or conclusions about a company's financial position drawn from the company's published financial statements would not be regarded as inside information.

### *Material effect on price*

**[26.285]** Inside information must be such that if it were generally available, a reasonable person would expect it to have a material effect on the price or value of particular financial products. Information has a “material effect” only if the information would, or is likely to, influence persons who commonly acquire financial products in deciding whether to acquire or dispose of those financial products: s 1042D.

In *Hannes v DPP (No 2)* [2006] NSWCCA 373, the facts of which are set out at [26.295], it was held that:

materiality is concerned with investor conduct and, more particularly, with the question as to whether the particularised information would or would be likely to influence persons who commonly invest in securities in deciding whether or not to subscribe for, buy or sell specified securities. ... This might generally be said to be concerned with the capacity of information to influence investor behaviour which, in turn, has a material effect on price or value of securities. Accordingly, materiality is concerned with information which might be said to be price sensitive.

### *Possession of information*

**[26.290]** A person in possession of inside information is an insider only if that person knows, or ought reasonably to know, that the information is inside information. The legislation provides an inclusive definition of the word “information”. It includes matters of supposition and other matters that are insufficiently definite to warrant being made

known to the public, as well as matters relating to the intentions, or likely intentions, of a person: s 1042A.

*Hannes v DPP (No 2)* [2006] NSWCCA 373

**[26.295]** Hannes was convicted of insider trading under the predecessor of the current insider trading provisions. He was a director of a Macquarie Bank subsidiary, Macquarie Corporate Finance Ltd (MCF), which was advising TNT Limited on a friendly takeover by a Dutch company. A few weeks before the takeover was publicly announced, Hannes, using a false identity, instructed a stockbroker to acquire \$90,000 worth of TNT call options on the securities market. When the takeover became public the options increased significantly in value and Hannes stood to make over \$2 million profit.

The Court of Criminal Appeal held that Hannes possessed “information” for the purposes of the previous insider trading laws. Even though Hannes was not part of the MCF team advising TNT and was not told about the team’s activities in relation to TNT, he drew an inference, based on the conduct of the MCF team members, that the TNT takeover was being planned.

**[26.300]** A body corporate is deemed to possess any information that an officer of the body corporate possesses if the information came into the officer’s possession in the course of the performance of their duties as an officer: s 1042G(1)(a). For the purposes of this section, a person is an “officer” of a body corporate only if that person comes within the s 9 definition of “officer”. In *ASIC v Citicorp Global Markets Australia Pty Ltd (No 4)* [2007] FCA 963, a Citicorp trader who was authorised to transact large share trades for his company was held not to be an officer because he was not involved in policy making and decisions that affected the whole or a substantial part of the business of his employer corporation.

This section also limits the liability of an employer corporation where a person is an officer of the corporation within the meaning of s 9 but acquires inside information while acting outside the course of the performance of duties as an officer. For example, if an officer acquires inside information on the golf course, knowing it to be inside information, and uses it to trade in financial products on the body corporate’s behalf, the officer may contravene the prohibition against procuring trading in s 1043A(1)(d) and the prohibition against tipping in s 1043A(2). However, because of the operation of s 1042G(1)(a), the body corporate, which derived the financial benefit of the inside information and on whose behalf the officer traded, does not contravene the insider trading prohibitions.

As discussed at [26.250], to be categorised as an insider, s 1043A(1)(b) requires that the person knows or ought reasonably to know the information is inside information. If an officer of a body corporate knows any matter or thing because they are an officer of the body corporate, it is presumed that the body corporate knows that matter or thing: s 1042G(1)(b).

If an officer of a body corporate, in that capacity, is reckless as to a circumstance or result, it is presumed that the body corporate is reckless to that circumstance or result: s 1042G(1)(c).

The effect of s 1042G is that if an officer of a body corporate possesses inside information knowing it to be inside information, then both the officer and the body corporate are regarded as insiders and both are subject to the prohibitions in s 1043A. Section 1042H applies to partnerships and is similar in effect to s 1042G.

## Exceptions to the insider trading prohibitions

**[26.305]** There are numerous exceptions to the insider trading provisions set out in ss 1043B–1043J. Some of these exceptions alleviate unintended consequences of a strict application of the insider trading provisions, such as the Chinese walls exception in s 1043F, and others facilitate acceptable commercial activity, such as the underwriters and financial services licensees exceptions in ss 1043C and 1043K.

### *Chinese walls*

**[26.310]** Under ss 1043A(1) and 1042G(1), if an officer of a body corporate possesses inside information, knowing it to be inside information, neither the officer nor the body corporate is permitted to trade in the financial products that are the subject of the inside information. Section 1043F provides an exception for bodies corporate and in certain circumstances permits them to trade in financial products notwithstanding that one or more officers possesses inside information about the financial products.

A body corporate, whose officers possess inside information, may trade in financial products if it has a “Chinese wall” in place. A Chinese wall is an administrative arrangement used by large financial institutions that quarantines information within one part of the institution and prevents information possessed by persons in one part of the organisation from being passed on to persons in other parts of the organisation. In *ASIC v Citicorp Global Markets Australia Pty Ltd (No 4)* [2007] FCA 963, it was held that in order for a Chinese wall to be considered effective in managing conflicts of interest, it must be consented to by the client. The following criteria are also relevant:

- the physical separation of departments to insulate them from each other;
- an educational program, normally recurring, to emphasise the importance of not improperly or inadvertently divulging confidential information;
- strict and carefully defined procedures for dealing with situations where it is thought the wall should be crossed, and the maintaining of proper records where this occurs;
- monitoring by compliance officers of the effectiveness of the Chinese wall; and
- disciplinary sanctions where there has been a breach of the wall.

The court noted that Chinese walls were often porous and adequate arrangements required not just a raft of written policies and procedures but a thorough understanding of the procedures by all employees and a willingness and ability to apply them to various possible conflicts.

The establishment of an effective Chinese wall enables a financial services licensee to comply with the requirement in s 912A(1)(aa) to have in place adequate arrangements for the management of conflicts of interest that may arise in relation to the provision of financial services as part of the financial services business of the licensee. The duties of financial services licensees are discussed at [26.75].

Section 1043G provides a similar “Chinese wall” exception for members of a partnership.

## *Underwriters*

**[26.315]** Underwriters and sub underwriters are usually financial institutions who, for an underwriting fee, agree to acquire securities and other financial products issued by a body corporate that are not taken up by others. Further, underwriters and sub underwriters are often active in marketing the financial products. By entering into an underwriting agreement, the body corporate ensures the success of its issue. Usually, an underwriter will insist on obtaining information about the issuing body corporate and the proposed issue before it agrees to enter into an underwriting agreement.

If underwriters were subject to the insider trading provisions, it would severely curtail the practice. For this reason, s 1043C(1) provides a blanket exemption from the primary prohibition for underwriters and sub underwriters in respect of applying for or acquiring securities or managed investment products under an underwriting or sub underwriting agreement, as well as in respect of disposing of the securities or managed investment products. Further, s 1043C(2)(a) exempts persons from the tipping prohibition in s 1043A(2) where they communicate inside information about the securities or managed investment products solely for the purpose of procuring a person to enter into an underwriting or sub underwriting agreement. Underwriters are also exempt from the tipping prohibition where they communicate inside information solely for the purpose of procuring a person to either enter into a sub underwriting agreement or to apply for the securities or managed investment products: s 1043C(2)(b).

## *Holders of financial services licences*

**[26.320]** Section 1043K permits holders of financial services licences, such as stockbrokers and their representatives, to enter into transactions as agents of clients notwithstanding that the licensee or any representative possesses inside information. In order to qualify for the exemption:

- the licensee or representative (“the agent”) must enter into the trading transaction under the specific instructions of a client (“the principal”); and
- the licensee must have a Chinese wall in operation which could reasonably be expected to ensure that, at the time of the transaction, inside information in the possession of the licensee or of any representative was not communicated to the agent and that no advice with respect to the transaction was given to the principal or the agent by a person in possession of the information; and
- the information was not so communicated, and no such advice was so given; and
- the principal is not an associate of the licensee or any representative.

## Consequences of breaching prohibitions

**[26.325]** A breach of the insider trading prohibitions is a criminal offence and the court may make a compensation order. The insider trading prohibitions are also designated financial services civil penalty provisions. These provisions are discussed at [26.345].

### *Criminal penalties*

**[26.330]** An individual who breaches the primary prohibitions in s 1043A(1) or the tipping prohibition in s 1043A(2) is guilty of a criminal offence punishable by a maximum imprisonment of 15 years and a pecuniary penalty of the greater of 4,500 penalty units or three times the value of the benefit gained or detriment avoided as a result of the insider trading.

The maximum penalty for a body corporate guilty of breaching the insider trading prohibitions is the greater of 45,000 penalty units or three times the value of the benefit derived from (or detriment avoided) by the contravention or 10 per cent of the body corporate's annual turnover: s 1311C.

#### *Director of Public Prosecutions (Cth) v Hill [2015] VSC 86*

**[26.332]** In 2014, Lukas Kamay and Christopher Hill, who had met while students, pleaded guilty to insider trading and other related charges. Kamay was employed as an Associate Director at the National Australia Bank, on its wholesale foreign exchange sales desk. Hill was employed as an analyst at the Australian Bureau of Statistics (ABS) and had access to ABS data relating to the Main Economic Indicators (MEI data), which was kept in strict confidence until its public release. Hill obtained and provided the MEI data to Kamay prior to its public release and Kamay used that information to either buy or sell margin foreign exchange contracts. Hill, whose wrongdoing contributed to a profit of \$195,000, was sentenced to three years and three months' imprisonment.

Unknown to Hill, Kamay engaged in further insider trading which resulted in a profit of more than \$8 million, the largest insider trading profit to come before an Australian court. Kamay was sentenced to seven years and three months' imprisonment, the longest sentence for insider trading imposed in Australia.

### *Defences against criminal prosecution*

**[26.335]** There are two defences available to a person prosecuted for an offence against s 1043A(1) or (2).

The s 1043M(2)(a) defence protects a diligent investor who relies on information that is "generally available" as defined in s 1042C(1)(b)(i). There is no liability if the information came into the possession of the accused solely as a result of the information having been made known in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest in financial products of a kind whose price



or value might be affected by the information. There is a corresponding defence in a prosecution for a breach of the tipping prohibition under s 1043A(2): s 1043M(3).

## *Compensation liability*

**[26.340]** Section 1043L sets out the situations when the court may make a compensation order under s 1317HA against an insider who contravenes the s 1043A prohibitions.

Under s 1043L(2), an insider who applied for or procured another person to apply for financial products is liable to pay compensation to the issuer of the products for any damage suffered by it.

|                                 |
|---------------------------------|
| The amount of the compensation. |
|---------------------------------|

The amount of the compensation is the difference between the price of the financial product and the price at which they would have been likely to have been disposed of had the information been generally available.

ASIC may, if it considers that it is in the public interest to do so, bring an action in the name of, and for the benefit of, the issuer of the financial product for the recovery of that compensation: s 1043L(6).

Where an insider acquired financial products from another person (the disposer) who did not possess the inside information, the disposer may recover compensation from the insider: s 1043L(3). The amount of the compensation is the difference between the price at which the financial products were acquired by the insider from the disposer and the likely price for which they would have been acquired if the information had been generally available.

In the case of a contravention of s 1043A that involves a disposal of financial products by an insider, s 1043L(4) enables the acquirer who did not possess the information to recover compensation from the insider. The amount of the compensation is the difference between the price at which the financial products were disposed of and the likely price for which they would have been disposed of had the information been generally available.

Potentially, an insider may be liable for double the financial benefit gained by the contravention. This is because the insider is liable to not only either the acquirer or disposer of the financial products under s 1043L(3) or (4), but also under s 1043L(5) for the same amount to the issuer of the financial products traded by the insider. ASIC may, if it considers that it is in the public interest to do so, bring an action in the name of, and for the benefit of, the body corporate for the recovery of that loss: s 1043L(6).

Section 1043O gives the court additional powers to deal with insider trading. The s 1043O powers, which are similar to those available in cases of unacceptable conduct in takeovers, enable the court to make a variety of orders to ensure that insiders are denied any benefits from a contravention. The orders include:

- restraining the exercise of voting or other rights attached to financial products;
- restraining the acquisition or disposal or directing the disposal of financial products;
- vesting the financial products in ASIC; and
- cancelling an AFS licence.



## Financial services civil penalty provisions

[26.345] Numerous provisions of the *Corporations Act* are designated as financial services civil penalty provisions by s 1317E. These include the insider trading provisions.

The extension of the civil penalty provisions contained in Pt 9.4B to financial services contraventions aims to overcome the difficulty ASIC once had in successfully prosecuting offences arising from breaches of the financial services provisions. The criminal burden of proof – beyond reasonable doubt – applies to such prosecutions and it is difficult to prove elements of the offences to that standard as many elements refer to the defendant's state of mind. Prior to the introduction of the civil penalty regime there were very few successful cases involving breaches of the market misconduct provisions, despite considerable anecdotal evidence that such prohibited practices, especially insider trading, may often take place. The operation of the civil penalty provisions enables actions to be brought where the provisions are contravened and the requisite burden of proof is on the balance of probabilities.

Where the court is satisfied that a financial services civil penalty provision has been contravened, it must make a declaration of contravention. If the contravention is serious or materially prejudices acquirers or disposers of the relevant financial product, the court may impose the maximum financial services civil penalty:

- in the case of an individual, the greater of 5,000 penalty units or three times the benefit derived from (or detriment avoided by) the contravention;
- in the case of a body corporate the greater of:
  - 50,000 penalty units;
  - three times the benefit derived from (or detriment avoided by) the contravention; or
  - 10 per cent of the annual turnover of the body corporate, up to a maximum of 2.5 million penalty units.

The civil penalty provisions in the context of breach of directors' duties are discussed at [19.120]–[19.150].

## Tutorial questions

1. Nancy works in the mergers and acquisitions section of a large firm of chartered accountants. Benson Ltd, one of the firm's clients, was contemplating a takeover of Cook Manufacturing Ltd. While Nancy was working on the feasibility of such a takeover, she concluded that Benson ought to proceed with the takeover and offer Cook Manufacturing Ltd's shareholders \$8 per share. The shares were trading at \$3.50 on the ASX. The directors of Benson Ltd agreed with Nancy's conclusions and decided to proceed with the takeover.
  - (a) Advise Nancy if and when she can buy shares in Cook Manufacturing Ltd.
  - (b) What are the legal consequences if Nancy tells her boyfriend, Peter, of Benson's takeover plans and he buys Cook Manufacturing shares before the news of the takeover becomes public?

2. At a recent board meeting of Welstar Ltd, Victor, one of the company's directors, became aware that Welstar was about to buy a large parcel of shares in Flexizin Ltd, a listed company. After buying the Flexizin shares, Welstar intended to make a takeover bid for the rest of Flexizin's shares. Victor thought that when Welstar Ltd's initial purchase became public knowledge it would act as a signal of Welstar's takeover intentions and that Flexizin's share price would increase significantly. He therefore arranged for his wife's company, Spousal Investments Pty Ltd, to buy shares in Flexizin Ltd ahead of Welstar's purchase. Spousal Investments Pty Ltd later sold the Flexizin Ltd shares after Welstar's takeover bid was publicly announced and made a large profit.

Advise ASIC whether there has been a breach of the *Corporations Act* in the above circumstances.

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.
- For further corporations law links and material, please refer to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## Chapter 27

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# Managed investments and CCIVs

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### Key points

- A managed investment scheme (MIS) is a scheme that involves people contributing funds to acquire an interest in a common enterprise. The pooled funds are invested to produce financial benefits for scheme members. A feature of MISs is that members do not have day-to-day control over the operation of the scheme.
- As a general rule, MISs that have more than 20 members must be registered by ASIC.
- Registered MISs must have a responsible entity (RE) that operates the scheme and performs the functions conferred on it by the scheme's constitution and the *Corporations Act*. A responsible entity of a scheme must be a public company that holds an Australian financial services licence authorising it to operate an MIS.
- All registered MISs must have a constitution whose provisions bind the scheme members and the responsible entity. A registered scheme must also have a compliance plan that explains how the responsible entity will ensure compliance with the scheme's constitution and the *Corporations Act*.

- If fewer than half the directors of the responsible entity are external directors, the responsible entity must establish an independent compliance committee to monitor the operation of the scheme and the adequacy of the compliance plan.
- A corporate collective investment vehicle (CCIV) is a new type of company limited by shares used for fund management. A CCIV comprises one or more sub-funds operated by a single corporate director.

## Introduction

**[27.05]** This chapter discusses managed investment schemes (MISs) and corporate collective investment vehicles (CCIVs). An MIS is a scheme that involves members contributing money or money's worth that are either pooled or used in a common enterprise. An MIS is operated by a responsible entity (RE) and members usually do not have day-to-day control over the scheme's operation. MISs are regulated by Ch 5C (ss 601EA–601QB) of the *Corporations Act*. Subject to some exceptions, an MIS must be registered by ASIC. The RE of a registered MIS must hold an Australian financial services licence (AFSL). Financial services licences are discussed at [26.75].

Interests in registered MISs are included in the definition of “financial products”. Part 7.9 of the *Corporations Act* sets out the financial product disclosure requirements relating to the issue and sale of financial products including interests in registered MISs. This is discussed at [26.80]–[26.110]. The Pt 7.9 requirements are similar to the Ch 6D fundraising disclosure requirements, discussed in Chapter 7.

Occasionally, complex legal issues arise when an MIS or its RE suffers financial difficulties. The CAMAC report, *Managed Investment Schemes* (2012), canvassed a number of reform options to address this issue. This report may be viewed on the CAMAC website which is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>. After the release of the *Managed Investment Schemes* report, CAMAC published a discussion paper *The Establishment and Operation of Managed Investment Schemes* (2014) which is also linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

In March 2023, the government announced that it would ask Treasury to review the regulatory framework governing MISs.

A CCIV is a new type of company limited by shares designed to attract Australian and overseas investors. A CCIV must consist of one or more sub-funds operated by a single corporate director. Investors can buy shares in any of the sub-funds. The *Corporate Collective Investment Vehicle Framework and Other Measures Act 2022* (Cth) added a new Chapter 8B to the *Corporations Act* which established the regulatory corporate framework for CCIVs. The framework is discussed at [27.70] onwards. The tax framework is outside the scope of this book.

## What is a managed investment scheme?

**[27.10]** Section 9 defines the term “managed investment scheme” as a scheme with the following features:

- People contribute money or money's worth as consideration to acquire rights (interests) to benefits produced by the scheme.
- Any of the contributions are to be pooled, or used in a common enterprise, to produce financial benefits, or benefits consisting of rights or interests in property, for the people (the members) who hold interests in the scheme.
- Members do not have day-to-day control over the operation of the scheme.

CAMAC noted in its 2012 report, *Managed Investment Schemes*, that “schemes are a means of pooling, or using in a common enterprise, wholesale or retail investors’ funds or other property for commercial projects” such as:

- listed real property and infrastructure schemes
- unlisted property trusts and syndicates and mortgage funds
- cash, bonds, equity and multi-sector managed funds
- timeshare, horse breeding or racing, serviced strata and film schemes
- agribusinesses, including forestry.

A key feature of the s 9 definition of a “managed investment scheme” is that scheme members do not have day-to-day control over the operation of the scheme. An MIS’s operations are controlled by an RE which is discussed at [27.20].

According to CAMAC, while most schemes are either pooled schemes or common enterprise schemes, some schemes combine features of both types. In a pooled scheme, members’ contributions are pooled usually in a unit trust-based investment arrangement, with the RE acting as the trustee. Schemes that hold real estate or infrastructure assets for investment purposes are examples of trust-based pooled schemes. The units in some of these trusts are listed on the ASX with the units traded in similar ways as shares in listed companies. Members’ units in a trust-based pooled scheme are sometimes stapled to shares in a management company. This means that the units and shares cannot be separately traded. Stapled securities are discussed at [8.30].

A common enterprise scheme typically involves members entering into a series of contractual agreements with the RE and/or other parties that deal with the ongoing operation of the scheme. Such schemes do not involve a pool of assets under management. Instead, they involve a common enterprise carried out in accordance with the contractual agreements. Agribusiness schemes are often structured as common enterprise schemes. Scheme members may, for example, own agricultural assets, such as trees in a forest plantation or ostriches on an ostrich farm and enter into contracts with the RE or other external parties to cultivate and manage the agribusiness.

A wide range of specific types of investments, such as a franchise, a regulated superannuation fund and a retirement village scheme, are excluded from the definition of an MIS. Investment in shares or debentures in a body corporate are also excluded. Similarly excluded are partnerships with more than 20 members.

Interests in registered MISs are referred to in s 761A as “managed investment products” and come within the s 764A definition of financial products. This means that the financial product disclosure requirements of Pt 7.9 of the *Corporations Act* apply to the issue and sale of such interests. These requirements are discussed at [26.110].

## Registration

**[27.15]** As a general rule, the regulatory framework of Ch 5C of the *Corporations Act* applies only to MISs that are required to be registered with ASIC. Section 601ED sets out when an MIS must be registered.



|                                           |
|-------------------------------------------|
| When must an MIS be registered with ASIC? |
|-------------------------------------------|

Section 601ED(1) requires an MIS to be registered if it (by itself or together with other closely related schemes as determined by ASIC) involves more than 20 members or the MIS has been promoted by a person who is in the business of promoting such schemes or an associate of that person.

Under s 601ED(2), an MIS does not have to be registered if all the issues of interests in the scheme that have been made would not have required the giving of a product disclosure statement (PDS) under Div 2 of Pt 7.9 had the scheme been registered when the issues were made. The requirement for PDSs is discussed at [26.80]–[26.110]. This means, for example, that MISs whose interests were offered to no more than 20 persons over a 12-month period and did not raise \$2 million or more do not have to be registered.

ASIC is responsible for registration of MISs. A person who seeks to register an MIS must lodge an application with ASIC: s 601EA. The application must be accompanied by a copy of the scheme's constitution, the scheme's compliance plan and a statement signed by the RE's directors certifying that those documents comply with relevant provisions. The application must also give details identifying the proposed RE and the auditor of the scheme's compliance plan.

Section 601ED(5) makes it an offence for a person to operate an MIS that must be registered unless the scheme is registered. If s 601ED(5) is contravened, the court has a discretion to wind up the scheme on the application of ASIC, the scheme operator or a member of the scheme: s 601EE.

*ASIC v Chase Capital Management Pty Ltd (2001) 19 ACLC 476*

**[27.17]** An investment club was operated in contravention of s 601ED(5) in that the scheme had not been registered. It was held that the exercise of the court's discretion to wind up the scheme involved similar considerations as a winding-up of a company on the just and equitable ground under s 461(1)(k), discussed at [24.360]–[24.435]. The court considered that it was in the public interest to wind up the scheme as there had been regular breaches of investor protection provisions – in particular, the offering of securities without a prospectus.

## The responsible entity

**[27.20]** One of the main features of the managed investment regulatory framework is the requirement that a registered scheme has an RE to perform the functions conferred on it by the scheme's constitution and the *Corporations Act*: s 601FB(1). The RE is liable to scheme members for all aspects of the scheme's operation.

Unlike a company, an MIS is not currently regarded as a separate legal entity. In a pooled scheme, the RE, as principal, is personally liable to other contracting parties for debts and obligations incurred in operating the MIS. In such schemes, the RE also holds the legal title to scheme property in trust for scheme members. The position of the RE

of a common enterprise scheme is more complex. In some of these schemes, the RE may transact with external parties as principal and is therefore personally liable for debts and obligations incurred in that capacity. However, in practice, a common enterprise scheme often involves the members entering into agreements with external parties as principals using the RE as their agent. In such situations, members bear personal liability to the other contracting party. CAMAC, in its 2012 report, *Managed Investment Schemes*, observed that these complexities create legal problems when either a common enterprise scheme or its RE is in financial distress arising from the intermingling of the affairs and property of the scheme itself and of its members.

CAMAC also noted that further complexities arise for common enterprise schemes because the *Corporations Act* permits a company to be the RE of more than one MIS. CAMAC referred to such REs as multi-function REs. By way of contrast, a single function RE operates only one MIS. Currently if a multi-function RE becomes insolvent, there may be difficulties in disentangling its own personal assets and liabilities from those as operator of a number of schemes.

CAMAC made a number of recommendations to overcome these various legal difficulties and complexities. It suggested changing the law to make an MIS a separate legal entity distinct from its RE and scheme members. The MIS would then hold the legal title to all scheme property and would be principal in all agreements entered into by the RE as operator of the scheme. Like a company, an MIS would be capable of suing or being sued in its own name. CAMAC also recommended that the creation of new common enterprise schemes should be prohibited and that new schemes should only be operated by single function REs. These recommendations have not been adopted.

## Licensing

**[27.25]** The RE of a scheme must be a public company that holds an AFSL (see [26.75]) authorising it to operate an MIS: s 601FA. ASIC administers the licensing of REs. An applicant for licensing will have to, among other things, satisfy ASIC that it is of good fame and character, has expertise to perform the duties associated with being an RE and has available adequate resources (including financial, technological and human resources) to run the scheme competently: ss 912A(1) and 913B(3).

## Statutory duties

**[27.30]** The RE of an MIS is subject to a wide range of statutory duties under s 601FC. The duties include the duty:

- to act honestly (s 601FC(1)(a));
- to exercise the degree of care and diligence that a reasonable person would exercise if they were in the RE's position (s 601FC(1)(b));
- to act in the best interests of members and, if there is a conflict between the members' interests and its own interests, give priority to the members' interests (s 601FC(1)(c));
- to treat members of the same class equally and all members fairly (s 601FC(1)(d)); and
- not to make improper use of scheme information (s 601FC(1)(e)).

Section 601FD imposes a similar range of duties on the officers of an RE. These include duties to act honestly, exercise the degree of care and diligence that a reasonable person would exercise if they were in the officer's position, act in the best interests of members and prioritise members' interest if there is a conflict between members' interests and the interests of the RE, not make improper use of information and not make improper use of their position as an officer. The duties to act in the best interests of members and to give priority to the members' interests if there is a conflict between the members' interests and the interests of the RE involve ascertaining the purpose and terms of the scheme rather than the success or otherwise of a transaction. The duties are not satisfied by an honest or reasonable belief. A contravention occurs when a director prioritises their own interests over those of members even if the director acted honestly and reasonably: *ASIC v Lewski* [2018] HCA 63.

In *ASIC v Daly* [2023] FCA 290, a registered MIS directors contravened their duty of care in s 601FD(1)(b) when they caused loans to be made from the registered MIS to an unregistered MIS. The loans also meant the directors failed to act in the best interests of the registered MIS's members in contravention of s 601FD(1)(c). The directors also made improper use of their positions for purposes of s 601FD(1)(e) when they applied for personal loans from the registered MIS.

There are duties imposed on employees by s 601FE. These duties imposed on officers and employees are subject to the civil penalty provisions discussed at [19.120]–[19.150] and override any conflicting duty the officers and employees may have under Ch 2D.

Section 601MA gives members of a scheme the right to sue the RE for any loss or damage due to its breach of any of the managed investment provisions of the *Corporations Act*.

## Related party transactions

**[27.35]** Sections 601LA–601LE apply a modified version of the *Corporations Act* provisions dealing with financial benefits to related parties of public companies to responsible entities. The related party provisions are discussed at [16.40]–[16.80].

The object of the modified related party provisions is to protect the scheme property and the interests of members in the scheme property by requiring disclosure and member approval of financial benefits to the RE or its related parties that could diminish or endanger scheme property or adversely affect the interests of members: s 601LB.

In *ASIC v Daly* [2023] FCA 290, a de facto officer of a registered MIS repeatedly contravened the modified related party provision in s 601LB when he was involved in transferring funds from the registered MIS to an unregistered MIS without obtaining approval from the registered scheme's members. The funds transfer was the giving of a financial benefit. The unregistered MIS was regarded as the parent of the registered MIS and hence the two MISs were related parties. The court decided that the arm's length exception to the related party provisions did not apply.

## Constitution

**[27.40]** A registered MIS must have a constitution contained in a document that is legally enforceable between the members and the RE: s 601GB. While the *Corporations Act* does

not set out detailed contents requirements for the constitution, s 601GA specifies that it must make adequate provision for the following matters:

- the consideration that is to be paid to acquire an interest in the scheme (s 601GA(1)(a));
- the investment powers of the RE (s 601GA(1)(b));
- the method by which complaints made by members in relation to the scheme are dealt with (s 601GA(1)(c)); and
- the winding-up of the scheme (s 601GA(1)(d)).

ASIC Regulatory Guide RG 134 *Managed Investments: Constitutions* assists operators of registered MISs and their advisers understand ASIC's views on the content requirements of constitutions for schemes. Regulatory Guide RG 134 is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources/>.

## Compliance plan and compliance committee

**[27.45]** A registered MIS must have a compliance plan that sets out the measures that the RE will apply in operating the scheme to ensure compliance with the scheme's constitution and the *Corporations Act*. The RE has a duty to ensure that the compliance plan meets the minimum contents requirements of s 601HA: s 601FC(1)(g). The RE has a duty to comply with the compliance plan: s 601FC(1)(h).

If fewer than half the directors of the RE are external directors, the RE is required to establish a compliance committee, the majority of whose members must be independent of the RE: s 601JA. A person is regarded as an external director if they have not been an executive officer, employee or in a designated relationship under s 601JA(2) within the past two years.

The function of the compliance committee is to monitor the operation of the MIS and the adequacy of the compliance plan.

## Members' rights to withdraw

**[27.50]** The constitution of an MIS must state whether members have a right to withdraw their investments from a scheme: s 601GA(4). Withdrawals from a "liquid" scheme are not permitted unless the constitution permits it: s 601KA. A scheme is liquid if its liquid assets account for 80 per cent of the value of the scheme property: s 601KA(4).

If the scheme is not liquid, ss 601KB–601KE impose restrictions on the right to withdraw. For example, under s 601KB(1), the RE of a registered scheme that is not liquid may offer members an opportunity to withdraw to the extent that particular assets are available and can be converted to money in time to satisfy withdrawal requests. The RE must not satisfy withdrawal requests until the withdrawal offer period has closed. If the value of withdrawal requests exceeds the amount available for withdrawal, the requests must be met on a pro-rata basis in accordance with a formula: s 601KD.

## Scheme financial reports and audit

**[27.55]** The financial reporting provisions of the *Corporations Act*, discussed in Chapter 22, also apply to a registered MIS. For example, a registered scheme is required to:

- keep written financial records (s 286);
- prepare financial reports and have them audited (ss 295 and 301);
- send the financial reports and auditor's report to scheme members (s 314). The deadline for sending these reports to members is within three months after the end of the financial year (s 315(3));
- lodge the financial reports, directors' report and auditor's report with ASIC within three months after the end of the financial year (s 319); and
- confirm or correct the Annual Extract of Particulars provided by ASIC by lodging a Return of Particulars when necessary (ss 346A–346C).

## Meetings of scheme members

**[27.60]** Part 2G.4 of the *Corporations Act* contains provisions dealing with meetings of members of a registered MIS. To a large extent, these provisions are based on the meeting provisions of public companies. These are discussed in Chapter 21. The main difference is that, unlike public companies, an MIS is not required to hold an AGM.

## Winding-up and deregistration

**[27.65]** The *Corporations Act* contains separate provisions for the winding-up and deregistration of MISs in Pts 5C.9 and 5C.10.

Circumstances under which a registered scheme may be wound up.

A registered scheme may be wound up in the following circumstances:

- The constitution of a scheme may provide for the winding-up of the scheme at a specified time or on the happening of a specified event: s 601NA.
- The members of a registered scheme can call a meeting and pass an extraordinary resolution directing the RE to wind up the scheme: s 601NB.
- The RE can take steps to wind up a registered scheme if it considers that the purpose of the scheme has been or cannot be accomplished: s 601NC.
- The court may direct the RE to wind up the scheme if the court thinks it just and equitable to do so: s 601ND(1)(a). Court-directed winding-up on the just and equitable ground may be made on the application of the RE, a director of the RE, a member of the scheme or ASIC. The court may also direct the RE to wind up the scheme on the application of a judgment creditor where the creditor's execution of judgment has been returned unsatisfied: s 601ND(1)(b). In *Re Banksia Mortgages Ltd* [2013] VSC 451, the court granted an RE's application to wind up an MIS on the just and equitable ground based on a failure of substratum. Due to the scheme's inability to take on new

investments or roll over existing investments, the RE suffered dwindling management fees and was unable to recruit a replacement RE. As a consequence, the purpose of the scheme could no longer be accomplished.

|                                                  |
|--------------------------------------------------|
| Voluntary deregistration of a registered scheme. |
|--------------------------------------------------|

A registered scheme may be deregistered voluntarily or by ASIC. Voluntary deregistration is initiated when the RE lodges a deregistration application with ASIC: s 601PA. Such an application may only be made if:

- the number of members of the scheme falls below 20 and all the members consent to the deregistration; or
- the registered scheme was not required to be registered and all the members consent to the deregistration; or
- the scheme ceases to be an MIS as defined in the *Corporations Act*.

Under s 601PB, ASIC may deregister a scheme if:

- the scheme's RE, constitution or compliance plan does not satisfy the *Corporations Act* requirements; or
- the scheme's property is not clearly identified as such and is not held separately from the property of the RE or property of other schemes; or
- the response to a Return of Particulars given to the RE of the scheme by ASIC is at least six months late, no other documents have been lodged by or on behalf of the scheme in the last 18 months, and ASIC has no reason to believe that the scheme is being operated.

## Corporate collective investment vehicles

**[27.70]** The *Corporate Collective Investment Vehicle Framework and Other Measures Act 2022* (Cth) added a new Chapter 8B to the *Corporations Act*. According to the Explanatory Memorandum of the amending legislation, a key policy objective of the legislation is to increase the competitiveness of Australia's managed funds industry internationally to attract offshore investment. CCIVs are corporate funds vehicles with features similar to those typically found in Europe and Asia. This provides greater familiarity for offshore investors and fund managers than MISs which are based on trust structures.

To be registered, a CCIV must be a company limited by shares and have only one director: s 1222(a) and (c). The director must be a public company that holds an AFSL authorising it to operate and conduct the affairs of the CCIV. A CCIV must have at least one sub-fund and each sub-fund must have at least one member: s 1222(d) and (e). Sub-funds are registered by ASIC and allocated an Australian registered fund number (AFRN): s 1222S. A sub-fund of a CCIV is all or part of the business of a CCIV that is registered as a sub-fund: s 1222Q(1). A sub-fund does not have a legal personality: s 1222Q(2).

Upon a CCIV's registration, it must lodge a notice with ASIC stating whether it is a retail or wholesale CCIV: s 1222A(4). A retail CCIV must lodge a compliance plan with ASIC: s 1222A(6). A CCIV is regarded as retail if it has at least one investor to

whom sub-fund securities were issued or transferred in circumstances that would have required a PDS to be given to them: s 1222K. A CCIV is wholesale unless it has at least one investor that acquires securities in the CCIV as a retail client. Because investors in wholesale CCIVs are regarded as more sophisticated, such CCIVs are subject to a less onerous regulatory framework than that applicable to retail CCIVs.

Retail CCIVs with a single sub-fund may apply for listing in an Australian financial market. Wholesale CCIVs must not be listed: s 1222N.

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.



## Chapter 28

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# ASIC's investigatory, information-gathering and enforcement powers

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### Key points

- ASIC is a Commonwealth government authority set up by the *Australian Securities and Investments Commission Act 2001* (Cth) (*ASIC Act*) and is the main government agency responsible for regulating Australia's companies and financial services, products and markets.
- ASIC has extensive powers to investigate suspected contraventions of the *Corporations Act* on its own initiative. It also has the power to investigate suspected contraventions of other laws that concern the management or affairs of companies or involve company or financial services fraud or dishonesty. The responsible Commonwealth Minister, the Treasurer, may also direct ASIC to investigate these matters where this is in the public interest.
- The *ASIC Act* gives ASIC wide information-gathering powers to facilitate its investigations. ASIC can examine any person if it believes that that person can provide information relevant to an ASIC investigation. An examinee must answer questions on oath and does not have the usual privilege against self-incrimination.
- ASIC has wide powers to inspect any books and records that the *Corporations Act* obliges companies to keep. It can also require people to produce such books and records.
- If, as a result of an investigation, ASIC believes that there is a contravention of the law, it has the power to initiate prosecutions for criminal offences or applications for civil penalty orders. ASIC also has the power to apply to the court for the compulsory winding-up of a company, the appointment of a receiver over company property, or proceedings in the name of a company, shareholder or creditor.

## Introduction

[28.05] Provisions dealing with the investigation of the affairs of companies have been part of Australian companies' legislation since the 19th century. These investigatory provisions have been used as a means of discovering the facts surrounding major corporate collapses as well as improper and illegal activities.

The investigatory, information-gathering and enforcement powers of ASIC are largely set out in the *ASIC Act*.

The *ASIC Act* sets out ASIC's investigatory and information-gathering powers.

Section 11(1) of the *ASIC Act* provides that ASIC has such functions and powers as are conferred on it by or under the corporations legislation. Section 5(1) defines the term "corporations legislation" to mean the *ASIC Act* and the *Corporations Act*.

Section 12A gives ASIC certain functions and powers in relation to:

- monitoring and promoting market integrity and consumer protection in relation to the Australian financial system;
- insurance and superannuation;
- business names registration; and
- monitoring and promoting market integrity and consumer protection in relation to the payments system by promoting matters including the adoption of approved industry standards and codes and sound customer–banker relationships.

ASIC's investigatory and information-gathering powers in relation to insurance and superannuation are beyond the scope of this book.

In addition to the functions and powers conferred on ASIC by the *ASIC Act*, ss 596A and 596B of the *Corporations Act* allow ASIC, among others, to apply to the court to summon a present or former officer for examination about a corporation's examinable affairs. Sections 596A and 596B are discussed at [32.400]–[32.460].

Section 12 of the *ASIC Act* permits the Minister to give ASIC written directions about policies it should pursue, or priorities it should follow, in performing or exercising any of its functions or powers. The Minister, however, is not permitted to give directions to ASIC about a particular case: s 12(3).

In October 2022, the Parliamentary Joint Committee on Corporations and Financial Services (PJC) commenced an inquiry into ASIC's capacity and capability to undertake proportionate investigation and enforcement action arising from reports of alleged misconduct. The inquiry's terms of reference include asking whether ASIC is meeting the expectations of government, business and the community with respect to regulatory action and enforcement. The adequacy of ASIC's resources in enabling it to ensure investigations and enforcement action progress in a timely manner is also under review.

ASIC's Annual Reports summarise the outcomes of its investigations and ASIC's Enforcement Outcomes Reports contain details of the enforcement outcomes achieved

by ASIC over the previous six-month period. The Annual Reports and the Enforcement Outcomes Reports, published on ASIC's website, are linked to the Understanding Company Law website at <http://www.asic.gov.au/about-asic/asic-investigations-and-enforcement/asic-enforcement-outcomes/>.

## ASIC's investigatory powers

**[28.10]** A number of provisions of the *ASIC Act* give ASIC investigatory powers. Section 13 is a general provision that gives ASIC broad powers to conduct investigations on its own initiative. Under s 13(1), ASIC may make such investigation as it thinks expedient for the administration of the "corporations legislation" (the *ASIC Act* and the *Corporations Act*) where it has reason to suspect that there may have been committed:

- a contravention of the corporations legislation; or
- a contravention of a Commonwealth, State or Territory law that either concerns the management or affairs of a body corporate or managed investment scheme or involves fraud or dishonesty and relates to a body corporate, a managed investment scheme or to financial products.

Before ASIC can begin a s 13(1) investigation, it must have reason to suspect that a contravention of the corporations legislation or other law has occurred. Provided ASIC has reason to suspect a contravention of a relevant law, s 13(1) permits it to investigate other matters that ASIC thinks is "expedient for administration of the corporations legislation": *ASIC v Sigalla (No 2)* [2010] NSWSC 792. For example, if ASIC had reason to suspect that directors breached their duty of care and diligence in contravention of s 180 and in the course of that investigation ASIC formed the view that an employee and not the directors was negligent, ASIC could investigate that employee's behaviour.

### *Boys v ASC* [1998] FCA 1

**[28.15]** In this case, the court held that the Australian Securities Commission (ASIC's predecessor) was entitled to appoint a receiver and his legal adviser as consultants to assist the ASC in carrying out its investigation under s 13. This appointment was on the basis that their fees would be paid out of the company's assets and not by the ASC.

**[28.20]** Section 13(2) gives ASIC investigatory powers in relation to unacceptable circumstances in takeovers. As discussed at [25.240]–[25.245], ASIC, among others, may apply to the Takeovers Panel for a declaration of unacceptable circumstances: *Corporations Act*, s 657C(2). Under s 13(2) of the *ASIC Act*, where ASIC has reason to suspect that unacceptable circumstances have occurred, it may make such investigation as it thinks expedient:

- for the purposes of determining whether to make an application to the Takeovers Panel; or
- otherwise for the due administration of the corporations legislation.

As discussed at [32.375], s 533 of the *Corporations Act* obliges liquidators to report certain matters to ASIC. These matters include Commonwealth or State offences that appear to have been committed by officers or members in relation to companies. Sections 422 and 438D place similar reporting obligations on receivers and administrators.

ASIC may investigate matters raised in administrators', receivers' and liquidators' reports.

Pursuant to s 15 of the *ASIC Act*, ASIC, on receipt of such reports, has the power to investigate the matters to which liquidators' or receivers' reports relate for the purpose of determining whether a person should be prosecuted for an offence.

While the investigatory powers conferred by ss 13 and 15 are exercised on ASIC's initiative, the *ASIC Act* specifies that the relevant Minister (the Commonwealth Treasurer) can also direct ASIC to investigate certain matters where the Minister is of the opinion that such investigation is in the public interest: s 14(1). Section 14(2) lists a broad range of matters in respect of which the Minister may direct an ASIC investigation. These include:

- an alleged or suspected contravention of the corporations legislation;
- an alleged or suspected contravention of a Commonwealth or State law that:
  - concerns the management or affairs of a body corporate; or
  - involves fraud or dishonesty and relates to a body corporate or financial products;
- the affairs, or particular affairs, of a corporation;
- dealing in financial products; or
- the establishment or conducting of a financial market.

At the end of an investigation under either s 13 or s 15, ASIC may prepare a report about the investigation setting out its findings: s 17. Such reports must be prepared if the Minister so directs. ASIC has no discretion in respect of s 14 investigations. Preparation of a report at the end of such investigations is mandatory.

Section 16 enables ASIC to prepare interim reports where, in the course of an investigation, it forms the opinion that an interim report will assist the protection, preservation or prompt recovery of property where a serious contravention of the law has been committed. An interim report can also be prepared where ASIC is of the opinion that there is an urgent need for a law to be amended.

Copies of a report of investigations are distributed to the Minister who may then cause it to be published: s 18(1) and (4). Where a report relates to a serious contravention of the law, ASIC may also distribute copies to:

- the Australian Federal Police;
- the Australian Crime Commission;
- the Director of Public Prosecutions; or
- a prescribed agency.

# Information gathering

## Examination of persons

**[28.25]** ASIC has wide powers to examine persons where it suspects or believes, on reasonable grounds, that a person can give information relevant to a matter under investigation: s 19. ASIC may give written notice requiring a person to give ASIC all reasonable assistance in connection with the investigation.

The examination may be conducted by a Commissioner, a member of ASIC's staff or an inspector to whom the power has been delegated. At the examination, the examinee is required to give all reasonable assistance and answer questions on oath.

The notice requiring a person to attend an examination must state the general nature of the matter that is being investigated: *Johns v Connor* [1992] FCA 246. There is no need for the notice to identify the person suspected of a contravention: *Stockbridge v Ogilvie* [1993] FCA 469.

An examination is conducted in private: s 22. Section 23 gives an examinee the right to legal representation. During the examination, the lawyer may address the inspector and question the examinee. It is an offence for any person to be present at an examination other than the examinee, the inspector, a Commissioner, an approved ASIC staff member or the examinee's lawyer: s 22.

An examinee does not have the usual privilege against self-incrimination. Under s 68(1)(a), persons cannot refuse or fail to give information on the basis that the information might tend to incriminate them or make them liable to a penalty. However, an answer cannot be used against a person in criminal proceedings or civil penalty proceedings if, before answering the question, the person had claimed that the answer may tend to be incriminating: s 68(3).

Further, as a general rule, an examinee is required to give information at a s 19 examination even if that information is subject to legal professional privilege: *Corporate Affairs Commission of New South Wales v Yuill* [1991] HCA 28. However, under s 69, a lawyer who is required to give information at an examination or is obliged to produce a book that is privileged is entitled to refuse to comply with that requirement unless the person on whose behalf the lawyer acts consents to the lawyer complying with the requirement. A lawyer who claims privilege must give ASIC a written notice identifying the name and address of the client. The lawyer must also give particulars that identify the documents or books that are subject to the privilege.

Subject to certain exceptions, statements made by an examinee during the course of an examination are generally admissible as evidence against any person in any proceedings: s 76. The exceptions include such matters as:

- self-incrimination in criminal or civil penalty proceedings; and
- claims of legal professional privilege.

Under s 25(1), ASIC may give a copy of a written record of the examination together with any related book to a person's lawyer if the lawyer satisfies ASIC that the person is carrying on, or is contemplating in good faith, a proceeding in respect of the matter

to which the examination related. ASIC may also supply any other person with similar records subject to such conditions (if any) as it thinks appropriate: s 25(3). Section 127(1) requires ASIC to take all reasonable measures to protect from unauthorised use or disclosure, information given to it in confidence. Disclosure is permitted under s 127(4) if the ASIC chairperson is satisfied that particular information will enable or assist:

- the Takeovers Panel, CADB, the Financial Reporting Council and other similar agencies to perform or exercise any of their functions or powers;
- the government or an agency of a State or Territory to perform a function or exercise a power; or
- a government or an agency of a foreign country to perform a function, or exercise a power, conferred by a law in force in that foreign country.

Section 127(2B) specifically permits ASIC to disclose information to a Royal Commission and s 127(2A) permits ASIC to disclose information to the Minister and certain other government agencies including the Australian Taxation Office.

## Inspection of books

**[28.35]** Sections 28–39C of the *ASIC Act* deal with ASIC’s powers to inspect books required to be kept by the corporations legislation. Section 5(1) defines “books” to include:

- a register;
- financial reports or financial records however compiled, recorded or stored;
- a document;
- banker’s books; and
- any other record of information.

Section 29 authorises ASIC to inspect, without charge, any book required to be kept under the corporations legislation. Under s 28, ASIC is able to require production of any other books only:

- for the purposes of the performance or exercise of any of the functions or powers of ASIC under the corporations legislation;
- for the purposes of ensuring compliance with the corporations legislation;
- in relation to an alleged or suspected contravention of the corporations legislation or a law that involves fraud or dishonesty and relates to a body corporate or financial products; or
- for the purposes of an investigation.

Apart from those books generally available, ASIC may gain access to specified books relating to the affairs of a body corporate by giving a notice to produce to the body or an eligible person: s 30. Under s 5(1), an “eligible person” is:

- a past or present officer of a body corporate; or
- a present or former employee, agent, banker, solicitor or auditor of a body corporate.

In *ASC v Lucas* [1992] FCA 339, it was held that s 30 permitted the ASC to gain access to an auditor's audit manual and quality control manual and the file and working papers in relation to the management of the audit.

Sections 31 and 32A enable ASIC to give similar notices to produce specified books relating to financial products and services.

Section 33 enables ASIC to give a person a written notice requiring the production to it of specified books that are in the person's possession and relate to the affairs of a body corporate. A bank's contractual obligation to keep its customers' affairs confidential is not a reasonable excuse for failing to comply with a s 33 production notice: *ASC v Zarro (No 2)* [1992] 34 FCA 98. ASIC may obtain a search warrant and seize any books whose production could be required under the Act, regardless of whether or not a notice to produce the material has been issued: ss 35 and 36.

A failure to comply with a notice given under s 33 is an offence unless there was a reasonable excuse: s 63. This refers to physical or practical difficulties involved in the production of the books. It does not include an undertaking of confidentiality: *ASC v Ampolex Ltd* (1995) 38 NSWLR 504.

## Disclosure of information about financial products

**[28.40]** Sections 40–48 of the *ASIC Act* deal with ASIC's power to quickly obtain information about financial products in situations where it is inappropriate to conduct a formal examination. Section 41 permits ASIC to require:

- a person who carries on a financial services business to disclose the identity of parties to an acquisition or disposal of financial products and any instructions given in relation to that acquisition or disposal;
- any person to disclose whether they acquired or disposed of financial products as trustee for another and, if so, the identity of, and instructions given by, the beneficiary; and
- a person who operates a financial market to disclose the identities of the persons who acted in relation to an acquisition or disposal of financial products.

Section 40 restricts the s 41 powers of ASIC to require disclosure of information about financial products. It can exercise those powers only:

- for the purposes of the performance or exercise of any of ASIC's functions and powers;
- for the purposes of ensuring compliance with the corporations legislation;
- in relation to an alleged or suspected contravention of the corporations legislation, or a contravention of a law of the Commonwealth, or States or Territories where the contravention concerns the management or affairs of a body corporate, or involves fraud or dishonesty; and
- for the purposes of an investigation.

Section 43 also gives ASIC the power to require disclosure:

- from a director, secretary or executive officer of a body corporate: information that may have affected a dealing in financial products that has taken place; or

- from any person whom ASIC believes on reasonable grounds is capable of giving information about dealings in financial products:
  - of advice, an analysis or a report given by a person who carries on a financial services business;
  - of the financial position of a financial services business carried on by a person giving such advice; or
  - of an audit or auditor's report.

Under s 43(1), the power to require disclosure in relation to financial products can be exercised only where ASIC considers that:

- it may be necessary to exercise its powers under s 794D of the *Corporations Act* to suspend trading in particular financial products;
- a contravention of certain provisions in relation to financial products, such as false trading and market rigging, may have been committed;
- a contravention of Ch 6C (the substantial shareholder provisions or disclosure of relevant interest notices) may have been committed;
- a contravention of a Commonwealth law involving fraud or dishonesty in relation to financial products may have been committed; or
- unacceptable circumstances may have occurred during the course of a takeover.

## Enforcement

**[28.45]** An ASIC investigation or report can have several consequences. Section 49 of the *ASIC Act* enables ASIC to initiate prosecutions for criminal offences where an investigation reveals contraventions of the law. As discussed at [28.50], ASIC may decide to initiate civil proceedings in the name of a company under s 50.

ASIC also has standing under s 1324 to apply to the court for an injunction restraining conduct where a person has engaged in conduct that constitutes a contravention of the *Corporations Act*, counsels or procures a person to contravene the Act or is in any way knowingly concerned in or party to the contravention. An example of an action brought by ASIC under s 1324 is discussed at [19.153]. Section 1324 also enables any person whose interests are affected by a contravention of the *Corporations Act* to apply for an injunction. This is further discussed at [24.305]–[24.315].

An investigation can also lead to the winding-up of a company. Section 461(1)(h) of the *Corporations Act* provides a ground for the compulsory winding-up of a company where ASIC has stated in a report of an investigation that it is of the opinion:

- that the company cannot pay its debts and should be wound up; or
- it is in the interests of the public, the members or the creditors that the company should be wound up.

A person whom ASIC thinks appropriate may seek a remedy under s 232 of the *Corporations Act* where it has investigated matters connected with the affairs of a company: *Corporations Act*, s 234(e). This is discussed at [24.15]–[24.280].

Where ASIC is carrying out an investigation of the acts or omissions of a person, it may apply to the court under s 1323 of the *Corporations Act* for a wide variety of orders



designed to protect the interests of the creditors of the person under investigation. These orders include:

- prohibiting the person under investigation or any associate transferring assets out of Australia;
- prohibiting the person under investigation from leaving Australia without consent of the court; and
- appointing a receiver or trustee in respect of the property of the person under investigation. This is the most common order sought. Receivers are discussed in Chapter 30.

## Section 50 class actions

**[28.50]** Under s 50 of the *ASIC Act*, ASIC has broad powers to begin and carry on certain civil proceedings in the name of a company where it appears as a result of an investigation or examination that it is in the public interest to do so. These proceedings are for the recovery of damages for fraud, negligence, default, breach of duty or other misconduct committed in connection with a matter to which the investigation or examination related.

ASIC may initiate proceedings in the name of the company.

The purpose of s 50 is to enable ASIC to act in the public interest by bringing proceedings where the company or another person has suffered loss as a result of misconduct and does not have the resources to pursue their claims. The power under s 50 does not extend to ASIC carrying on a proceeding that it did not commence: *Carey v ASIC* [2008] FCA 963.

ASIC can bring legal proceedings in the name of the company whether or not the company consents.

ASIC may also bring an action in the name of a shareholder or creditor of a company.

ASIC may also bring an action in the name of a shareholder or creditor. In the case of a natural person, their consent must be given. Although ASIC is the active party in the litigation, any remedy obtained is for the benefit of the person in whose name the action is brought. Section 50 enables ASIC to commence proceedings against directors in the name of the company for breach of their fiduciary duties. It may also commence proceedings against a trustee for breach of trust: *Walsh v Permanent Trustee Australia Ltd* (1996) 14 ACLC 1443.

*ASC v Deloitte Touche Tohmatsu* [1996] FCA 753

**[28.55]** The court held that s 50 gives ASIC an extremely wide discretion to bring proceedings. ASIC is required to form a judgment as to the public interest in deciding whether proceedings should be brought. This is largely a question of fact and by its nature is not generally subject to review by the courts unless there is a failure to address the correct legal questions or the process of reasoning was manifestly unreasonable.

## Hearings

[28.60] ASIC has the power to hold hearings for the purposes of the performance or exercise of any of its functions and powers: *ASIC Act*, s 51. Hearings cannot, however, be held for purposes of carrying out an investigation or for the purposes associated with applications for declarations of unacceptable conduct in takeovers. As discussed at [28.20], there are separate procedures for the examination of persons in such circumstances.

The *Corporations Act* requires ASIC to hold a hearing in certain situations. For example, s 739 allows ASIC to make a stop order where it is satisfied that a disclosure document contains a misleading or deceptive statement in contravention of s 728. Before making such an order, ASIC must hold a hearing and give any interested people a reasonable opportunity to make submissions on whether the order should be made: s 739(2).

ASIC has a discretion whether to hold a hearing in public or private: *ASIC Act*, s 52. In exercising its discretion, ASIC is required to have regard to a number of considerations, such as the confidential nature or otherwise of the matters that may arise, as well as the public interest. A hearing must be held in private if this is required by the corporations legislation: s 54.

Members of ASIC have the power to summon persons to attend a hearing and give evidence or produce documents: s 58. Proceedings at hearings are conducted with as little formality and technicality, and with as much expedition, as requirements of national scheme laws and a proper consideration of the matters permit: s 59. At a hearing, ASIC is not bound by the formal rules of evidence but is required to observe the rules of natural justice. Rules of procedure applicable to courts do not apply to ASIC because it exercises an administrative function. ASIC can therefore reopen a hearing after receiving new evidence: *Boucher v ASC* (1996) 14 ACLC 999.

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.
- For further corporations law links and material please refer to the Understanding Company Law website at <http://www.uclaw.com.au>.

## Chapter 29

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# Corporate insolvency

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## Key points

- The main aim of corporate insolvency law is to provide a fair and orderly process for dealing with the financial affairs of insolvent companies.
- The *Corporations Act* provides for six main types of external administrations for insolvent companies: voluntary administrations; deeds of company arrangement; restructuring practitioner appointed; restructuring plans implemented; liquidations (also called winding-up); and provisional liquidations. Since companies are not necessarily insolvent just because a receiver of their property has been appointed, receivership is not an external administration. While a scheme of arrangement may be implemented in the case of an insolvent company, schemes are more commonly utilised to implement a merger or a restructure of a solvent company.
- Receivership is a form of administration in relation to property of a company that involves the appointment of an independent, registered insolvency practitioner called a “receiver”. The role of a receiver appointed by a secured creditor is to take possession of the secured property, sell it and, out of the proceeds, repay the secured debt owed by the company. While receiverships do not come within the statutory definition of “external administration” they usually arise in the context of an insolvent debtor company and bear close similarities in some respects to voluntary administrations and liquidations.
- Voluntary administration involves the appointment of a registered, independent insolvency practitioner (called an “administrator”) who takes complete control of an insolvent company, usually for a relatively short period of time. The aims of the voluntary administration provisions of the *Corporations Act* are to maximise the chances of the company or its businesses remaining in existence and, if this is not possible, to achieve a better return to creditors than would result from an immediate winding-up.
- A deed of company arrangement is one of the possible outcomes for a company that is put into voluntary administration. The aims of the voluntary administration scheme are largely achieved by deeds of company arrangement.
- The restructuring process, which is the most recent external administration, begins when the directors of an eligible company appoint a restructuring practitioner who assists with the development of a restructuring plan to repay existing debts owed to creditors. While the restructuring framework is modelled on voluntary administration, unlike voluntary administration, directors continue to control the company during restructuring.
- Liquidation is a form of external administration that ultimately results in the company being deregistered and ceasing to exist as a legal entity. It involves the appointment of an independent registered liquidator who takes control of the company from its directors and shareholders. Liquidation is the process under which the company’s affairs are wound up, its property sold, debts owed to its creditors repaid and the surplus (if any) distributed among its shareholders.

- Schemes of arrangement for insolvent companies are a form of external administration that enables the rights and liabilities of shareholders and creditors to be reorganised under court supervision. The aim of a scheme of arrangement is to obtain a binding agreement that modifies, reorganises or alters the legal rights of creditors and shareholders.

## Introduction

**[29.05]** This chapter provides an overview and summary of the various types of insolvency regimes. Chapters 30–32 present separate detailed discussions of each of these regimes.

Insolvency law has evolved over a long period of time to deal with insolvent debtors who are unable to pay debts owing to creditors. Debtors may be people or companies. While the general principles dealing with insolvent people and insolvent companies have similar objectives and are broadly similar, different legislation applies in each case. Insolvent individuals are said to become “bankrupt” and are dealt with under the *Bankruptcy Act 1966* (Cth). Corporate insolvency is regulated by the external administration provisions of Ch 5 of the *Corporations Act* which provides for the following types of insolvency regimes:

- voluntary administration discussed at [31.05]–[31.230];
- deed of company arrangement discussed at [31.235]–[31.365];
- restructuring and restructuring plans discussed at [31.390]–[31.460];
- liquidation (also called “winding-up”) discussed in Chapter 32;
- provisional liquidation discussed at [32.390]; and
- scheme of arrangement.

Secured creditors or the court may appoint a receiver, receiver manager or other controller to take possession of the secured property of a company for the purpose of selling it and repaying the secured debt. These are discussed in Chapter 30. Schemes of arrangement are another process that can be utilised by creditors. These are discussed at [29.155] and [29.160].

This chapter presents an overview of corporate insolvency.

The features of these forms of external administration are summarised in this chapter and are discussed in detail in Chapters 30–32 of this book. It is a common feature of these different regimes (other than restructuring) that an independent and qualified insolvency practitioner, who is a registered liquidator, takes over the management of the company or its property from its directors. During restructuring directors remain in control of the company’s business and affairs.

Corporate insolvency law plays an important role in promoting economic efficiency as an effective insolvency regime deals with failed companies so as to allow more efficient businesses to acquire the assets of or replace inefficient insolvent businesses. In its report, *Corporate Insolvency in Australia* (July 2023), the Parliamentary Joint Committee on Corporations and Financial Services (PJC) noted the importance of the corporate insolvency regime to the broader Australian economy:

The framework seeks to provide viable companies an opportunity to restructure and continue trading. Where this is not possible, it provides mechanisms for the closure of unviable businesses and reallocating resources towards other productive uses, thus serving a broader function in the Australian economy.



The PJC's report is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources>.

Section 600K incorporates Sch 2, the *Insolvency Practice Schedule (Corporations)*, which sets out provisions that are generally applicable to all types of external administrations, which exclude receiverships and schemes of arrangement. The *Insolvency Practice Schedule (Corporations)* includes rules dealing with registering and disciplining practitioners, determining practitioner remuneration, handling of funds, record-keeping and providing information, convening and conducting meetings of creditors and reviews of external administrations.

## Aims of insolvency law

[29.10] Insolvency law plays an important part in corporate regulation because it is inevitable that from time to time companies will fail, leaving unpaid debts. The consequences of insolvency may affect many parties, including creditors, employees, taxation authorities, directors, suppliers and customers. In some high-profile corporate collapses the interests of the general public have also been severely affected. Insolvency law attempts to balance the often competing interests of these various groups. While the various insolvency regimes sometimes have different objectives, it is helpful to identify the broad aims of insolvency law. The Australian Law Reform Commission's *General Insolvency Inquiry* (1988) (Harmer Report) identified the following aims of insolvency law as the basis of its law reform proposals:

- The fundamental purpose of an insolvency law was to provide a fair and orderly process for dealing with the financial affairs of insolvent individuals and companies.
- Insolvency law should provide mechanisms that enable both debtor and creditor to participate with the least possible delay and expense.
- An insolvency administration should be impartial, efficient and expeditious.
- Insolvency law should provide a convenient means of collecting or recovering property that should properly be applied toward payment of the debts and liabilities of an insolvent person.
- The principle of equal sharing between creditors should be retained and in some areas reinforced.
- The end result of an insolvency administration, particularly as it affects individuals should, with very limited exceptions, give effective relief or release from the financial liabilities and obligations of the insolvent.
- Insolvency law should, as far as convenient and practical, support the commercial and economic processes of the community.
- As far as is possible and practical, insolvency laws should not conflict with the general law.
- Insolvency law should enable ancillary assistance in the administration of an insolvency originating in a foreign country.

The insolvency regime that will apply in a particular case generally depends upon the course of action taken by the creditors or directors of the insolvent company. A creditor

may enforce rights conferred by contract or by operation of insolvency law. A secured creditor will often be able to exercise self-help by appointing a receiver under a power conferred by a debenture or other loan documentation. Creditors of an insolvent company will often initiate the winding-up of the company while the directors of an insolvent company may initiate voluntary liquidations or commence voluntary administrations.

## Receivership

**[29.15]** Receivership involves the appointment of a receiver of property of a company. Since the person who is appointed as a receiver must be a registered liquidator, this ensures that the receiver is independent and experienced. A receiver is usually appointed by a secured creditor of a company to take possession of the secured property, sell it and repay the secured debt owed by the company out of the sale proceeds.

A receiver's role is to take possession of secured property, sell it and repay the secured debt out of the sale proceeds.

While a receiver may be appointed in respect of the property of a partnership or an individual, receiverships are usually over a company's property. Part 5.2 (ss 416–434) of the *Corporations Act* deals with receiverships over the property of a company and is discussed in detail in Chapter 30.

The appointment of a receiver is not the only right that may be conferred on secured creditors if a company defaults under its loan agreement. Secured creditors may also have the right to personally take possession of secured property. Secured creditors who do this are referred to as “mortgagees in possession”. Alternatively, secured creditors may appoint an agent (called an “agent for a mortgagee in possession”) to act on their behalf. As the role of an agent for the mortgagee in possession is very similar to that of a receiver, the *Corporations Act* regulates mortgagees in possession and their agents in the same way as receivers. Receivers, mortgagees in possession and agents for mortgagees in possession are all “controllers” as defined in s 9: see [30.20].

## Appointment by secured creditors

**[29.20]** A receiver may be appointed by secured creditors such as debenture-holders or by the court. In most cases, a company enters receivership when a secured creditor appoints a receiver to take control of property secured by a security interest that the company has granted to the secured creditor. This is sometimes referred to as “a private appointment”: see [30.35].

A secured creditor's right to appoint a receiver arises from the terms of the loan agreement or debenture.

A secured creditor's right to appoint a receiver arises from the terms of the loan agreement or debenture. This agreement also specifies the property that is subject to the security interest. Where the secured property includes the business of the company, the loan

agreement usually gives the receiver the power to manage the business as this may maximise the value of the secured assets. In such cases, the receiver is referred to as a “receiver and manager”.

## Why would secured creditors appoint a receiver?

**[29.25]** One of the advantages of receivership for secured creditors is the speed with which it can be implemented. It is not necessary to obtain court approval for the appointment of a receiver. Further, as receivers must be registered liquidators, they are expected to be experienced and skilled in managing insolvent companies.

The loan agreement, or debenture, specifies the circumstances in which a secured creditor may appoint a receiver or receiver and manager. In most cases, a receiver is appointed if the company has breached one or more of its obligations under the loan agreement, such as non- payment of interest or principal.

Default in payment is just one event that may trigger a secured creditor’s right to appoint a receiver. Usually loan agreements also give secured creditors the right to appoint a receiver if the debtor company’s business is operating at a loss, ceases to operate or another creditor files an application to wind up the company.

## Appointment by the court

**[29.30]** The *Corporations Act* also gives the court the power to appoint a receiver: see [30.55]–[30.75]. For example, under s 1323(1)(h), the court may appoint a receiver over the property of a person or a company that is the subject of an Australian Securities and Investments Commission (ASIC) investigation of a suspected contravention of the *Corporations Act*: see [28.45]. The purpose of such an appointment is generally limited to protecting the interests of the company’s creditors by preventing the company’s property from being dissipated while it is under the investigation.

## Duties of receivers

**[29.35]** While a privately appointed receiver’s main duties are owed to the appointing secured creditor, the receiver also owes the debtor company common law and statutory duties to exercise powers in good faith and for proper purpose and a duty of care not to sacrifice the company’s interests recklessly: see [30.125]–[30.140]. In addition, under s 420A, receivers are required to exercise reasonable care in selling the secured property for not less than its market value: see [30.150]. These duties recognise that there are other parties whose interests are affected by the insolvency of the debtor company, including unsecured creditors and directors who have guaranteed the company’s debts.

A privately appointed receiver owes duties to the company.

The role of a receiver appointed in respect of property secured by a non-circulating security interest such as a fixed asset (see [11.125]) is to take possession of the property secured by the security interest, sell it and repay the debt due to the secured creditor.

Any surplus after the sale of the property subject to the non-circulating security interest is returned to the company. The powers of a receiver are discussed at [30.95]–[30.115].

On the other hand, where a receiver has been appointed in respect of property secured by a circulating security interest such as over trading stock or debts (see [11.105]–[11.120]), s 433 specifies that before the circulating security interest creditor is repaid, proceeds from the sale of the secured property must first go to paying the debts owed to certain unsecured creditors who are given priority in a winding-up. These include employee entitlements such as unpaid wages, superannuation contributions and leave entitlements: see [30.175] and [32.675].

## Effect of receivership on the company and its directors

**[29.40]** The appointment of a receiver does not affect the legal personality of the company even though when a receiver takes control of significant company assets; this has a major effect on the company and the operation of its business. The company continues to exist as a separate legal entity and remains the legal owner of its property: see [30.80].

The company continues to exist after the appointment of a receiver.

Receivership does not displace the company's board of directors. They remain in office, but their ability to deal with the secured property is severely restricted. If a receiver and manager is appointed to take control of the company's business, the directors' management powers are superseded by the powers of the receiver and manager. Despite this, directors are still subject to their various fiduciary and statutory duties. For example, they must still comply with their obligations to ensure that the company prepares its annual financial reports, even though the company's business is under the control of a receiver and manager.

## Effect of receivership on unsecured creditors

**[29.45]** In contrast to voluntary administration or liquidation, receivership does not result in a moratorium or stay on the commencement of legal proceedings against a company. Unsecured creditors of a company in receivership retain their rights to sue the company for non-payment of their debts. However, any rights they may have in respect of the secured property are subordinated to the secured creditor who appointed the receiver. Unsecured creditors may apply to the court to wind up the company on the grounds of insolvency.

Unsecured creditors retain their rights to take legal proceedings.

Receivership does not mean that pre-receivership contracts are automatically terminated. However, a receiver, as agent for the company, may decide to repudiate contracts if their continued performance is of no advantage to the conduct of the receivership. If a contract is repudiated, the company will be liable for damages to the other contracting party.

## Impact of voluntary administration and liquidation on receivership

**[29.50]** The commencement of voluntary administration has a significant impact on a secured creditor's ability to appoint a receiver. During voluntary administration, there is a moratorium or stay of all legal proceedings against the company: see [31.175]–[31.200]. This means that secured creditors cannot enforce their security interests by appointing a receiver over the company's property except with the administrator's or court's consent: s 440B; see also [31.190]. Secured creditors' rights to enforce their security interests and appoint a receiver resume after voluntary administration ends unless they have agreed to a deed of company arrangement: see [31.190].

The moratorium need not affect a secured creditor with a perfected security interest over the whole, or substantially the whole, of the property of a company: see [31.210]. Under s 441A, such a secured creditor can enforce their security interest within the "decision period" and personally take possession of the company's property or appoint a receiver. The "decision period" is defined in s 9 as being within 13 business days of either the commencement of administration or the secured creditor being given notice of the administrator's appointment.

A company may be in liquidation and receivership at the same time. Unsecured creditors may apply to wind up a company on the ground of insolvency even though a secured creditor has appointed a receiver. Similarly, a secured creditor may appoint a receiver even though the company is being wound up. A liquidator's role is to look after the interests of unsecured creditors while the receiver represents the secured creditor who made the appointment.

While a receiver's right to take possession and sell the secured property continues despite the liquidation of the company, liquidation terminates the receiver's position as agent for the company and the receiver becomes personally liable for debts incurred in carrying on the company's business after the commencement of liquidation: see [30.120]. A receiver may, however, continue to carry on the company's business with either the liquidator's consent or court approval: s 420C.

## Termination of receivership

**[29.55]** Receivership terminates when the receiver achieves the object of the appointment: see [30.205]. This usually occurs when the secured property is sold and the debt due to the secured creditor is discharged and the debts of the receivership, such as the receiver's cost and fees, are paid. The receiver is obliged to account to the company for any surplus. If the company is not in liquidation, termination of receivership results in a resumption of the directors' control of the company's affairs.

The court has the power to terminate a prolonged receivership that may impede an orderly winding-up. Under s 434B, a liquidator of a company that is wound up in insolvency may apply to the court for an order that a receiver cease to act. The court may make such an order only if it is satisfied that the objectives for which the receiver was appointed have been largely achieved.

## Voluntary administration

[29.60] The voluntary administration scheme is governed by the provisions of Pt 5.3A of the *Corporations Act*. There are two distinct phases of the voluntary administration scheme. The first phase begins with the appointment of a voluntary administrator. The second phase commences at the conclusion of a creditors' meeting that decides the company's future. Depending on the decision made by the creditors at this meeting, there is a transition from voluntary administration to either liquidation or deed of company arrangement.

The voluntary administration scheme is discussed in detail in Chapter 31.

### Aim of voluntary administration

[29.65] The aim of the voluntary administration provisions of the *Corporations Act* is to maximise the chances of the company or its businesses remaining in existence and, if this is not possible, to achieve a better return to creditors than would result from an immediate winding-up: s 435A; see also [31.10].

Voluntary administration aims to achieve a better return to creditors than would result from an immediate winding-up.

Voluntary administration involves the appointment of a registered liquidator as administrator. The administrator takes control of an insolvent company (see [31.65]–[31.75]) usually for a relatively short period of time: see [31.40]. An administrator's task is to investigate the affairs of the company (see [31.60]) and to report on whether a compromise or arrangement can be negotiated that would be acceptable to the company and its creditors: see [31.145]. Ultimately, however, the fate of the company is determined by its creditors, who have the final say as to what should happen to the company after voluntary administration ends. Under s 439C, creditors can choose whether:

- the company enters into a deed of company arrangement;
- the company is wound up; or
- the administration is terminated.

Voluntary administration is intended to be a more flexible form of external administration for an insolvent company than liquidation or a scheme of arrangement which is discussed at [29.155]. The voluntary administration procedure is quick to implement and is a relatively cheap form of insolvency administration. It is designed to facilitate the negotiation of compromises or other arrangements with an insolvent company's creditors and where appropriate, to provide for a smooth transition to liquidation with the minimum of expensive court cases and formal creditor or shareholder meetings.

### Who initiates voluntary administration?

[29.70] In most cases, the decision to put a company into voluntary administration is made by a company's directors and does not require approval of the shareholders, creditors or

the court: see [31.20]. Directors may appoint an administrator if they believe that the company is insolvent or is likely to become insolvent at some future time: s 436A(1).

Voluntary administration is usually initiated by the directors.

While it is relatively rare, a company may also be put into voluntary administration by its liquidator or a creditor who has an enforceable security interest over the whole, or substantially the whole, of a company's property: ss 436B and 436C; see [31.25]–[31.30].

## Why would directors initiate voluntary administration?

**[29.75]** Directors may decide to put their company into voluntary administration for a number of reasons. They may choose to do so to achieve a better outcome for shareholders and creditors. They may also be encouraged to take early action because of a number of legislative incentives.

The insolvent trading provisions encourage directors of companies in financial difficulties to appoint an administrator as soon as possible after the company becomes insolvent. Directors' personal liability to pay compensation for breaching s 588G arises only if their company goes into liquidation: s 588M. Directors may avoid personal liability if they put their company into voluntary administration and it executes a deed of company arrangement that is acceptable to creditors.

Even if a company is wound up, directors may avoid personal liability for contravening s 588G if, pursuant to s 588H(5), they can establish that they took all reasonable steps to prevent the company from incurring debts when there were reasonable grounds to suspect that it was insolvent. In determining whether the s 588H(5) defence has been proved, s 588H(6) directs the court to have regard to any action the director took with a view to appointing an administrator, when that action was taken and the results of the action.

Placing an insolvent company in voluntary administration may also be an attractive option for directors who have personally guaranteed their company's debts. While the company is under voluntary administration, s 440J prevents creditors from enforcing guarantees against directors: see [31.200]. Section 440J also prevents creditors from enforcing guarantees of company debts provided by a director's spouse or other relatives.

Income tax legislation may also have the effect of prompting directors to put their company into voluntary administration at an early stage. The pay as you go (PAYG) tax payment system requires employers to withhold tax attributable to employee wages and salaries and remit the withheld amounts to the Australian Taxation Office on a regular basis. Under ss 222ANA–222AQD of the *Income Tax Assessment Act 1936* (Cth), directors of a non-remitting employer company may be personally liable to pay an amount equal to the company's liability unless they come to an arrangement to ensure that the withheld amounts are remitted or ensure that the company goes into voluntary administration or liquidation.

If directors decide to appoint an administrator, they lose their rights to run the company unless they have the administrator's written approval: s 437C.



## Duration of voluntary administration

[29.80] The *Corporations Act* seeks to ensure that a company is under voluntary administration for a relatively short period of time – about four weeks: see [31.40]. The effect of this is to put pressure on all parties concerned to decide the company's future. Further, during voluntary administration there is a stay or moratorium on all claims against the company: see [31.175]–[31.200]. The short duration of administration ensures that creditors, particularly secured creditors, are not unduly prejudiced by the moratorium.

A company is usually under voluntary administration for a relatively short period of time.

Voluntary administration commences on the day an administrator is appointed: s 435C(1). One of the administrator's obligations is to call a meeting of the company's creditors to make a decision about the company's future: see [31.125]–[31.155]. The date an administration ends depends on the time that meeting is held and the nature of the decision creditors make at that meeting.

The creditors' meeting to decide the company's future must be held within five business days after the end of the "convening period": s 439A(2). The convening period is the period of 20 business days beginning on the day after administration begins: s 439A(5). The convening period is extended to 25 business days if the administration begins in December or is less than 25 business days before Good Friday. The court may also extend the convening period under either s 439A(6) or 447A. The period of voluntary administration can also be extended if creditors decide to adjourn their meeting. However, the adjournment cannot exceed 45 business days: s 439B(2).

At the creditors' meeting to decide the company's future, creditors have three alternatives: s 439C. They may resolve that the company execute a deed of company arrangement, the company be wound up or the administration should end.

Voluntary administration ends on the date of the creditors' meeting if the creditors resolve that the company should be wound up or if they decide to end the administration.

If creditors decide that the company should execute a deed of company arrangement, the deed must be executed by both the company and the administrator within 15 business days after the creditors' meeting. If the deed of company arrangement is executed, voluntary administration ends and the company becomes subject to the terms of the deed: s 444B(2). If the company fails to execute the deed within the 15-business day period, voluntary administration ends and the company is deemed to have entered into a creditors' voluntary winding-up: s 446A(2).

A difficulty with the voluntary administration scheme which often arises in the case of large companies with complex businesses is the extremely short-time limit imposed by the legislation for the completion of an administrator's investigations and report to creditors. In these cases, it is often necessary for the administrator to seek extensions of time.



## Role of the voluntary administrator

**[29.85]** Administrators take control of the company's affairs when they are appointed and directors lose their powers to manage even though they remain in office: see [31.65].

Administrators take control of the company's affairs.

Administrators must be registered liquidators: s 448B; see [31.45]. This ensures that administrators are experienced and skilled insolvency practitioners. Administrators must also be independent of the company, its officers, its creditors and the company's auditor: s 448C. From a creditor's perspective, an administrator's insolvency experience and independence is one of the advantages of the voluntary administration scheme because often creditors have lost trust and confidence in the abilities of an insolvent company's directors to manage its business.

One of the first tasks of an administrator is to convene a creditors' meeting within eight business days of appointment: s 436E. At this meeting, creditors have the opportunity to remove the administrator appointed by the directors and appoint someone else as a replacement: see [31.120]. At this meeting, creditors may also decide whether to appoint a creditors' committee of inspection to assist the administrator with matters relating to the administration and to monitor the administrator's conduct.

As soon as practicable after being appointed, the administrator must investigate the financial position and circumstances of the company: s 438A(a); see [31.60]. The administrator must then form an opinion as to whether it would be in the creditors' interests that the company enter into a deed of company arrangement, end the administration or wind up the company: s 438A(b).

Administrators must investigate the company and report to creditors.

Administrators are required to convene a second creditors' meeting within 20 business days of the "convening period". At this meeting, creditors are given the opportunity to decide the company's future: see [31.125]–[31.155]. To assist creditors in making their decision, s 439A(4)(a) requires the administrator to give creditors a report about the company's business, property, affairs and financial circumstances. As well as the administrator's recommendation about the future course for the company, the report must set out whether the administrator believes there are any voidable transactions that would be recoverable by a liquidator if the company were wound up. The administrator's report should also indicate whether directors breached their fiduciary or *Corporations Act* duties such as insolvent trading and the prospects of a liquidator recovering compensation from them.

## Effect of voluntary administration on creditors

**[29.90]** With some exceptions, while a company is under voluntary administration, there is a moratorium or stay of all claims or legal proceedings against the company and guarantors of its debts: ss 440A–440J; see [31.175]–[31.200].

During voluntary administration there is a moratorium or stay of all claims against the company.

The moratorium ensures that administrators have breathing space to carry out their task and prevents the piecemeal break-up of the company's property by individual creditors that may undermine the company to the detriment of the majority of its creditors.

During voluntary administration, secured creditors cannot enforce their security interests over the company's property except with the administrator's or court's consent: s 440B. Secured creditors' rights to enforce their security interests resume after voluntary administration ends unless they have agreed to a deed of company arrangement. Similarly, owners or lessors cannot recover possession of leased property during voluntary administration. Owners' and lessors' rights to repossess leased property resume after voluntary administration ends unless they have agreed to a deed of company arrangement.

A secured creditor with a security interest over the whole, or substantially the whole, of the property of a company has the ability to enforce the security interest within the "decision period" (s 441A) and personally take possession of the company's property or appoint a receiver. The "decision period" is defined in s 9 as being within 13 business days of the day administration begins or within 13 business days of the secured creditor being given notice of the administrator's appointment. Because of the powerful position of a creditor with security over all of a company's property, there is little point in requiring such a creditor to be subject to the moratorium and wait until the normal end of voluntary administration before they can enforce their security and take possession and sell the company's property.

## Deeds of company arrangement

**[29.95]** A deed of company arrangement is one of the possible outcomes for a company that is put into voluntary administration. The s 435A objects of the voluntary administration scheme – to save insolvent companies or their businesses or achieve a better return for their creditors than liquidation – are largely achieved by deeds of company arrangement.

The aims of the voluntary administration scheme are largely achieved by deeds of company arrangement.

A company becomes subject to a deed of company arrangement in the following manner. As discussed at [31.145], one of the key tasks of a voluntary administrator is to report to creditors on whether it would be in their interests that the company executes a deed of company arrangement. Other interested parties, such as directors or major shareholders, may also propose deeds of company arrangement. If creditors vote in favour of a proposed company arrangement and the company and the voluntary administrator execute the deed, voluntary administration ends: s 435C(2)(a). The company's voluntary administrator becomes the administrator of the deed unless the creditors appoint someone else: s 444A(2).

## Types of deeds of company arrangement

**[29.100]** The voluntary administration scheme allows for considerable flexibility as to the terms of a deed of company arrangement to enable the arrangement to meet the particular needs and circumstances of the company and its various creditors: see [31.235]–[31.250].

Common features of deeds of company arrangement.

Typically, deeds of company arrangement may have any one or more of the following features:

- provision for a moratorium under which the company has additional time to pay debts incurred prior to the commencement of voluntary administration. The company, under the control of the deed administrator, is permitted to continue operating its business;
- provision for a compromise under which the creditors agree to accept payment of a lesser amount in final settlement of their debts;
- a combination of a moratorium and compromise with creditors; and
- an orderly sale of all the company's property over an agreed period of time.

## Effect of deeds of company arrangement on creditors

**[29.105]** The moratorium that operates during voluntary administration terminates when a deed of company arrangement is executed. The creditors become subject to the provisions of the deed: see [31.275]–[31.290].

A deed of company arrangement binds all unsecured creditors.

A deed of company arrangement binds all unsecured creditors in relation to any claims that arose on or before the commencement of voluntary administration: s 444D(1). As a result, while the deed is in force, unsecured creditors are not permitted to apply to wind up the company or begin legal action to recover their debts without leave of the court: s 444E.

Secured creditors resume their rights to enforce their security and take possession of, and sell, secured property at the end of the voluntary administration moratorium.

Deeds bind secured creditors only if they voted in favour of the deed.

With some exceptions, secured creditors are bound by a deed only if they voted in favour of the deed: s 444D(2). As a result, the terms of a deed must be acceptable to secured creditors if the company needs to continue using secured property. Similarly, owners and lessors of property are bound by a deed only if they voted in favour of the deed: s 444D(3).

## Why would creditors agree to a deed of company arrangement?

**[29.110]** Under s 439C, the creditors, at the second creditors' meeting during voluntary administration, may resolve that the company execute a deed of company arrangement, that the company should be wound up or that administration should end. The voluntary administration scheme enables creditors to decide whether putting the company into liquidation or entering a deed of company arrangement produces a better outcome for them. This decision will include an assessment of the likelihood of a liquidator increasing the amount of the company's assets available for distribution to creditors by successful proceedings against directors for insolvent trading or other breaches of fiduciary or statutory duties.

In some cases, directors may be prepared to contribute to funds available for distribution to creditors in a deed of company arrangement from their own personal resources to avoid potentially higher claims brought by a liquidator. This is likely to be the case if, prior to the commencement of voluntary administration, directors have failed to prevent insolvent trading, have received unfair preferences, or have breached their fiduciary duties by not taking creditors' interests into account. In addition, directors may be willing to contribute their own funds to a deed of company arrangement to regain control over the company's business or purchase some or all of its assets, perhaps for a higher price than would be paid by outsiders. Directors may be in a better position to utilise the company's carry forward tax losses than third-party purchasers of the company's shares.

Creditors who supplied goods and services to a company prior to its voluntary administration may be induced to vote in favour of a deed if this results in the company continuing as a customer. Creditors may also vote in favour of a deed if they perceive that the company can trade its way out of financial trouble with more competent management provided by the deed administrator or a purchaser of the company's business.

## Limitations of voluntary administration scheme

**[29.112]** While the voluntary administration scheme has proved to be a frequently used insolvency process that facilitates the restructure of both large and small scale businesses, there are suggestions that the scheme has limitations. The Explanatory Memorandum to the Treasury Laws Amendment (2021 Measures No 5) Bill 2021 (Cth) observed that voluntary administration tended to be a high-cost process that:

may limit the usefulness of voluntary administration for small businesses especially. For small businesses, the high costs of voluntary administration can also consume most or all of the value of a small business's assets, making successful restructure difficult. The powers and expertise of an administrator for a large firm may not be in line with the needs of a distressed small business (who may simply need an avenue to pay down an outstanding debt). Small and family businesses may be especially reluctant to call in an external administrator to take over the running of a company, reducing the opportunity for a company to restructure early when it is more likely to be viable.

These considerations led to the government introducing the reconstruction process as a cheaper, less complex alternative to voluntary administration for insolvent small businesses.

# Reconstruction process for small companies

[29.113] The *Corporations Amendment (Corporate Insolvency Reforms) Act 2020* (Cth) inserted a new restructuring process into the *Corporations Act* and allows eligible insolvent companies, with the assistance of a restructuring practitioner, to retain control of their business, property and affairs while developing and entering a restructuring plan with creditors. The aim of a restructuring plan is to facilitate the repayment of existing debts to enable the company to stay in business and avoid being liquidated. While the restructuring process is largely modelled on the voluntary administration scheme, it provides a cheaper and swifter alternative to the one-size-fits-all voluntary administration scheme for small non-complex businesses. The restructuring process is discussed in detail in [31.390]–[31.475].

The restructuring process begins when the directors of an eligible company resolve to appoint a restructuring practitioner who must be a registered liquidator and independent of the company: ss 456B and 456C. The directors must also resolve that they have reasonable grounds for suspecting that the company is insolvent or likely to be insolvent at some future time.

|                     |
|---------------------|
| Eligible companies. |
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Restructuring may only be initiated for a company that satisfies certain eligibility criteria on the day the restructuring practitioner is appointed. A liabilities test is one of the eligibility criteria. A company satisfies this test if the company's total liabilities on the day, when restructuring begins, do not exceed the amount specified in the *Corporations Regulations* (currently \$1 million). There are other criteria that ensure that restructuring cannot be used to facilitate phoenix activity even if a company does not exceed the \$1 million liability test. A restructuring practitioner cannot be appointed to a company if it has already commenced other forms of external administration: s 453B(2).

|                           |
|---------------------------|
| Directors retain control. |
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Unlike the voluntary administration scheme, while a company is under the restructuring process, its directors retain control of its business, property and affairs: s 453K. Even though directors retain control of the company, they must obtain the restructuring practitioner's consent if the company purports to enter into a transaction or dealing outside its ordinary course of business: s 453L(2). The restructuring practitioner may only give consent if the restructuring practitioner believes on reasonable grounds that it would be in the interests of the creditors for the company to enter into the transaction or dealing: s 453L(6). Directors who fail to prevent the company incurring debts during restructuring are exempt from the insolvent trading prohibitions in relation to transactions in the ordinary course of business or for debts incurred with the restructuring practitioner's consent: ss 588GAAB and 588GAAC.

The restructuring practitioner's role is to facilitate and assist directors to develop a restructuring plan. A restructuring plan can only deal with debts incurred by the company prior to the beginning of restructuring.

Before a restructuring plan is made, the company must have paid all its employee entitlements and its taxation reporting obligations must have been substantially complied with: reg 5.3B.24. The requirement to have paid all employee entitlements that are payable does not require payment of amounts which may be owed but are not yet payable.

Under s 453J(1) the restructuring practitioner may terminate the restructuring if the restructuring practitioner believes on reasonable grounds that:

- the company does not meet the eligibility criteria for restructuring; or
- it would not be in the interests of the creditors to make a restructuring plan; or
- it would be in the interests of the creditors for the restructuring to end; or
- it would be in the interests of the creditors for the company to be wound up; or
- any other grounds prescribed by the *Corporations Regulations*.

The directors, with the assistance of the restructuring practitioner, may propose a restructuring plan to the creditors: s 455A(1). The company is taken to be insolvent once the plan is proposed to creditors: s 455A(2). Creditors can vote on the plan without the need for physical meetings. If the creditors approve the plan, the restructuring practitioner administers the plan in accordance with its terms. A restructuring plan terminates if the company's obligations under the plan have been fulfilled and all admissible debts or claims have been dealt with in accordance with the plan.

## Liquidation

**[29.115]** Liquidation (also called “winding-up”) is a form of external administration that ultimately results in the company being deregistered and ceasing to exist as a legal entity.

Liquidation is a form of external administration that ultimately results in the company being deregistered and ceasing to exist as a legal entity.

Liquidation is an orderly process under which the company's affairs are wound up, its property sold, debts owed to its creditors repaid to the extent the value of the company's assets allow and the surplus (if any) distributed among its shareholders.

The *Corporations Act* recognises two modes of liquidation:

- compulsory liquidation (by order of the court); and
- voluntary liquidation.

There are two forms of voluntary liquidation:

- members' voluntary winding-up (see [32.190]); and
- creditors' voluntary winding-up: see [32.195].

The common feature of all types of liquidations is the appointment of a registered liquidator.

The common feature of all types of liquidations is the appointment of a registered liquidator.

In this chapter, we are concerned with winding-up insolvent companies. Liquidation of such companies may take place in one of two ways. Creditors (or other eligible applicants, such as a director, ASIC, or a shareholder) may force the company into liquidation by obtaining a court order to this effect. This is referred to as “compulsory liquidation” (or “compulsory winding-up”). In a compulsory winding-up, the court appoints the liquidator.

A creditors’ voluntary winding-up does not require a court order. It may be initiated by the members passing a special resolution to wind up the company and it turns out the company is insolvent. A creditors’ voluntary winding-up is also one of the possible outcomes of a voluntary administration: s 439A. In such cases, the voluntary administrator becomes the liquidator: s 446A. The creditors then have the right to replace the liquidator previously appointed by the shareholders: s 499.

## Aims of liquidation

**[29.120]** The liquidation provisions of the *Corporations Act* aim to ensure that:

- creditors, particularly unsecured creditors, share equally and fairly in the distribution of an insolvent company’s insufficient assets;
- hopelessly insolvent companies cease trading for the good of the wider business community; and
- there is an investigation into an insolvent company’s affairs prior to the commencement of the winding-up for the purpose of discovering the reasons for the insolvency.

## Compulsory liquidation – winding-up in insolvency

**[29.125]** The provisions of Pt 5.4, ss 459A–459T regulate compulsory liquidation of an insolvent company. These provisions refer to liquidation in such circumstances as “winding-up in insolvency” (see [32.10]–[32.65]) to emphasise the distinction between the compulsory winding-up of solvent and insolvent companies. Compulsory liquidations of solvent companies usually involve disputes between shareholders and are discussed at [24.330]–[24.435].

Who may apply for a winding-up in insolvency?

Section 459P lists the persons who may apply to the court for a winding-up in insolvency: see [32.20]. The eligible applicants include creditors, the company, a contributory, a director and ASIC. The most common applicant who initiates a winding-up in insolvency is an unsecured creditor who has been unsuccessful in obtaining payment of a debt from the company. While secured creditors may also apply to the court for a winding-up order, this is rare because secured creditors are able to sell the secured property and repay their debt out of the proceeds.

There are several stages to obtaining a compulsory winding-up order, discussed in detail at [32.55]. A creditor or other eligible applicant must file an application to wind up a company with the court which will set a date for the application to be heard. An application for a winding-up in insolvency must be determined within six months after



it is made: s 459R. This gives sufficient time for the applicant to comply with other necessary requirements. These include serving a copy of the application on the company, lodging a copy of the application with ASIC and advertising the filing of the application in the prescribed manner.

At the hearing of the application, the court must be satisfied that the company is insolvent before it will make an order to wind the company up in insolvency. A creditor may prove that a company is insolvent in several ways: see [32.65].

Section 459C(2) contains several circumstances in which the court may presume that a company is insolvent: see [32.65]. These presumptions are designed to assist creditors to prove that a debtor company is insolvent for purposes of a winding-up application. For example, a company is presumed to be insolvent if it has failed to comply with a statutory demand (see [32.70]–[32.150]) that the creditor served on the company: s 459C(2)(a). This is the most common way that creditors prove insolvency.

A statutory demand is a formal document signed by a creditor that specifies the amount of the debt (at least \$4,000, “the statutory minimum”) owed by the company.

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|--------------------|
| Statutory demands. |
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The statutory demand must require the company to pay the amount demanded within 21 days after the demand is served on it: s 459E. If the company fails to comply with the demand 21 days after it is served, it is presumed to be insolvent for the purposes of the creditor’s subsequent application for winding-up in insolvency.

Some creditors serve statutory demands to pressure debtor companies into paying genuinely disputed debts. Some debtor companies try to delay paying by asserting they have a dispute about the debt even though this has no genuine merit. The *Corporations Act* takes the view that a winding-up hearing is not the appropriate forum for deciding the merits of disputed debts: see [32.150].

Section 459G allows a company to apply to the court for an order setting aside a statutory demand served on it. The company’s application to set aside may only be made within 21 days after service of the statutory demand. Under s 459H, the court may set aside a statutory demand if it is satisfied that there is a genuine dispute about the existence or amount of the debt or that the company has an offsetting claim against the creditor. The court also has the power to vary the demand if the “substantiated amount” of the debt is equal to or greater than the \$4,000 statutory minimum.

A creditor may also prove that a company is insolvent by providing evidence that a company is unable to pay its debts as and when they become due and payable: s 95A; see [32.60]. This is often difficult to prove in practice because the conclusion that a company is insolvent requires an examination of its entire financial position and ought not be drawn simply from evidence of a company’s temporary lack of liquidity. Insolvency is proved by evidence of a company’s inability to pay debts as they fall due from its cash resources or from selling or mortgaging its assets: *Sandell v Porter* (1966) 115 CLR 666.



## Creditors' voluntary winding-up

**[29.130]** Unlike a winding-up in insolvency, putting a company into a creditors' voluntary winding-up does not involve a court order. As discussed at [32.195], a company may enter into a creditors' voluntary winding-up in a number of different ways.

Transition from voluntary administration to a creditors' voluntary winding-up.

The *Corporations Act* provides for a smooth transition from voluntary administration to a creditors' voluntary winding-up. Under s 439C, creditors of a company under administration may resolve that the company be wound up. Creditors will pass such a resolution if they decide that a deed of company arrangement is not in their best interests. A company will also convert from being under voluntary administration to a creditors' voluntary winding-up if it contravenes s 444B(2) by failing to execute a deed of company arrangement that was approved by its creditors: s 446A(1)(b). A company that is subject to a deed of company arrangement also converts to a creditors' voluntary winding-up if its creditors pass a resolution terminating the deed and that the company be wound up: s 446A(1)(c).

A creditors' voluntary winding-up may also stem from a members' voluntary winding-up: see [32.195]. Where a shareholders' meeting is called to pass a special resolution to wind up the company under a members' voluntary winding-up, its directors are required to provide the shareholders with a declaration of solvency: s 494. The company must call a creditors' meeting if the declaration of solvency is not provided or if the directors form the view that the company is unable to pay its debts. The creditors' meeting must be held either on the day of the shareholders' meeting or the next day: s 497. If shareholders pass the winding-up resolution, it proceeds as a creditors' voluntary winding-up and the creditors have the ultimate say as to who will be the liquidator. A members' voluntary winding-up may also convert into a creditors' voluntary winding-up if the liquidator appointed by the members forms the opinion that the company is insolvent even though the directors made a solvency declaration.

Simplified liquidation.

**[29.132]** The *Corporations Amendment (Corporate Insolvency Reforms) Act 2020* introduced a new simplified liquidation process into the *Corporations Act* which allows small companies to go into a simpler, quicker and less costly liquidation which aims to provide greater returns to creditors, including employees, than the existing process. There are a number of eligibility requirements that must first be met. These include that the company must have less than \$1 million in liabilities, it must be in a creditors' voluntary winding-up and the company has complied with its taxation obligations. The process will not be adopted if creditors, holding at least 25 per cent in value of the company's debts, direct the liquidator not to do so.

Under the simplified process, certain general liquidation provisions are not applicable. These include the need to prepare a liquidator's report to ASIC under s 533 about suspected contraventions of the *Corporations Act* and the requirement to hold physical meetings of creditors, instead information can be provided and voting conducted electronically. Unfair preferences are only voidable if they occurred within three months before the relation-back day unless a creditor under the transaction was a related entity of the company and the value of the transaction was more than \$30,000. The simplified process must stop if the liquidator finds reasonable grounds to believe that a director, or the company, has engaged in conduct that has had a material adverse effect on the interests of creditors.

## Powers of a liquidator

**[29.135]** When a company is placed in liquidation, the liquidator takes control of the company: see [32.275]–[32.280]. Sections 477 and 506 give liquidators extensive powers. These include the ability to:

- carry on the company's business so far as is necessary for the beneficial disposal or winding-up of that business;
- sell all or any part of the company's property; and
- bring or defend legal proceedings in the name of the company.

Liquidators are given extensive powers to access company books and obtain information from the officers and employees: ss 477(3), 483(1) and 530A. In addition, anyone who may be able to provide information and assistance about insolvent companies can be summoned by the court to attend an examination of an inquisitorial nature under ss 596A and 596B. Liquidators often initiate such examinations to:

- facilitate the recovery of property belonging to the company;
- discover whether the conduct of directors and officers led to the company's insolvency; and
- investigate possible causes of action against third parties.

## Effects of winding-up on the company and on creditors

**[29.140]** Winding-up has a significant impact on unsecured creditors: see [32.200]–[32.203]. Prior to liquidation, all creditors are free to pursue their own legal action to enforce payment of their debts. This right is lost once liquidation commences.

Creditors' rights after commencement of winding-up.

A creditor's pre-liquidation right to enforce its debts through legal action is replaced by an orderly, collective process controlled by the company's liquidator.

**Table 29.1: Effects of winding-up on the company and on creditors**

| The company                                                                                                                                           | Creditors                                                                                                                                                                                                                  |
|-------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"> <li>• A company continues to exist as a legal entity even though it has been placed into liquidation.</li> </ul>   | <ul style="list-style-type: none"> <li>• Secured creditors are largely unaffected by the winding-up of a debtor company. Creditors' rights to take possession and sell secured property are unaffected: s 471C.</li> </ul> |
| <ul style="list-style-type: none"> <li>• Liquidators take complete control of the company.</li> </ul>                                                 | <ul style="list-style-type: none"> <li>• Unsecured creditors must lodge a proof of debt and are entitled to a distribution only after secured creditors have been paid in full.</li> </ul>                                 |
| <ul style="list-style-type: none"> <li>• Directors lose their powers to manage the company's affairs.</li> </ul>                                      | <ul style="list-style-type: none"> <li>• Unsecured creditors generally participate in distributions on the basis of receiving equal proportions of their debts.</li> </ul>                                                 |
| <ul style="list-style-type: none"> <li>• Shareholders lose their right to transfer shares and cannot pass resolutions at general meetings.</li> </ul> |                                                                                                                                                                                                                            |

## Division of assets

**[29.145]** One of the main tasks of a liquidator is to sell the company's property and divide the proceeds among the persons who are entitled.

Creditors are paid ahead of shareholders.

A fundamental principle of insolvency law is that creditors are paid first and then the surplus (if any) is divided among the company's shareholders.

Creditors must prove their debts before they are entitled to share in the division of the company's assets: see [32.645]–[32.665]. If there are sufficient funds available, a creditor whose proof of debt is admitted by the liquidator is repaid in full. Such repayments are referred to as “dividends”. Generally, secured creditors are unaffected if the debtor company goes into liquidation and are not obliged to prove their debts. Secured creditors retain their rights to sell the secured property and repay themselves out of the proceeds.

Unsecured creditors generally participate equally in the distribution of the company's assets.

The policy of the *Corporations Act* is that all unsecured creditors with provable debts participate equally in the distribution of the company's assets on a winding-up. If there are insufficient funds available to meet them all in full, they are paid proportionately. This is called the “*pari passu* rule”: see [32.670].

Certain unsecured debts are given preferential treatment by ss 556–564 and have priority in repayment ahead of all other unsecured debts: see [32.675].

While these statutory priorities detract from the *pari passu* rule, they are justified because they assist an orderly winding-up and the public acceptance of the fairness in recognising the special position of employees of an insolvent company.

Section 556 ranks certain categories of preferential debts in order of priority of repayment. If there are sufficient funds to pay preferential debts in the first rank, they are paid in full. If there is a surplus, it is distributed to the next rank of preferential debts and so on. Where there are insufficient funds to pay all preferential debts within a particular rank, those creditors are repaid an equal proportionate amount.

## Recovery of pre-liquidation transactions

**[29.150]** Certain transactions between an insolvent company and other persons entered into before the commencement of winding-up can have the effect of reducing the amount available for distribution to creditors when the company is wound up.

Once appointed, a liquidator may apply to the court for orders making certain pre-liquidation transactions voidable and recover the value of any property lost as a result of the transaction for the benefit of the general body of unsecured creditors of the company.

The various types of pre-liquidation transactions are discussed at [32.475]–[32.615]. In this chapter, we only consider unfair preferences and uncommercial transactions.

### Unfair preferences.

Under s 588FA(1), a transaction that takes place prior to the commencement of winding-up between a company and a creditor is an unfair preference if it results in the creditor receiving, in respect of a debt owed to the creditor, more than the creditor would receive in respect of the debt if the transaction were set aside and the creditor were to prove for the debt in a winding-up: see [32.485]. Repaying all or part of a debt due to an unsecured creditor is an example of an unfair preference. To the extent that an unsecured debt is repaid prior to liquidation, the creditor receives 100 per cent of the amount repaid. If the repayment did not occur and the company went into liquidation due to its insolvency, the unsecured creditor would have been entitled to share *pari passu* with other creditors of equal rank. As a result of being repaid prior to liquidation, the repaid unsecured creditor receives an advantage over the company's other unsecured creditors. This is contrary to the *pari passu* rule that provides for equal treatment of creditors in a winding-up.

### Uncommercial transactions.

Under s 588FB(1), a transaction of the company that occurs prior to the commencement of winding-up is an uncommercial transaction if it may be expected that a reasonable person in the company's circumstances would not have entered into the transaction: see [32.520]. Examples of uncommercial transactions include gifts made by the company,

sales of company property for significantly less than market value and company purchases at significantly more than market value. Section 588FB is designed to prevent pre-liquidation disposals of company property that result in the recipients receiving a gift or obtaining a bargain of such magnitude that cannot be explained by normal commercial practice.

#### Insolvent transactions.

Before a liquidator can avoid a transaction as an unfair preference or uncommercial transaction, the liquidator must satisfy the court that it was an insolvent transaction and a voidable transaction as defined in ss 588FC and 588FE, respectively. An unfair preference or uncommercial transaction is an insolvent transaction (see [32.585]) if it was entered into at a time when the company was insolvent or the company became insolvent because of entering the transaction. A company is insolvent if it is unable to pay its debts as and when they fall due: s 95A. The s 588E presumptions of insolvency assist a liquidator in proving that a company was insolvent for purposes of establishing that a transaction was an insolvent transaction.

An insolvent transaction is regarded as a voidable transaction if it was entered into during a certain period prior to the “relation-back day” as defined in s 9 and discussed at [32.590]. In the case of a court-ordered winding-up, the relation-back day is the date of filing the application for winding-up with the court. Section 588FE sets different time periods prior to the relation-back day depending on whether the insolvent transaction is an unfair preference or an uncommercial transaction.

An insolvent transaction that is an unfair preference is a voidable transaction if it was entered into either during the six months ending on the relation-back day or between the relation-back day and the day the winding-up commenced: s 588FE(2).

#### Voidable transactions.

An insolvent transaction that is an uncommercial transaction is a voidable transaction if it was entered into during the two years ending on the relation-back day: s 588FE(3). If a “related entity” (defined in s 9) is party to an insolvent transaction, it is a voidable transaction if it was entered into during the four years ending on the relation-back day: s 588FE(4).

There are several other types of voidable transactions such as unfair loans (s 588FD), unreasonable director-related transactions (s 588FDA), transactions to defeat creditors (s 588FE(5)) and creditor-defeating dispositions (s 588FDB): see [32.545]–[32.567].

Under s 588FE, the court may make a variety of orders where it is satisfied that a transaction was a voidable transaction: see [32.595]. For example, where the voidable transaction was an unfair preference, the court can order that the creditor refund the company money the creditor was paid under the transaction. A creditor who does this then stands in line with the other unsecured creditors and may prove for the debt in the winding-up.

Section 588FG(2) protects persons who are parties to a voidable transaction: see [32.600]–[32.610]. The court cannot make a s 588FF order prejudicing the rights or interests of a person who:

- became a party to the voidable transaction in good faith; and
- had no reasonable grounds for suspecting that the company was insolvent; and
- provided valuable consideration under the transaction or changed their position in reliance on the transaction.

## Deregistration

**[29.153]** The final outcome of a liquidation is that the company is deregistered from the register of companies. ASIC may deregister a company on the application of its liquidator or directors if it is not carrying on business and has few assets and no liabilities. ASIC may also initiate the deregistration of a company if it has not lodged documents and does not appear to be carrying on business.

## Schemes of arrangement

**[29.155]** The arrangement and reconstruction provisions of Pt 5.1, ss 410–415 regulate schemes of compromise or arrangement. Such schemes are a form of external administration that enables the rights and liabilities of shareholders and creditors of a company to be reorganised. The aim of a scheme of arrangement is to obtain a binding agreement that modifies, reorganises or alters the legal rights of creditors and shareholders.

Schemes of arrangement may take several different forms. A scheme may involve a moratorium or compromise of creditors' claims against a debtor company with the company being managed by an independent insolvency practitioner as scheme administrator. A scheme may also provide for a "debt for equity swap" in which creditors take up shares in a debtor company. Schemes of arrangement are also used in a non-insolvency context to facilitate a merger between two or more companies. In this context, a scheme of arrangement may be used as an alternative to a takeover.

Setting up a scheme of arrangement is a complex, expensive and time-consuming process. The *Corporations Act* does not regulate the types of schemes that can be established. Instead, the legislation provides a mechanism for initiating a scheme, obtaining approval of the scheme and detailed procedural requirements for the duration of an approved scheme.

To a large extent, the voluntary administration provisions of Pt 5.3A, particularly those that deal with deeds of company arrangements, can achieve similar outcomes for insolvent companies and their creditors as moratorium and compromise schemes of arrangement. The voluntary administration is a far more efficient means of dealing with companies in financial difficulties than schemes of arrangement because voluntary administration is swifter, cheaper and more flexible.

A moratorium currently operates in the case of voluntary administrations (see [29.90] and [31.175]) and while a restructuring plan is being developed: see [31.415].

Initiating a scheme of arrangement is expensive because it requires an application to be made to the court for an order to convene meetings of shareholders and creditors. A draft explanatory statement that explains the effect of the proposal must be provided to the court and a copy given to the company's shareholders and creditors and ASIC. If the court is satisfied with the draft explanatory statement, it will order that the various meetings be held. At these meetings, the various parties consider and vote on a proposed scheme. If the necessary shareholder and creditor approvals are obtained, there must be another court hearing to obtain formal court approval of the scheme. The court considers whether the proposed scheme is fair and equitable between the different classes of shareholders and creditors.

**[29.160]** A scheme of arrangement may be approved by the court even though it may be inconsistent with and overrides the constitution of the company: *Ashton Millson Investments Ltd v Colonial Ltd* [2001] VSC 183. However, in *Re White Horses Pty Ltd (No 2)* [2016] QSC 282, the court refused to approve a scheme of arrangement that would have had the effect of varying class rights without affording particular classes of shareholders the protection of s 246B(2). Variation of class rights is discussed at [8.155]–[8.195].

## Tutorial questions

*There are additional tutorial questions on various aspects of corporate insolvency at the end of Chapters 31 and 32.*

Vandalay Chocolate Sprouts Pty Ltd, which operated its business from a factory it rented from Industrial Park Ltd, had been experiencing extreme financial difficulties and its financial records were a hopeless mess. It was continually late in paying debts owed to its suppliers and employees' wages. With Christmas coming up, its directors were uncertain whether the company would be able to pay its employees their holiday pay entitlements.

The company's main creditors were:

- its bank, which is owed \$1 million. This loan was unsecured but was guaranteed by the directors of Vandalay Chocolate Sprouts Pty Ltd;
- Industrial Park Ltd, which was owed \$75,000 arrears of rent; and
- its employees, who were owed \$350,000 unpaid wages.

About three months ago, the company was paid \$100,000 by one of its customers. This was deposited into the company's bank account, reducing the amount due to the bank.

How would each of the creditors referred to above be affected if Vandalay Chocolate Sprouts Pty Ltd were placed in voluntary administration? Would your answer be different if the company was wound up in insolvency? Explain.

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.
- For further corporations law links and material please refer to the Understanding Company Law website at <http://www.uclaw.com.au>.



## Chapter 30

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# Receivership

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## Key points

- A company enters receivership when a receiver or a receiver and manager is appointed in respect of some or all of its property.
- Receivership is a form of administration of a company's property that involves the appointment of an independent, qualified insolvency practitioner as a receiver. The role of a receiver appointed by a secured creditor is to take possession of secured property, sell it and, out of the proceeds, repay the secured debt owed by the company.
- Appointing a receiver enables a secured creditor to enforce rights in relation to a secured debt without recourse to the courts.
- Where the secured property includes the business of a debtor company, the terms of a debenture or other secured loan agreement generally give a receiver wide power to manage the business of the company. This is done to maximise the return to the secured creditor. Such a receiver is known as a "receiver and manager".
- The court may also appoint a receiver. Such appointments, while rare, are usually made where the secured assets are in jeopardy. A court-appointed receiver is usually appointed for specific purposes and for a limited duration.
- Receivers are given wide powers in carrying out their roles. An important power is to sell the company's secured property for the purpose of discharging the secured debt. Receivers are under a statutory duty to take reasonable care in selling secured property. Receivers also owe a common law duty to the debtor company to exercise the power of sale in good faith. Receivers are included in the definition of "officer" and are therefore subject to the duties imposed on officers such as directors.
- Where a receiver is appointed over property secured by a circulating security interest, the receiver must repay certain unsecured debts ahead of the amount owed to the secured creditor with the circulating security interest. These include specified employee entitlements such as unpaid wages.
- Receivers are liable for certain debts incurred by them in the course of the receivership. This encourages outsider parties to continue dealing with a company in receivership and enables the receiver to carry on the company's business. As an agent of the company, a receiver is entitled to be reimbursed by the company. A receiver will also generally obtain an indemnity from the appointing creditor to be further protected from personal liability.

## Receivers and controllers

**[30.05]** Receivership is a form of administration of a company's property that involves the appointment of an independent, qualified insolvency practitioner called a "receiver". The role of a receiver appointed by a secured creditor is to take possession of secured property, sell it and, out of the proceeds, repay the secured debt owed by the company. Receivership therefore enables a secured creditor to enforce rights in relation to the debt without recourse to the courts.

A receiver's role is to take possession of secured property and repay the secured debt owed by the company.

Since a company is not necessarily insolvent just because a receiver of the company's property has been appointed, s 5-20 of the *Insolvency Practice Schedule (Corporations)* does not regard a company to be under external administration merely because a receiver, receiver and manager, or other controller has been appointed in relation to property of the company.

ASIC and the Australian Restructuring Insolvency & Turnaround Association publish joint information sheets for creditors (INFO 54) and employees (INFO 55) that give an overview of receivership. These information sheets are available on the ASIC website and are linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources>.

## Receivership

**[30.10]** A company enters receivership when a receiver is appointed in respect of some or all of its property. Sections 416–434 contain provisions that apply when a company enters receivership or an agent for a mortgagee in possession takes control of its property. These provisions, however, are not an exclusive statement of the law concerning receiverships, as certain aspects are left to the general law.

A receiver is a person who is appointed to collect and receive the debts and other property belonging to another person.

The *Corporations Act* does not comprehensively define the term "receiver". At common law, a receiver is a person who is appointed to collect and receive the debts and other property belonging to another person. "Receivership" is not a term that applies exclusively to company law. A receiver can be appointed whenever an impartial person is required to collect and receive debts and other assets. For example, a receiver may be appointed to collect the property of a partnership pending the resolution of disputes between the partners.

Debenture trust deeds usually provide for the appointment of a receiver if the company defaults in its obligations under the trust deed. In such cases, receivership is a method of enforcing a debenture. The receiver collects and sells the property secured by the debenture on behalf of the debenture-holders and distributes the proceeds to

them. However, a receiver can be appointed in circumstances other than pursuant to a debenture. The circumstances when a receiver can be appointed are discussed at [30.35].

## Distinction between “receiver” and “receiver and manager”

[30.15] Both the *Corporations Act* and the general law distinguish between a “receiver” and a “receiver and manager”. The distinction between these terms was explained in *Re Manchester & Milford Railway Co* (1880) 14 Ch D 645. Lord Jessel MR stated:

“A receiver” is a term which was well known in the Court of Chancery, as meaning a person who receives rents or other income, paying ascertained outgoings, but who does not, if I may say so, manage the property in the sense of buying or selling or anything of that kind ... If it was desired to continue the trade at all it was necessary to appoint a manager, or a receiver and manager as it was generally called. He could buy and sell and carry on the trade ... So that there was a well-drawn distinction between the two. The receiver merely took the income and paid necessary outgoings and the manager carried on the trade or business.

A receiver and a receiver and manager are included in the s 9 definition of “officer”.

Both a receiver and a receiver and manager of the property of a corporation are included in the s 9 definition of “officer”. Under s 90, a receiver of the property of a body corporate is deemed to also be a manager of the corporation if that person manages the affairs or has power under the terms of the appointment to manage the affairs of the body corporate.

It is usual for receivers to be appointed with wide management powers. Further, s 420 gives wide powers to all receivers, including the power to carry on the business of the corporation. For the purposes of Pt 5.2, ss 416–434, a receiver in relation to property of a corporation includes a receiver and manager unless a contrary intention appears.

## Controllers and managing controllers

[30.20] Where a debtor company defaults under a secured loan agreement, a secured creditor may also take possession of secured property personally. The secured creditor is referred to as a “mortgagee in possession” and, like a receiver, comes within the s 9 definition of “controller”.

A controller is a receiver or someone who acts in a similar role.

Under s 9, a “controller” in relation to property of a corporation is:

- a receiver, or receiver and manager, of that property; or
- anyone else who (whether or not as agent for the corporation) is in possession or has control of that property for the purpose of enforcing a security interest.

Secured creditors usually appoint an agent to act on their behalf rather than act personally (called an “agent for a mortgagee in possession”). In many respects, the roles of a receiver

and agent for a mortgagee in possession are similar and both come within the definition of “controller”.

Some provisions apply only to “managing controllers”. These are defined in s 9 as being receivers and managers or other controllers who have the power to manage the corporation to which they are appointed, rather than merely taking possession of the secured property.

## Who may be a receiver?

**[30.25]** A receiver must be a registered liquidator: s 418(1)(d). This requirement ensures that a receiver has appropriate educational qualifications and experience. The registration of liquidators is discussed at [32.225]. Only natural persons can become registered liquidators and hence receivers. However, certain authorised corporations, such as authorised trustee companies, may act as receivers, even though they are not registered liquidators: s 418(3).

|                                                |
|------------------------------------------------|
| Persons disqualified from acting as receivers. |
|------------------------------------------------|

Section 418(1) disqualifies certain persons from being appointed or acting as receiver of the property or part of the property of a corporation. The purpose of these disqualifications is to ensure that a receiver is independent of the company and its secured creditors. The disqualified persons are:

- a mortgagee of any property of the corporation;
- an auditor or a director, secretary, senior manager or employee of the corporation;
- a director, secretary, senior manager or employee of any body corporate that is a mortgagee of any property of the corporation;
- a director, secretary, senior manager or employee of a body corporate related to the corporation; or
- a person who has, at any time within the immediately preceding 12 months, been a director, secretary, senior manager or employee or promoter of the corporation or of a related body corporate. ASIC may, if it thinks fit, waive this exclusion.

## Appointment of a receiver

**[30.30]** A receiver or receiver and manager can be appointed in a number of ways, but is usually appointed by either secured creditors, such as debenture-holders, or by the court.

### Appointment by secured creditors

**[30.35]** Debenture trust deeds and other secured loan agreements usually provide for the appointment of a receiver or receiver and manager if the company defaults in its obligations. The *Corporations Act* refers to the appointment of a receiver in such circumstances as an appointment under an instrument. The appointment of a receiver

by secured creditors is also referred to as a “private appointment” or an appointment “out of court”.

Circumstances which trigger the right to appoint a receiver.

A debenture trust deed usually gives debenture-holders or their trustee the power to appoint a receiver if the borrowing company defaults in paying any due instalment. Most debentures also allow a receiver to be appointed in a wide variety of situations. For example, it is quite common for a trust deed to permit a receiver to be appointed if:

- the company ceases to carry on its business or is operating at a loss;
- any person files an application to wind up the company;
- the company reduces its capital; or
- the security is put at risk by a failure to maintain or insure it. In cases where large corporations become insolvent, it may be advantageous for the debenture-holder to appoint more than one receiver and manager to act jointly and severally. The appointment of joint and several receivers must be specifically authorised by the debenture deed: *Kendle v Melsom* [1998] HCA 13.

In *NZI Securities (Aust) Ltd v Poignand* (1994) 51 FCR 584, the court stated:

a receiver is appointed when the document of appointment is handed to the receiver by a person having authority to appoint in circumstances in which it may fairly be said that he was appointing the receiver and where the receiver accepts the appointment.

The formalities for the appointment of a receiver are governed by general law, which does not require the appointment to be under the company seal.

### *Defective appointment*

**[30.40]** Secured creditors must comply strictly with the terms of the debenture or other security agreement when appointing a receiver. However, a secured creditor may misstate the grounds for appointment of a receiver but still make a valid appointment on other grounds that existed at the time of appointment. The secured creditor does not have to possess knowledge of these grounds at the time of appointment: *Retail Equity Pty Ltd v Custom Credit Corp Ltd* (1991) 9 ACLC 404. Where a receiver discovers a breach of the debenture, this may be relevant to justify the receiver’s appointment: *Canberra Advance Bank Ltd v Benny* [1992] FCA 823.

If there is some defect in the appointment, a receiver who takes possession of the secured property may be liable in damages to the company as a trespasser. An appointment of a receiver may also be ineffective because of some defect in the debenture or security agreement itself. For example, as discussed at [11.205], under s 588FL a secured party’s security interest in personal property vests in the grantor company (and therefore the secured party loses the right to enforce their security interest) where the company goes into liquidation, voluntary administration, executes a deed of company arrangement, a restructuring practitioner is appointed or the company makes a restructuring plan

(referred to as the “critical time”) if the security interest was perfected, registered or became enforceable against a third party after the latest of:

- six months before the critical time; or
- 20 days after the security agreement came into force; or
- a later time ordered by the court under s 588FM.

Section 588FP affects the validity of the appointment of a receiver pursuant to a security interest granted by a company in favour of its officers or their associates: see [11.150]–[11.170]. Under that section, a security interest granted by a company is void if the secured party is an officer, a former officer or a person associated with the officer or former officer *and* the secured party purports to take a step to enforce the security interest within six months after it is made without leave of the court. The appointment of a receiver (or the entry into possession of the secured property for purposes of enforcing the security interest) is regarded as “a step in the enforcement of the security interest”: s 588FP(3). A court may grant leave for the security interest to be enforced if it is satisfied that the company was solvent at the time the security interest was granted and it is just and equitable for the court to do so: s 588FP(4).

### *Declaration of validity of appointment*

**[30.45]** Section 418A allows a receiver, a mortgagee who has entered into possession, the corporation or any of its creditors to apply to the court for an order declaring whether the appointment or the entry into possession was valid. The appointment or entering into possession may be invalid either because the security agreement creating the security interest itself was invalid or the appointment or entering into possession was invalid under an otherwise valid security agreement.

### *Relief where receiver improperly appointed*

**[30.50]** Section 419(3) protects receivers and other controllers from being sued because of some defect in their appointment. That provision gives the court power to grant relief to an improperly appointed controller if it is satisfied that when the person assumed control of the corporation’s property there was a reasonable belief that the appointment was proper. Where this is the case, the court may transfer liability for the improper appointment to the person who made the improper appointment.

Despite the protection afforded by s 419(3), prudent receivers also usually obtain an indemnity from the secured creditor to protect themselves from being personally liable because of a defective appointment or invalid debenture.

### *Ipsso facto clauses*

**[30.51]** Section 434J stays the enforcement of rights against a company that amend or terminate an agreement because of the appointment or existence of a managing controller (managing controller includes a receiver and manager) over the whole or substantially the whole of the company’s property. Clauses in an agreement that purport to terminate or amend existing rights are referred to as *ipso facto* clauses. Such clauses

may reduce the scope for a successful restructure or prevent the sale of the business as a going concern. In addition, s 434J also imposes a stay of *ipso facto* clauses where a company is placed into voluntary administration or where the company has been the subject of a formal restructure such as a Pt 5.1 scheme of arrangement where that scheme is for the purpose of avoiding insolvent liquidation. *Ipso facto* clauses in the context of voluntary administration are discussed at [31.201].

## Appointment by the court

### *ASIC application: s 1323*

**[30.55]** Section 1323(1)(h) allows ASIC to apply to the court for the appointment of a receiver of the property of a person or a company:

- where an investigation is being carried out under the *ASIC Act* in relation to an act or omission by a person that constitutes an offence under the *Corporations Act*;
- where a prosecution has been instituted against a person for a contravention of the *Corporations Act*; or
- where a civil proceeding has been instituted against a person under the *Corporations Act*.

The court may appoint a receiver if it considers it necessary to protect the interests of any persons to whom the company may be liable.

The court may appoint a receiver if it considers it necessary or desirable to do so for the purpose of protecting the interests of any persons to whom the company may be liable. The appointment of a receiver under s 1323(1)(h) is a drastic step not to be taken lightly. The person seeking the remedy must show that the interests of the persons to whom the company is or may become liable require protection and a lesser remedy would be inadequate: *Beach Petroleum NL v Johnson* [1993] FCA 392.

Section 1323(1) also enables the court to make other orders apart from the appointment of a receiver. The purpose of the section is to freeze property of a person where there is an investigation being carried out by ASIC into conduct that contravenes or may contravene the *Corporations Act*. The freezing of the property is to benefit a person who may bring an action based on a breach of the legislation by providing property against which judgment may be enforced.

The powers of a receiver appointed under s 1323(1)(h) are limited to preventing a company from dealing with its property and do not extend to sales of assets and investigations to determine whether offences had been committed: *ASC v Aust-Home Investments Ltd* (1993) 112 ALR 683. Section 1323 is also discussed at [28.45].

### *Where it is just and convenient*

**[30.60]** A receiver or receiver and manager may also be appointed by a State or Territory Supreme Court pursuant to provisions in legislation governing the jurisdiction of such courts. For example, s 62 of the *Supreme Court Act 1958* (Vic) gives the court power to



appoint a receiver where it appears to be “just and convenient” to do so. This enables the court to appoint a receiver on the application of a mortgagee if the company defaults in payment of the secured debt.

The court may appoint a receiver where the secured property is in jeopardy.

The court can also appoint a receiver where the secured property is in jeopardy, even though the company has not defaulted or the events that justify the appointment of a receiver by debenture-holders have not yet occurred. For example, the property may be in jeopardy if the company's unsecured creditors threaten liquidation proceedings. The court may also appoint a receiver when a company defaults under several debentures and it would be more convenient to have the one person acting in relation to all the debentures.

*Bond Brewing Holdings Ltd v National Australia Bank Ltd* [1991] 1 VR 386

[30.65] It was held that the court did not have the power to permit an unsecured creditor of a company in financial difficulties to apply for the appointment of a court-appointed receiver to manage the affairs of the company in the absence of consent or non-opposition from the company. Even where the company or a friendly creditor applies for such an appointment, it would not be made unless the court was satisfied that the substantial body of creditors supported it.

[30.70] In most cases, the person appointed by order of the court is appointed as a receiver and manager. Because of the courts' general reluctance to interfere in the internal management of companies, the duration of a receiver's appointment is relatively short. The appointment is usually made for a specific purpose such as the sale of the company's business as a going concern, the investigation of the conduct of directors or to safeguard the company's assets.

The court has a discretion to extend the period of receivership even where the grounds upon which the appointment was made have gone. If there is a reasonable expectation that a claim will be made, it may be necessary to retain the security that the receivership gives until the claim is dealt with: *Corporate Affairs Commission v ASC Timber Pty Ltd* (1993) 11 ACLC 141. In this case, a receivership was extended for six months to allow a liquidator and ASIC reasonable time to make a claim.

Section 427 requires a person who obtains a court order for the appointment of a receiver or appoints a controller under powers contained in a security agreement, or for the purpose of enforcing a security interest, to lodge a notice to this effect with ASIC within seven days of the order or appointment.

## Privately appointed and court-appointed receivers

[30.75] Privately appointed receiver managers have different functions from court-appointed receiver managers. In *Duffy v Super Centre Development Corp Ltd* [1967] 1 NSW

382, a privately appointed receiver's function was described as making an effort to restore the financial prosperity of the company. Whereas a court-appointed receiver's function is not that of a company "doctor", but rather that of a company "caretaker" who preserves the company's assets.

A court-appointed receiver manager is regarded as an officer of the court. This is also the case with a liquidator appointed by order of the court. Court-appointed receivers and managers are under more stringent duties than receivers appointed out of court. The duties of receivers are discussed at [30.125]–[30.185]. Debentures usually provide for the appointment of a receiver or receiver and manager to avoid the legal costs associated with applications to the court for an appointment.

## Effect of appointment

**[30.80]** The appointment of a privately appointed receiver does not affect the legal personality of the company, nor does it displace the board of directors. The company continues to be the legal owner of the secured property even though a receiver is appointed and takes possession of that property. The appointment of a receiver and manager or other controller does, however, affect the ability of the directors to exercise their powers of management.

Despite the appointment of a receiver and manager or controller, the directors retain certain powers. They can still initiate legal proceedings in the name of the company under s 418A to challenge the validity of the appointment of the receiver or other controller.

*Deangrove Pty Ltd v Commonwealth Bank of Australia* [2001] FCA 173

**[30.85]** It was held that where a company in receivership has a claim against the debenture-holder and the receiver declines to pursue the claim, the directors are entitled to initiate and maintain proceedings in the name of the company, provided the directors offer the company a satisfactory indemnity against the costs. The requirement for an indemnity against cost is designed to ensure that the interests of the debenture-holder are not prejudiced.

**[30.90]** The ability of a company to continue its business will generally be greatly restricted after the appointment of a controller. The appointment itself will usually trigger the conversion of a circulating security interest in property into a non-circulating security interest. This revokes the power of the company to deal with its secured assets in the ordinary course of business. The directors retain greater residual powers where the controller has control over only part of the company's assets.

While a receiver and manager may supersede the board, the directors are still subject to the duties imposed by the *Corporations Act*. For example, they are still responsible for the preparation and lodgment of annual financial reports.

## Powers of a receiver

### Source of receivers' powers

**[30.95]** Privately appointed receivers, receivers and managers and other controllers derive their powers from the debentures or security agreements under which they were appointed. Court-appointed receivers or receivers and managers have those powers granted to them by the court that appointed them.

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|--------------------------------|
| Statutory powers of receivers. |
|--------------------------------|

Section 420(2) gives certain specific powers to receivers in addition to those conferred upon them by the terms of the court order or instrument under which they were appointed. These powers are conferred for the purpose of enabling receivers to attain the objectives for which they were appointed. The inclusion of statutory powers alleviates many of the problems that may arise from poorly drafted debentures.

Under s 420(2), a receiver has powers to:

- enter into possession and take control of property of the corporation;
- lease, let or hire or dispose of property of the corporation;
- borrow money on security of property of the corporation;
- convert property of the corporation into money;
- carry on any business of the corporation;
- execute any document, bring or defend any proceedings or do any other act or thing in the name of and on behalf of the corporation; and
- make an application for the winding up of the corporation in the name of the corporation. The courts interpret the power to carry on the company's business in a broad way so as to enable a receiver and manager to enter into any transactions that are advantageous to the company.

The powers listed in s 420(2) apply to both court- and privately appointed receivers unless the terms of the court order or instrument under which they were appointed specify otherwise. In addition, s 420(1) confers upon a receiver the general power to do all things necessary or convenient to be done for, or in connection with, or as incidental to, the attainment of the objectives for which the receiver was appointed.

### Power to sell assets secured by prior security interest

**[30.100]** A managing controller of property of a corporation may apply to the court for an order authorising the sale of specified property even though it is subject to a prior security interest that has priority over the controller's security interest in that property: s 420B(1). The court may only make such an order if satisfied that the sale is in the best interests of the corporation and its creditors and will not unreasonably

prejudice the rights or interests of the party with the prior security interest. In order to obtain a court order under s 420B, the controller must have the power to sell the property, apart from the existence of the prior security interest and the controller must have unsuccessfully attempted to obtain the consent of the secured party with the prior security interest: s 420B(2) and (3).

In considering the interests of the secured party with the prior security interest, the court may have regard to the effect on the proceeds of a sale whether the property subject to the prior security interest was included or not: s 420B(4). This may involve a consideration of the difference in price between a sale of all assets as a going concern and the separate sales of assets excluding the disputed property. The court is not limited in the matters it may consider: s 420B(5).

The interests of the secured party with the prior security interest may be protected if the court allows a sale of the property subject to conditions: s 420B(6). For example, a sale may be allowed if all or part of the net proceeds of the sale are applied in payment of specified amounts secured by the prior security interest.

Section 324B addresses a problem that could arise where a receiver manager is appointed by a creditor who has been granted a circulating security interest but another secured creditor already holds a prior security interest over a significant asset of the company. In such situations, the receiver is prevented from disposing of the assets of the company, particularly the business of the company as a going concern, at the most favourable price. This may be detrimental to achieving a beneficial realisation of the company's assets for all creditors and others, such as guarantors of the company's debts. Section 420B aims to achieve a balance between an orderly dealing with the property of the company and protecting the security interest of a prior secured creditor.

## Power to obtain information

**[30.105]** Sections 429 and 430 assist a controller in exercising their power to get in the company's assets, by enabling the controller to obtain information from the company's officers and others.

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|-------------------------------|
| Report of affairs of company. |
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The directors and secretary of a company are required to submit a report of the affairs of the company, as at the date of the appointment of the controller. The report must be provided within 10 business days after a controller notifies the company of their appointment: s 429. Within one month after receiving the report, the controller must lodge a copy with ASIC, together with any comments they may wish to make. The report and comments must also be sent to the trustee for debenture-holders.

Under s 430, controllers can also require reports to be submitted to them by other persons such as:

- present or former officers;
- persons who took part in the formation of the company; and
- present or former employees.

To assist controllers in carrying out their work, s 431 entitles them to inspect, at any reasonable time, any books of the corporation that relate to the secured property. Any person who refuses or fails to allow the receiver to inspect such books is guilty of an offence.

*Re Jet Corp of Australia Pty Ltd* (1985) 3 ACLC 216

**[30.110]** The company's receivers applied for an order under the predecessor of s 431 compelling the auditors to make available photocopies of the company's records in their possession. It was held that the auditors' photocopies of the company's records belonged to the company. Further, even though the auditors had a lien over the documents and could therefore retain possession until their fees were paid, s 431 allowed the receiver to inspect them. This was so notwithstanding that the inspection would deprive the lien of its main value. Section 431 did not, however, enable the receivers to inspect audit notes that were not part of the original documents. These were intended to be confidential.

**[30.115]** A receiver may be authorised by ASIC to apply to have a person examined under s 596A: *Whelan v ASC* [1993] FCA 839. The right to conduct an examination may be useful in acquiring information about the company's assets or to assist an investigation into possible claims against the company's directors or auditor. Examinations are discussed at [32.400]–[32.460].

## Effect of liquidation on the powers of a receiver

**[30.120]** A receiver of property of a corporation that is being wound up may carry on and do whatever is necessary to carry on the corporation's business. The approval of the liquidator or the court must be obtained: s 420C(1).

Where the receiver carries on the business of the corporation, the receiver does so as agent of the company: s 420C(3). This means that the receiver has a right of indemnity from the company's assets for expenses and liabilities incurred in carrying on the company's business and the receiver continues to carry on the company's business as agent for the secured party: *Mercantile Credits Ltd v Atkins (No 1)* (1985) 1 NSWLR 670.

### Receivers' right of indemnity.

While a receiver is liable for debts and expenses incurred during the receivership, this is without prejudice to any rights of indemnity that the receiver has: s 419(1). The consequences of a receiver being regarded as an agent of the company under s 420C are that the receiver must look to the assets of the company or an indemnity from the appointing creditor to meet liabilities incurred in carrying on the business of the company. Such debts and liabilities are not costs and expenses of the winding up for the purposes of determining priorities among unsecured creditors under s 556(1): s 420C(4).

### Other powers of receiver after appointment of liquidator.

In addition to the power to carry on business, a receiver and manager may also exercise other powers after winding up commences. A receiver can take possession of property and may take legal action in the name of, and on behalf of the company under the statutory power contained in s 420(2)(k). The power to take legal action continues after the commencement of winding up where the action relates to property of the company that is subject to the security interest of the secured party who appointed the receiver. Even where a liquidator takes over the conduct of the legal action, a receiver may re-enter and resume control of the legal action if the cause of action is an asset secured by the debenture and there is no detriment to the liquidation: *SA Asset Management Corp v Sheahan* [1995] SASC 5182.

A receiver has a statutory power to make calls on shares where the security interest is over uncalled capital. A call can be made in the name of the corporation or in the name of the liquidator where a proper indemnity is given to the liquidator: s 420(2)(s).

A receiver is entitled to retain any documents relating to the secured property until the receivership ends: *Re High Crest Motors Pty Ltd* [1978] VR 688. Section 477(3) however gives a liquidator a statutory right to inspect and take copies of any books of the company even where they are in the possession of a receiver. The liquidator can also sell the secured property. However, any debts incurred by the receiver after the commencement of liquidation are no longer borne by the company, but by the receiver personally. The receiver's liability for contracts is discussed at [30.190]. A receiver and manager may exercise the power of sale of secured assets conferred by the mortgage debenture despite the winding up of the company: *Re Landmark Corp Ltd* (1968) 88 WN (Pt 1) (NSW) 195.

A receiver may probably use the seal of the company under s 420(2)(n), even though the company is in liquidation. This is because while s 477(2)(d) empowers the liquidator to use a seal of the company, it does not give clear, exclusive use to the liquidator.

The voidable antecedent transactions provisions of the *Corporations Act* (see [32.475]–[32.610]) apply to transactions entered into by receivers before the company is placed in liquidation. Voidable transactions include unfair preferences (see [32.485]) and uncommercial transactions: see [32.520]. If a receiver enters into such a transaction and the company is subsequently wound up, the liquidator may obtain a court order declaring the transaction to be void.

## Duties of receivers

### Common law duties

**[30.125]** A privately appointed receiver and manager's primary duty is to the appointing secured creditor. The receiver and manager is obliged to take possession of the secured property, to manage the company's business and ultimately to sell the secured property for the purpose of discharging the secured debt.

A receiver owes duties to both the secured creditor and company.

A receiver manager also owes duties to the company, in respect of the appointment as its agent, as well as to other secured creditors. Difficulties may arise where the interests of the appointing secured creditor conflict with the interests of the debtor company, its members or its unsecured creditors.

Receiver managers owe the same duties as mortgagees to use their powers for the sole purpose of securing repayment of the moneys owing under the debenture and not for their own purposes: *Barnes v Queensland National Bank Limited* (1906) 3 CLR 925. In this case, the mortgagee had conducted the sale in pursuit of a personal vendetta against the mortgagor which was not a power exercised in good faith. Receivers must also act in good faith: *Medforth v Blake* [1999] 3 WLR 922.

In *Expo International Pty Ltd v Chant* [1979] 2 NSWLR 820, Needham J considered the nature of the duties receivers owe to the company. He stated:

Those duties include the duty to exercise his powers in good faith (including a duty not to sacrifice the mortgagor's interests recklessly), to act strictly within and in accordance with the conditions of his appointment, to account to the mortgagor after the mortgagee's security has been discharged not only for the surplus assets but also for his conduct of the receivership. The latter duty, in my opinion, involves the duty to terminate the receivership by handing over the surplus assets to the mortgagor as soon as the interests of the mortgagee have been satisfied. I think the receiver would be acting outside his powers, or mala fide, if he failed to terminate the receivership because of some extraneous or collateral consideration ... There is, in my opinion, no warrant in the authorities for holding the receiver to be liable for loss caused by negligence.

*Cape v Redarb Pty Ltd (No 2)* (1992) 107 FLR 362

**[30.130]** A receiver and manager was appointed by the court to liquidate a solvent joint-venture company and distribute the proceeds to the two shareholder directors. It was held that a court-appointed receiver and manager had a duty to be fair and impartial. He owed a fiduciary duty to those interested in the property but was not an agent or trustee for those persons. In this respect, a court-appointed receiver and manager owes the same duties as a liquidator.

**[30.135]** At common law, receivers are required to exercise their powers honestly and in good faith and not to sacrifice the company's interests recklessly. A receiver does not breach this duty if the receiver is merely negligent in the management of the company's business or the sale of the secured property.

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| Duty to exercise powers in good faith. |
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Receivers breach their common law duty to act in good faith if they arrange for the sale of the secured property at a gross undervalue. Section 420A, discussed at [30.150], expands a receiver's common law duty in relation to the sale of secured property.



*Forsyth v Blundell* [1973] HCA 20

**[30.140]** A mortgagee advertised an auction to sell the secured property. The reserve price of \$120,000 was the amount owing under the mortgage. Prior to the auction a prospective bidder indicated interest in bidding up to \$150,000. Despite this, the mortgagee entered into a contract to sell the property privately to another purchaser for \$120,000. The High Court prevented the mortgagee from completing the sale. It held that the mortgagee had not acted in good faith and that he was either grossly careless or at least displayed a calculated indifference to the mortgagor's interests. A receiver is under a similar duty to act in good faith.

## Statutory duties

**[30.145]** Receivers and receiver managers are included in the definition of “officer” under s 9 and are consequently subject to the duties imposed by Ch 2D of the *Corporations Act*. The duties imposed on officers by Ch 2D are discussed at [13.20].

### *Reasonable care in selling secured property: s 420A*

**[30.150]** The role of a receiver appointed in respect of secured property is to take possession of the property, sell it and repay the debt due to the secured creditor who made the appointment. Any surplus after the sale of the secured property is returned to the company. The sale price of secured property may affect the interests of the secured creditor, the debtor company and any guarantor directors. The secured creditor is mainly concerned that the sale price at least covers the secured debt plus the costs of selling. However, the debtor company and any guarantor director will expect that the secured property is sold for the highest price possible to maximise the amount returned to the company and minimise the amounts directors may be liable for under their guarantees.

Section 420A imposes a specific duty on controllers in exercising a power of sale to take all reasonable care to sell property at not less than market value or for the best price that is reasonably obtainable, having regard to the existing circumstances when the property is sold. This duty does not limit the operation of a receiver's obligations under ss 180–184. Conduct which complies with ss 180–184 will likely comply with s 420A. The duties imparted on a receiver under statute are significantly higher than the duties imparted upon a receiver at general law: *Inkhorn Pty Ltd v Herbert* [2000] WASCA 333.

“Market value” is not necessarily the best price that could be achieved but the price that a willing purchaser would have to pay a vendor who is willing but not anxious to sell. The vendor is assumed to be knowledgeable about all the circumstances that affect the market value of the property. In the ordinary course, the sale price achieved on the open market is the market value but this is not always the case: *Fortson Pty Ltd v Commonwealth Bank of Australia* [2008] SASC 49.

The s 420A duty is not breached just because market value or the best price reasonably obtainable has not been achieved. It requires a failure by the receiver to take all reasonable care to sell the property for not less than market value or the best price that is reasonably obtainable having regard to the dynamic circumstances existing when the property was



sold: *Manda Capital Holdings Pty Ltd v PEC Portfolio Springvale Pty Ltd* [2022] VSC 381. In this case, the dynamic circumstances were the COVID-19 pandemic and associated lockdowns. In determining whether a receiver took all reasonable care, it is necessary to consider the sale process adopted by the receiver, including the timing of the sale, concept of market value and the extent to which a receiver may rely upon experts appointed by them: *Jeogla Pty Ltd v ANZ Banking Corporation Limited* (1999) 150 FLR 359. Part of this process may occur well before the actual sale of the property but may have an effect on the eventual price: *Deangrove Pty Ltd v Buckby* [2006] FCA 212.

Where there is any doubt as to the course of action a receiver should take, the receiver can apply to the court for directions: s 424. The power of the court to give directions has covered a wide range of matters; however, the court will not make a commercial decision for receivers under s 424: *Deputy Commissioner of Taxation v Best & Less (Wollongong) Pty Ltd* (1992) 10 ACLC 520.

A direction under s 424 is limited in scope in that a direction is not binding on third parties and there is a need for utility for directions to be granted. There must be an issue calling for the exercise of legal judgment and more than a business or commercial decision: *Re Mirabela Nickel Ltd; Ex parte Madden* [2018] WASC 335.

#### *White v Huxtable* [2006] FCA 559

**[30.155]** A receiver sought direction to establish whether it was lawful to sell secured property to a related party of the appointing creditor. It was held that this came within the operation of s 424, whereas questions such as whether the receiver properly exercised its power of sale depended on considerations such as good faith, proper procedure and fair price, which are considerations that fall outside s 424.

## Notification of appointment

**[30.160]** A secured party who appoints a receiver is required to notify ASIC of the appointment within seven days after making the appointment: s 427(1). A receiver or other controller is also required to notify the company and other relevant authorities of the appointment. A controller must forthwith serve a notice of the appointment on the company: s 429(2). A controller must also lodge a notice of their address with ASIC within 14 days: s 427(2).

A statement publicising the fact that a receiver or other controller has been appointed, must be set out after the company's name on all its public documents: s 428. These documents include the company's invoices, order forms and cheques.

## Financial records

**[30.165]** Section 421 sets out a managing controller's duties with respect to bank accounts and financial records. Section 421(1)(a), (b) and (c) requires a controller to maintain a separate bank account for each corporation over which they have control and pay all money of a corporation into that account within three business days of coming under the controller's control. Further, s 421(1)(d) requires a controller to keep such financial

records as correctly record and explain all transactions entered into by the controller. Directors, creditors or members of a corporation are entitled to inspect a controller's financial records unless the court orders otherwise: s 421(2).

### *Report about corporation's affairs*

**[30.170]** A managing controller of property of a corporation must prepare a report about the corporation's affairs: s 421A. This must be in the prescribed form and prepared and lodged within two months of appointment: s 421A(1) and (2).

The managing controller may omit information from the copy of the report available for inspection if they are of the opinion that the particular information would seriously prejudice the corporation's interests or the achievement of the objectives for which the controller was appointed or acted: s 421A(4).

### *Annual return by controller*

**[30.171]** Sections 422A–422D set out a number of reporting requirements. For example, s 422A(3) requires a controller of a corporation (such as a receiver) during all or part of a control return year to lodge an annual return in relation to the control of property of the corporation. The annual return must be in the prescribed form and be lodged with ASIC within three months after the end of the control return year: s 422A(4). The “control return year” is the period of 12 months beginning on the day the controllership first began and each subsequent 12-month period: s 422A(5).

A controller must also lodge a return with ASIC when the control of the property ends: s 422B(2). The end of controllership return must be in the prescribed form and be lodged within one month after the control of the property ends: s 422B(3). On the request of members, creditors or other specified persons, the last controller is obliged to notify that the end of controllership return was lodged: s 422B(4) and (5).

If a person is replaced as controller by another controller or by an external administrator, the former controller must transfer to the new controller possession or control of any books relating to the control of the property of the corporation within five business days after the new controller is appointed: s 422C.

If a person ceases to act as a controller, ASIC may, by written notice, require the controller to transfer to ASIC the books relating to the control of that property in the controller's possession or control: s 422D(1). ASIC must transfer the books to a new controller, if there is one: s 422D(3). The books must be transferred to the external administrator if the company is under external administration. ASIC must transfer the books to the corporation if it is unlikely that another controller or external administrator will be appointed: s 422D(4).

### *Priority debts*

**[30.175]** The purpose of a privately appointed receiver is to sell the secured property and distribute the proceeds to the secured creditor.

Section 433 governs the priority of payment of debts where a receiver is appointed on behalf of debenture-holders over property secured by a circulating security interest and the company is not in liquidation. It sets out the classes of debts that must be paid in priority to the debts of the circulating security interest creditor. Section 433 seeks to protect the position of preferential unsecured creditors (such as employees in respect of unpaid wages) by enabling them to be paid ahead of circulating security interest creditors who would otherwise have “scooped the pool” of the debtor company’s assets: *Re Langdon; Forge Group Ltd* [2017] FCA 170.

Under s 433(3), receivers must pay, out of the property coming into their hands, the following debts or amounts in priority to any claim for principal or interest due to the circulating security interest creditor:

- first, any amount that in a winding up is payable in priority to unsecured debts pursuant to s 562. These are amounts received by the company under an insurance contract from its insurer in respect of the company’s liability to third parties. This gives priority to injured employees covered by workers’ compensation insurance;
- secondly, if an auditor of the company has applied to ASIC under s 329(6) for consent to resign as auditor and this consent has been refused, the reasonable fees and expenses of the auditor incurred from the date of refusal to the date of the receiver’s appointment; and
- thirdly, any debt or amount that in a winding up is payable in priority to other unsecured debts pursuant to s 556(1)(e), (g) and (h) or s 560. This gives priority to amounts due to employees in respect of unpaid wages, unpaid amounts in respect of leave of absence and retrenchment payments. Section 556 is discussed at [32.675].

Section 433(3) requires a receiver who takes control of the property of an insolvent corporate trustee to pay its debts from the proceeds of trust assets in accordance with the statutory priorities it sets out. This means that employees of a company that is in receivership or liquidation are still entitled to their statutory priority over creditors whose debts are secured by a circulating security interest, as defined by s 340 of the *Personal Property Securities Act 2009* (Cth), in cases where the insolvent company acts as a trustee: *Carter Holt Harvey Woodproducts Australia Pty Ltd v The Commonwealth of Australia* [2019] HCA 20 (*Amerind* decision). The reasoning behind this decision in a receivership context also applies to the priority of employees’ claims in the winding up of a corporate trustee under ss 561 and 556. This is discussed at [32.730].

### *Receiver’s costs, expenses and fees*

**[30.180]** Since a receiver manager is generally appointed as agent of the company, the company is responsible for payment of the receiver’s remuneration, not the secured creditor. Most debentures and security agreements also specify the basis on which the remuneration is calculated.

The court also has power to fix the amount of remuneration paid to a receiver: s 425(1). A receiver’s remuneration can be varied by the court under s 425, but only on the application of the company’s liquidator, voluntary administrator, deed administrator or if the company is under restructuring, the company with the consent of the restructuring practitioner, the restructuring practitioner of a restructuring plan or ASIC.

The receiver concerned may apply to the court for an order to vary or amend an order under s 425. In fixing or varying the receiver's remuneration, s 425(8) requires the court to have regard to whether the remuneration is reasonable taking into account a range of factors.

A debenture trust deed usually gives the receiver's remuneration priority over the debt due to the debenture-holders. In *Waters v Widdows* [1984] VR 503, it was held that, notwithstanding the priorities set out in a predecessor of s 433, a receiver's right to the costs, expenses and fees of the receivership ranked ahead of the claims of the company's former employees for their holiday pay and long service leave entitlements. Section 433 only provides that employees rank ahead of the entitlement of the debenture-holder for payment of principal or interest in respect of the debenture.

## *Report breaches of duty to ASIC*

**[30.185]** Section 422 imposes a duty on receivers and other controllers to report misconduct to ASIC. This is similar to the obligation imposed on liquidators by s 533. A receiver must make a report where it appears that:

- a company's present or former officers or members have been guilty of an offence in relation to it; or
- a person who took part in the formation, promotion, administration or winding up of the company may have misappropriated any of its money or property or may have been guilty of negligence, default, breach of duty or breach of trust in relation to it.

Where a controller makes such a report, s 534 gives ASIC power to investigate the matter. In order to protect controllers when reporting possible offences, s 426 provides them with qualified privilege in defamation proceedings in respect of any matter arising from the report.

## **Liabilities of receivers**

### **Contracts**

**[30.190]** At common law, receivers were not personally liable to outsiders on any contracts made during the course of the receivership or control as they were agents of the company. However, under s 419(1), receivers become personally liable for certain debts incurred by them in the course of the receivership. Where they incur such debts within the scope of their agency, they are entitled to be reimbursed by the company. In some cases, the company may have insufficient funds so receivers generally obtain an indemnity from the appointing secured creditor to be protected from personal liability.

Section 419(1) does not extend to all debts incurred in the course of receivership. It applies only to debts for services rendered, goods purchased or property hired, leased, used or occupied. This does not include a debt for tax on income derived during the course of receivership, but does include wages of employees of the company.

Controllers' liability for rent.

Section 419A applies where a corporation entered into a lease or similar agreement before a controller was appointed or took control of the secured property and continued after that day to use, occupy or be in possession of the leased property.

The controller is then personally liable for the rent payable by the corporation: s 419A(2). The liability for rent commences seven days after the controller is appointed or enters into possession and continues as long as the corporation remains in possession or uses the property and the controller continues to act in their capacity. The seven-day period enables the controller to decide whether to continue a lease before becoming liable. The court may excuse the controller from liability where, for example, the controller was unaware of the existence of the lease during the seven days after appointment: s 419A(7). The controller is not taken to have adopted the lease agreement and, apart from payment of rent, is not liable for the performance of other terms of the agreement such as a covenant to repair in a lease: s 419A(8).

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| Pre-receivership debts. |
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A receiver is not personally liable for debts arising from contracts entered into by the company prior to the appointment that are completed during the course of the receivership. The creditor's right to payment of the unsecured debt is postponed until the receiver has discharged the debts of the debenture-holders and other preferred creditors.

A receiver and manager, being an agent of the company, may generally repudiate contracts made prior to the commencement of receivership without incurring personal liability: *George Barker Ltd v Eynon* [1974] 1 WLR 462. In such cases, the outsider only has remedies as an unsecured creditor against the company for breach of contract. The receiver, however, is required to honour contracts if this is required to protect the goodwill of the company's business.

## Breach of duty

**[30.195]** As discussed at [13.20], receivers and receiver managers are regarded as officers of the company for the purposes of the duties contained in Ch 2D of the *Corporations Act*. These duties are discussed in Chapter 13. If receivers breach these duties, they may be liable under the civil penalty provisions: [19.120]–[19.150]. Even though receivers are subject to these statutory duties, they are rarely sued for breach of duty.

Since receiver managers take part in the management of a company, they are also subject to examinations under ss 596A, 597 and 598. These provisions are discussed at [32.400]–[32.460]. These provisions enable the court, on application by ASIC or a liquidator, to examine the conduct of a receiver. If a receiver is found guilty of fraud, negligence, default, breach of trust or breach of duty in relation to the company, the court may direct the receiver to compensate the company for the loss or damage.

Section 423 specifically deals with failures by controllers to faithfully perform their functions or observe the requirements of the instrument under which they were appointed or their legal obligations. Under s 423(1), if it appears to the court or ASIC that a controller has not faithfully performed their functions or observed the law, the court or

ASIC may inquire into the matter and the court may then take such actions as it thinks fit. Such an inquiry into a controller's conduct may also be initiated by a complaint made by any person to the court or ASIC. Where ASIC reports to the court any matter that in its opinion is a misfeasance, neglect or omission on the part of a controller, the court may order the controller to make good any loss sustained by the corporation or such other order as it thinks fit: s 423(2). The court may investigate the performance or exercise of functions and powers of a controller by requiring the controller to answer questions, examining a person or investigating the controller's books: s 423(3). Section 423 is similar to Div 45 of the *Insolvency Practice Schedule (Corporations)* which deals with liquidators.

Where a person complains to the court about the conduct of a controller and seeks an inquiry, the applicant must show that there is a *prima facie* case that there is something that warrants investigation. The court then has a discretion whether to order an inquiry. The considerations which are relevant for a court to take into account in exercising its discretion include the strength and nature of the allegations, any answers offered by the controller, other available remedies, the likely amounts of money involved, the availability of funds to pay for any inquiry, the likely benefit to be derived from it and the legitimate "interest" of the applicant in the outcome. In the absence of clear misconduct, the courts are generally reluctant to order an inquiry under s 423 as to do so would tend to undermine ordinary litigation processes: *Oswal v Carson (No 3)* [2013] FCA 357.

Under s 599, any person aggrieved by any act, omission or decision of, *inter alia*, a receiver or receiver and manager has a right to appeal to the court. The court may confirm, reverse or modify the act or decision, or remedy the omission and make such orders and give such directions as it thinks fit.

#### *ASIC v Forestview Nominees Pty Ltd* [2006] FCA 1530

**[30.200]** ASIC brought winding up proceedings against a company in receivership. A director requested that the receiver and manager provide funding to oppose the winding up application, but the receiver and manager refused to do so and the director sought an order under s 1321. The court declined to intervene against a discretionary or evaluative decision or qualitative judgment made by a receiver and manager. The scope for intervention by the court under s 1321 was limited to cases where the person bringing the appeal could show error of law or significant factual error or unreasonableness such that the decision should not stand.

## Termination

**[30.205]** A receivership or controllership normally terminates when the receiver or controller achieves the objective of the appointment; that is, when the secured debt is discharged and the debts of the receivership or the controller are paid. The controller is obliged to end the receivership or cease to control property and account to the company or its liquidator for any surplus.

Sometimes, a continuation of the receivership may impede an orderly winding up by a liquidator and add to the costs of the winding up. Section 434B enables a liquidator of a company wound up in insolvency to apply to the court for an order that a controller cease to act as a receiver or retain control of all or part of the property of a corporation: s 434B(1) and (4).

The court may only make such an order if it is satisfied that the objectives for which the controller was appointed or entered into possession have been achieved as far as is reasonably practicable: s 434B(2). The court must consider the interests of the corporation, the secured party in relation to the prior security interest and the other creditors, as well as any other relevant matter: s 434B(3).

An order under s 434B does not otherwise affect a security interest over the property of a corporation. Nor does it limit any other power of the court to deal with controllers. For example, the court retains its powers under s 423.

A controller may be removed by the debenture-holder or secured party but not by the company, even though they are its agent. The right of a controller to resign will generally be set out in the mortgage debenture. In the absence of a contrary provision, a controller may be liable for breach of contract if resignation is premature.

The court may remove a controller in certain situations, such as where there has been a failure to act in the interests of the debenture-holders as a whole or the controller is disqualified under s 418.

A controller may also be removed for misconduct. A corporation may apply to the court for an order that a controller cease to act as a receiver or give up possession or control of property of the corporation. The court must be satisfied that the controller has been guilty of misconduct in connection with performing or exercising any functions or powers as a controller: s 434A. As discussed above, a controller may also be removed where the purported appointment or entering into possession was declared by the court to be invalid under s 418A.

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.
- For further corporations law links and material please refer to the Understanding Company Law website at <http://www.uclaw.com.au>.



## Chapter 31

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# Voluntary administration, deed of company arrangement and restructuring

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## Key points

- The voluntary administration scheme provides for the appointment of a voluntary administrator who takes control of an insolvent company.
- The aim of the voluntary administration scheme is to maximise the chances of the company or its businesses remaining in existence. If this is not possible, the scheme aims to achieve a better return to creditors than would result from an immediate winding-up. Creditor-approved deeds of company arrangement (DOCA) are the mechanism for achieving the scheme's aim.
- The voluntary administrator is usually appointed by resolution of the directors if they believe that the company is insolvent or likely to become insolvent. An administrator may also be appointed by a liquidator or secured creditor with a security interest over the whole, or substantially the whole, of the company's property.
- An administrator must convene at least two meetings of creditors. At the first meeting, creditors have the opportunity to replace the administrator and to appoint a creditors' committee of inspection to assist the administrator. The second meeting is for the creditors to decide whether the company executes a DOCA, voluntary administration ends or the company is wound up.
- During voluntary administration, a moratorium on claims against the company comes into effect. This enables administrators to carry out their role and creditors and certain others, such as lessors, are prevented from bringing actions to enforce their rights against the company or guarantees against the directors. The enforcement of such rights may be detrimental to the majority of creditors and may prevent the administrator from carrying on the business of the company in accordance with the objectives of the legislation.
- Where the administrator forms the opinion that it is in the creditors' interests to enter into a DOCA, a proposal is put to creditors who may resolve that the company enter into the DOCA. The terms of the DOCA may provide for debts to be compromised, payments to creditors to be delayed or paid in instalments and priorities among creditors to be determined. If the company executes a DOCA, it is binding on all unsecured creditors. Secured creditors are bound by the DOCA only if they have so agreed.
- Where creditors resolve to wind up the company, the company enters into a creditors' voluntary winding-up and the administrator usually becomes the liquidator.
- The restructuring process of the *Corporations Act* allows directors of eligible companies to retain control of the business, property and affairs of the company while developing a plan to restructure with the assistance of a restructuring practitioner and to enter into a restructuring plan with creditors.

## Voluntary administration scheme and restructuring eligible companies

**[31.05]** Parts 5.3A and 5.3B of the *Corporations Act* deal with the voluntary administration scheme and restructuring process, respectively. The Pt 5.3A provisions stemmed from recommendations made by the Australian Law Reform Commission (ALRC) in its 1988 *General Insolvency Inquiry* (the Harmer Report) that the legislation should provide for a procedure that encouraged a creative approach to insolvency. The Harmer Report considered that the other forms of external insolvency administration were unsatisfactory in that they were expensive, inflexible and slow to implement.

The voluntary administration scheme has proved to be a much more widely used form of external administration for insolvent companies than schemes of arrangement, discussed at [29.155].

The restructuring provisions provide a process for relatively small insolvent companies that enables their directors to retain control of their business, property and affairs, while developing a plan to restructure with the assistance of a restructuring practitioner and to enter into a restructuring plan with creditors: s 452A. The restructuring process bears some similarities to voluntary administration in that both types of external administration aim to enable a financially-distressed company to continue to operate where this is viable and the creditors agree. Both are initiated by the directors and involve the active role of an insolvency practitioner who has broad powers to do what is necessary to develop a restructuring plan or deed of company arrangement (DOCA) where appropriate. A moratorium on the enforcement of creditor rights operates in both situations and secured creditor rights are much the same in both types of external administration. A restructuring plan and a DOCA are both binding on unsecured creditors of the company.

There are some significant differences. The restructuring process is only available to small companies that meet certain eligibility requirements. Directors retain their role in continuing to run the company's business, although they are subject to certain constraints whereas in an administration, the administrator takes control of the company. The restructuring process is more informal and streamlined, so for example, creditor meetings can take place and documents disseminated by electronic means.

The voluntary administration scheme is discussed at [31.10]–[31.230]. The DOCA provisions are discussed at [31.235]–[31.385]. The restructuring provisions of Pt 5.3B are discussed at [31.390] onwards.

Section 600K of the *Corporations Act* contains the *Insolvency Practice Schedule (Corporations)*, which deals with external administrations. Under s 5-15 of the *Insolvency Practice Schedule (Corporations)* a company is taken to be in external administration if:

- the company is under voluntary administration (s 5-15(a)); or
- a DOCA has been entered into in relation to the company (s 5-15(b)); or
- a company is under restructuring (s 5-15(ba)); or
- a restructuring plan has been made in relation to the company (s 5-15(bb)).

## Aims of voluntary administration scheme

**[31.10]** Voluntary administration involves the appointment of an administrator who takes control of an insolvent company for a relatively short period of time. The administrator's task is to investigate the affairs of the company and to report on whether a compromise, arrangement or sale of assets can be negotiated that would be acceptable to the company and its creditors. Ultimately, however, the fate of the company is determined by its creditors who have the final say as to what should happen to the company after voluntary administration ends.

The aims of the voluntary administration scheme are set out in s 435A. They are: to maximise the chances of the company or its businesses remaining in existence (this is sometimes referred to as rehabilitation); and if rehabilitation is not possible, to achieve a better return to creditors than would result from an immediate winding-up.

A creditor-approved DOCA is the mechanism for achieving these aims.

### Advantages of voluntary administration.

In many cases the voluntary administration scheme provides a better form of external administration for the creditors of an insolvent company than does liquidation. The voluntary administration procedure is quick to implement and is a relatively cheap form of external administration.

It provides opportunities for some insolvent businesses to trade their way out of their financial difficulties and survive as going concerns via creditor-approved DOCA. This benefits the company's creditors and shareholders. Other stakeholders may also benefit if a financially-distressed business is saved. Employees may keep their jobs. The company's suppliers may retain a customer and continue to do business. However, not all insolvent businesses are salvageable. Where a company's business is no longer viable, the voluntary administration procedure provides for the company's smooth transition to liquidation, with the minimum of expensive court cases or additional creditor or shareholder meetings.

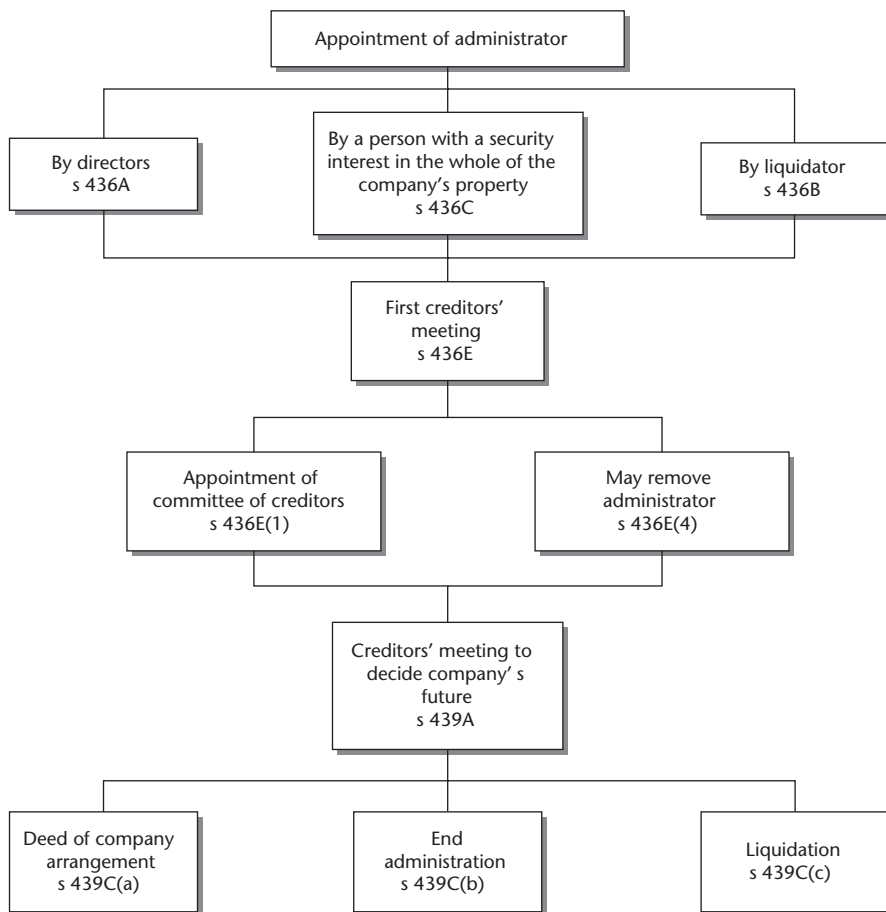
The voluntary administration procedure has two distinct phases. Under s 435C, the first phase – voluntary administration – commences with the appointment of an administrator who must be a registered liquidator and is therefore an experienced, independent insolvency practitioner. The *Corporations Act* gives an administrator powers to take control of the company's affairs from its directors and shareholders. During voluntary administration, a moratorium on claims against the company comes into effect. Voluntary administration ends, and the second phase of the procedure commences at the conclusion of the creditors' meeting, convened under s 439A, at which creditors make a decision about the company's future. Depending on what decision creditors make at this meeting, s 439C provides for a smooth transition from voluntary administration to one of the following three possible outcomes:

### Three possible outcomes of voluntary administration.

- a DOCA, under which the company may have the opportunity of being restored to a viable financial state to the ultimate advantage of its creditors, shareholders, employees and other stakeholders;
- winding-up the company. If the creditors select this outcome, the winding-up takes the form of a creditors' voluntary winding-up and usually the administrator becomes the company's liquidator; or
- voluntary administration terminates and control of the company is handed back to its directors and shareholders.

Figure 31.1 gives a diagrammatical overview of the voluntary administration procedure.

**Figure 31.1: Overview of voluntary administration procedure**



In a 2000 Productivity Commission Staff Research Paper, *Business Failure and Change: An Australian Perspective*, it was noted that even though the voluntary administration procedure provided opportunities for rescuing financially-distressed businesses, “it is designed primarily to serve the best interests of creditors” and not

the other corporate stakeholders. As creditors effectively control the debtor company's future, they are more likely to make decisions that maximise their return at the expense of the broader adverse economic and social consequences of the company's insolvency.

## Appointment of administrator

**[31.15]** A company can be put into voluntary administration quickly and with a minimum of expense. Voluntary administration of a company begins when an administrator is appointed: s 435C(1). Sections 436A, 436B and 436C specify who has the power to appoint an administrator.

Administrators are usually appointed by directors.

In most cases, the decision to put a company into voluntary administration is made by a company's directors: s 436A. While it is relatively rare, a company may also be put into voluntary administration by its liquidator: s 436B, or a secured party who has an enforceable security interest over the whole, or substantially the whole, of a company's property: s 436C.

In the case of large companies, it may be convenient to appoint two or more persons as joint administrators. This is permitted by s 451A.

### By directors

**[31.20]** In most cases, the decision to appoint an administrator is made by the directors and does not require approval of the shareholders, creditors or the court. A resolution passed by a majority of a company's directors may appoint an administrator if they believe that the company is insolvent or is likely to become insolvent at some future time: s 436A(1). A failure to so resolve makes the appointment of an administrator invalid: *Wagner v International Health Promotions Pty Ltd* (1994) 15 ACSR 419. A company is insolvent if it is unable to pay its debts as and when they fall due: s 95A. A company is also taken to be insolvent if the company proposes a restructuring plan to creditors: s 455A(2). Restructuring is discussed at [31.390]. The meaning of insolvency is further discussed at [32.60].

In *Re Lime Gourmet Pizza Bar (Charlestown) Pty Ltd* [2015] NSWSC 244, it was held that a valid appointment of an administrator requires directors to have an objectively genuine belief in the company's actual or likely insolvency. Directors, when making the decision to appoint an administrator, do not have to make a thorough inquiry into the company's finances. Actual knowledge of the company's inability to pay tax debts is enough to ground the requisite belief that the company is, or is likely to be, insolvent.

A director must independently make inquiry about the company's financial state and form a genuine opinion about the company's insolvency. A director cannot simply take at face value and unquestionably accept the opinion of other directors about the company's actual or likely insolvency: *Re Condor Blanco Mines Ltd* [2016] NSWSC 1196.

The appointment of an administrator can be invalidated if the directors have an ulterior motive in making the appointment and that motive was substantial in the sense that the appointment would not have been made without it.

In *ASIC v Planet Platinum Ltd* [2016] VSC 120, the court held that the directors' appointment of a voluntary administrator was invalid because they did not have a bona fide and genuinely formed opinion that the company was insolvent or was likely to become insolvent. When the resolution to appoint was passed the directors did not have any management accounts or other financial information concerning the company. The court did not accept the directors' assertion that the company was insolvent or likely to become insolvent. The court held that the administrator's appointment was for an improper purpose. A few days before the resolution to appoint an administrator, ASIC filed an application to wind up the company on the just and equitable ground pursuant to s 461(1)(k) and appointed a provisional liquidator. The evidence indicated that the directors' only reason for the appointment was to stop the appointment of a provisional liquidator. This was an improper purpose.

An administrator may be appointed before the company is insolvent but not after winding-up commences and a liquidator is appointed: s 436A(2).

The directors who pass the resolution appointing an administrator under s 436A must be people who have been formally appointed as directors. De facto directors cannot pass such a resolution: *Xie v Crisp* [2011] VSC 154.

The directors may appoint an administrator before the company actually becomes insolvent if they are of the opinion that the company is likely to become insolvent at some future time. This enables early identification and treatment of financial difficulties.

Why directors may decide to put a company into voluntary administration.

Directors may decide to put their company into voluntary administration for a number of reasons. They may choose to do so to achieve a better outcome for shareholders and creditors. They may also be encouraged to take early action by the threat of the imposition of personal liability under the insolvent trading provisions, discussed at [18.100]–[18.245]. These provisions provide an incentive for directors of companies in financial difficulties to appoint an administrator sooner rather than later. The directors' personal liability to pay compensation for breaching s 588G arises only if their company goes into liquidation: s 588M. Directors may avoid personal liability if they put their company into voluntary administration with a view that it executes a DOCA that is acceptable to creditors.

Even if the company is eventually wound up, directors may still avoid personal liability for contravening s 588G if, pursuant to s 588H(5), they can establish that they took all reasonable steps to prevent the company from incurring debts when there were reasonable grounds to suspect that it was insolvent. In determining whether the s 588H(5) defence has been proved, s 588H(6) directs the court to have regard to any action the director took with a view to appointing an administrator, when that action was taken and the results of the action. The restructuring process also provides directors with safe harbour protection from personal liability for insolvent trading. This is discussed at [31.415].



Placing an insolvent company in voluntary administration may also be beneficial for directors who have personally guaranteed their company's debts. While the company is under voluntary administration, s 440J prevents creditors from enforcing the guarantee against the director. Section 440J also prevents creditors from enforcing guarantees of company debts provided by a director's spouse or other relative. This is discussed at [31.200].

Income tax legislation may also have the effect of prompting directors to put their company into voluntary administration at an early stage. The pay as you go tax system requires employers to withhold tax attributable to employee wages and salaries and remit the withheld amounts to the Australian Taxation Office on a regular basis. Under ss 18-125 and 18-130 of Sch 1 of the *Taxation Administration Act 1953* (Cth), directors of a non-remitting company may be personally liable to pay an amount equal to the company's liability unless they come to an arrangement to ensure that the withheld amounts are remitted or ensure that the company goes into voluntary administration or liquidation.

Directors may use the voluntary administration process to avoid the investigation of possible breaches of their statutory or fiduciary duties that would occur in a liquidation, as a stalling tactic to frustrate threatened winding-up applications by creditors or to promote unviable DOCAs.

## By liquidator

**[31.25]** A liquidator or provisional liquidator may appoint an administrator by writing if they believe that the company is insolvent or is likely to become insolvent: s 436B(1). Section 436B(2) allows liquidators or provisional liquidators to appoint themselves as an administrator if the appointment is approved by either the creditors or with the leave of the court provided the existing liquidator does not have a conflict of duty or interest. Liquidators may put the company into voluntary administration to facilitate the company executing a DOCA that would produce better returns for its creditors than they would obtain from a liquidation.

## By a secured party

**[31.30]** A person who is entitled to enforce a security interest in the whole, or substantially the whole, of a company's property may also appoint an administrator. The security interest must have become and remained enforceable: s 436C(1). A secured party's ability to appoint an administrator under s 436C(1) arises only if the security interest is perfected within the meaning of the *Personal Property Securities Act 2009* (Cth). Perfection of security interests is discussed at [11.95]. A secured party cannot appoint an administrator under s 436C(1) if the company is in liquidation or provisional liquidation: s 436C(2).

## Notification of appointment

**[31.35]** The appointment of an administrator must be publicised in several ways. The administrator must lodge with ASIC a notice of appointment before the end of the next business day after the appointment and cause a notice setting out prescribed information about the appointment to be published in the prescribed manner: s 450A(1). Publication in

the prescribed manner means lodging the notice electronically with ASIC for publication on ASIC's publication website. Where a secured party appoints an administrator under s 436C, the secured party must give notice of the appointment to the company as soon as practicable: s 450A(2).

The administrator must also give written notice of the appointment to a person who holds a security interest in the whole, or substantially the whole, of the company's property: s 450A(3). As discussed at [31.210], such secured parties have specific statutory protection during the moratorium period. The notice of appointment must be given as soon as practicable and in any event before the end of the next business day after the administrator is appointed.

## Duration of administration

**[31.40]** Administration commences on the day an administrator is appointed: s 435C(1). A company is under voluntary administration for a relatively short period of time. The effect of this is to put pressure on all parties concerned to make a prompt decision about the company's future. Further, as discussed at [31.175]–[31.200], while a company is under administration, there is a stay or moratorium on all claims against the company. The short duration of administration tries to ensure that creditors are not unduly disadvantaged by the moratorium.

The date an administration ends depends on when the meeting of creditors that decides the company's future is held (see [31.125]–[31.140]) and the decision creditors make at that meeting. Administration ends on the date of the meeting if the creditors so resolve: s 439C(b). In such cases, the directors regain control of the company. Administration also ends on the date of the meeting if the creditors resolve that the company be wound up: s 439C(c). If creditors so resolve, the company moves from voluntary administration to a creditors' voluntary winding-up and the administrator assumes the role of liquidator: s 446A.

Alternatively, the creditors may resolve that the company execute a DOCA: s 439C(a). In such cases, the deed must be executed by both the company and the administrator within 15 business days after the creditors' meeting and the administration then ends and the company becomes subject to the terms of the deed: s 444B(2). If the company fails to execute the DOCA within the 15-business day period, the administration ends and the company is deemed to have entered into a creditors' voluntary winding-up: s 446A(1).

If the creditors fail to pass any resolution on the future of the company at the creditors' meeting, the administration ends and the directors regain control of the company: s 435C(3)(e).

Section 447A gives the court the power to make such orders as it thinks appropriate about how the voluntary administration provisions of the *Corporations Act* are to operate in relation to a particular company. For example, under s 447A(2) the court has the power to end an administration if it is satisfied that the company is solvent or the administration provisions are being abused. Section 447A gives the court the power to order a winding-up of a company in the public interest. In the case of a *prima facie* insolvent company, it may be appropriate to order its winding-up, particularly where a proposed DOCA will

not restore the company to financial health, potentially has the purpose or effect of quarantining third parties from investigation and recovery proceedings and has little realistic tangible upside for all creditors: *ASIC v Midland Hwy Pty Ltd* [2015] FCA 1360. Section 447A is discussed at [31.375]–[31.385].

## The administrator

### Who may be appointed?

[31.45] An administrator must be a registered liquidator: s 448B(2). The qualification requirements of registered liquidators are set out in ss 20-1 to 20-30 of the *Insolvency Practice Schedule (Corporations)* and are discussed at [32.225]. A person cannot be appointed as an administrator unless that person has consented to the appointment and has not withdrawn that consent: s 448A.

### Independence

[31.50] As is the case with a liquidator, an administrator must be independent of the company, its officers, creditors and auditor. A person connected with the company in these respects is disqualified from being appointed as an administrator of the company under s 448C without leave of the court.

Administrators' declaration of relevant relationships.

Administrators must declare any relevant relationships that they have had with the company or its officers within the preceding 24 months and any indemnities that they have been provided with: s 436DA. Copies of the declarations must be provided to as many creditors as reasonably practicable. In addition, the administrator must give the declarations to creditors at the same time as giving the notice of the first meeting of creditors: s 436DA(3). This allows creditors to make an informed decision about whom to appoint as administrator and perhaps vote against the appointment of an administrator who was perceived to be too friendly to directors. Section 60 defines the term “declaration of relevant relationships” and among other things, administrators must state whether they have had, within the preceding 24 months a relationship with the company, or an associate of the company. If there is such a relationship, the declaration must state the administrator's reasons for believing that the relationship does not result in the administrator having a conflict of interest or duty. As soon as practicable after providing creditors with copies of the declaration of relevant relationships, the administrator must also lodge a copy of the declaration with ASIC: s 436DA(4A).

*Re Korda, Ten Network Holdings Ltd* [2017] FCA 914.

[31.55] Voluntary administrators were appointed to a group of companies where they had previously been involved as “potential administrators” in pre-administration contingency planning and had been retained as consultants by the company's lawyers to undertake this planning. At no stage was advice given by the

administrators to the board, directors, management, creditors or other stakeholders of the group.

The court had to determine whether the administrators could comply with the duties of impartiality and independence “free of actual or potential conflicts of interest and actual or apparent bias”. The court held that an apprehension of bias could arise if the administrators had to investigate the solicitors who appointed them to undertake pre-administration planning and if the companies in the group subsequently went into liquidation, whether the pre-appointment payments to the administrators are voidable preferences. These potential conflicts could be adequately met by appointing an independent registered liquidator to prepare a limited report to creditors and supervise the administrators’ conduct on those specific matters.

This case illustrates the common practice of major distressed company restructurings where pre-appointment advice and planning is often given for a possible future administration in the event the “informal” restructuring strategies fail. This practice is generally beneficial for the company and its creditors even though some conflicts of interest may arise and need to be managed.

## Investigation of company

**[31.60]** As soon as practicable after being appointed, the administrator must investigate the financial position and circumstances of the company: s 438A(a).

The administrator must form an opinion as to which future course of action would be in the creditors’ interests.

Based on the investigation, the administrator must form an opinion as to which one of the three possible future courses of action would be in the creditors’ interests. The alternatives are whether the company and its creditors should enter into a deed of arrangement, end the administration or wind up the company: s 438A(b).

Because of the relatively short time limits imposed by the legislation, an administrator is generally not required to carry out an investigation in the same detail as a liquidator: *Hagenvale Pty Ltd v Depela Pty Ltd* (1995) 13 ACLC 885. It is also unrealistic to require an administrator to use the compulsory powers of examination under ss 596A and 596B to investigate the company’s affairs: *Deputy Commissioner of Taxation v Pddam Pty Ltd* (1996) 14 ACLC 659.

To enable the administrator to be properly informed, all the directors of the company must promptly hand over all books in their possession that relate to the company. If directors know where other books relating to the company are, their location must also be disclosed: s 438B(1). “Books” is defined in s 9 to include a register and any other record, accounts and documents.

The directors must also give the administrator a statement about the company’s business, property, affairs and financial circumstances within five business days after the

administration begins: s 438B(2). The directors must also be available to provide such further information as the administrator reasonably requires. A failure to provide the required assistance under s 438B is an offence: s 438B(4).

Persons are not entitled, as against the administrator, to retain possession of books of the company or claim or enforce a lien on such books: s 438C(1). A secured creditor, however, may retain possession of books under a security interest, but the administrator may inspect them and make copies: s 438C(2).

If, during the course of investigation of a company's affairs, it appears to the administrator that an officer or member of the company may have committed an offence, misapplied or retained property of the company or breached a duty to the company, the administrator must lodge a report about the matter and give assistance to ASIC: s 438D(1). The court may order an administrator to lodge such a report on the application of an interested person or of its own motion: s 438D(3).

The duty imposed on administrators under s 438D corresponds to similar duties to report imposed on receivers under s 422 and on liquidators under s 533.

## Powers

**[31.65]** Administrators have broad powers to enable them to carry out their functions properly. The administrator has general powers under s 437A to take control of the company's business, property and affairs, carry on, terminate or dispose of the company's business or property and perform any function and exercise any power that the company and its officers could previously perform or exercise. Section 437A gives administrators the power to sell all or part of the company's assets and business before the second creditors' meeting: *Re Global Food Equipment Pty Ltd* [2007] NSWSC 901. While exercising the s 437A powers, the administrator is taken to be acting as agent of the company: s 437B.

*Osborne Computer Corp Ltd v Airroad Distribution Pty Ltd* (1995) 37 NSWLR 382

**[31.70]** The Supreme Court of New South Wales held that s 437A did not allow an administrator to destroy a third party's rights in property created before the administration. In particular, s 437A did not give the administrator the power to take control of computer components in the possession of a computer assembler where those components were subject to a security interest created prior to the commencement of administration.

**[31.75]** The administrator has additional powers under s 442A. The administrator may remove a director from office, appoint a person as a director, do anything in the company's name and on its behalf (such as executing a document or bringing proceedings) and whatever else is necessary for the purposes of the administration.

|                                                 |
|-------------------------------------------------|
| Administrator may deal with circulating assets. |
|-------------------------------------------------|

Where a company's property was subject to a circulating security interest that stopped being a circulating security interest on the appointment of the administrator or for some other reason, the administrator may still deal with any of that secured property in any way that the company could deal with the secured property before it stopped being a circulating asset: s 442B. Circulating security interests are discussed at [11.105]–[11.120].

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| Right of administrator to dispose of company property. |
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The administrator may dispose of the business and property of the company without convening a general meeting of members: *Brash Holdings Ltd v Shafir* (1994) 12 ACLC 619. The administrator also has the power to terminate employment of company employees: *Australian Liquor, Hospitality & Miscellaneous Workers' Union v Terranora Lakes Country Club Ltd* (1996) 14 ACLC 1200.

In order to protect the interests of secured creditors and lessors and owners of property used by the company, the administrator is prevented from disposing of property that is subject to a security interest or is used by the company but owned by someone else such as leased property: s 442C(1). This general prohibition aims to protect the interests of secured creditors and lessors during the time their rights of enforcement are suspended.

There are, however, three exceptions to the general rule contained in s 442C(2) that enable an administrator to dispose of such assets. A disposal of assets may occur in the ordinary course of the company's business. This allows an administrator to sell trading stock that is subject to a circulating security interest. Assets may also be disposed of with the written consent of the secured party, owner or lessor or with the leave of the court. Such leave will only be given if the court is satisfied that arrangements have been made to adequately protect the interests of the secured party, owner or lessor: s 442C(3). The administrator's powers are subject to the rights of enforcement given to secured parties, owners and lessors by ss 441A–441K: s 442D. These rights are discussed at [31.205]–[31.230].

The s 442C prohibition does not prevent administrators from selling property in the company's possession that is subject to a retention of title clause under the *Personal Property Securities Act 2009* (Cth) (*PPS Act*). The administrator can sell the *PPS Act* retention of title property with clear title but is required to retain the amount received on sale for payment to the secured party: s 442CC(1A). The meaning of PPSA retention of title property is discussed at [11.135].

An administrator comes within the definition of “eligible applicant” in s 9. This enables an administrator to seek the issue of a summons for examination under ss 596A and 596B and enables an administrator to obtain information and conduct an examination in similar ways to a liquidator. The object of this power encompasses anything that may fairly be expected to advance the course of the administration and particularly the DOCA.

An administrator is deemed to be an officer of the company for the purposes of entitling a person dealing with the company to make the assumptions set out in s 129. These assumptions are discussed at [5.235]–[5.360]. The outsider may assume that

the administrator is acting within their functions and powers as administrator and is complying with the *Corporations Act*: s 442F(1).

## Liabilities and indemnity

### *Personal liability*

**[31.80]** An administrator comes within the s 9 definition of “officer” for purposes of the statutory duties in Pt 2D.1. An administrator may therefore be personally liable for breach of the duty of care under s 180(1) where there is a failure to pay close attention to the voluntary administration.

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| Liability for debts. |
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The administrator is personally liable for debts incurred in the course of the administration for services rendered, goods bought, property leased or used, the repayment of money borrowed, interest on money borrowed or borrowing costs: s 443A(1). This is despite any contrary agreement, although the administrator retains rights against the company or anyone else: s 443A(2). An administrator’s personal liability encourages third parties to do business with the company so as to enable it to trade out of difficulties. The court may modify the operation of s 443A under its broad power contained in s 447A to exclude the personal liability of an administrator. The power of the court to make orders under s 447A is discussed at [31.375]–[31.385].

*Molit (No 55) Pty Ltd v Lam Soon Australia Pty Ltd (No 2) (1996) 68 FCR 319*

**[31.85]** The Federal Court held that an administrator was not liable for damages caused by his removal of fixtures and fittings from leased premises. A liability for damages was not a debt for purposes of s 443A(1).

**[31.90]** Administrators are also personally liable for the payment of rent on property leased before their appointment: s 443B. This liability only arises after five business days from appointment, during which time the administrator can make a preliminary assessment of the financial position of the company and decide whether the continuation of the lease is the appropriate course. If the administrator decides not to continue the lease, no personal liability for rental payments is incurred.

The administrator is not liable for rental payments after a receiver of the property is appointed or a secured party or an agent of a secured party takes steps to assume control of the property subject to a security interest: s 443B(7). The court may also excuse the administrator from liability: s 443B(8).

**[31.100]** An administrator has qualified privilege in respect of statements made in the course of acting as the administrator: s 442E. This is similar to the qualified privilege of a liquidator under s 535. It aims to protect the administrator from defamation actions brought in respect of the contents of reports and other communications.



## Right of indemnity

**[31.105]** While the administrator may be personally liable for the debts referred to in s 443A(1) incurred in exercising powers during the administration, the administrator is entitled to be indemnified out of the company's property for these debts as well as for their remuneration: s 443D.

Priority of administrator's right of indemnity.

If the company goes into liquidation after voluntary administration, the administrator's right of indemnity has a priority over the company's unsecured debts under s 556(1)(c). This mechanism generally allows debts incurred by an administrator to receive higher priority than other pre-administration debts.

The right of indemnity under s 443D also has priority over the debts of the company secured by a circulating security interest over its property: s 443E(1). The indemnity does not take priority over debts owed to secured parties with non-circulating security interests in property. The administrator's indemnity also does not apply to debts secured by a circulating security interest where the secured party appointed a receiver or entered into possession of the secured property before the beginning of administration unless the secured party agrees: s 443E(2). Where a secured party with a circulating security interest appointed a receiver during administration, the administrator's indemnity only has priority in respect of the administrator's debts incurred, or the administrator's remuneration that accrued, before the secured party notified the administrator of the receiver's appointment: s 443E(3) and (4).

The administrator's right of indemnity is a lien on the company's property: s 443F(1). This lien has priority over another security interest only in so far as the right of indemnity has priority over debts secured by the other security interest: s 443F(2).

The operation of ss 443E(3) and 443F(2) limits the statutory right of an administrator to an indemnity and lien in relation to debts incurred and remuneration accruing after a receiver gives notice of appointment by a secured creditor. However, an administrator may still be entitled to a lien and remuneration for time spent exclusively on the realisation of assets on general equitable principles which are not displaced by Pt 5.3A.

## Remuneration

**[31.110]** The *Insolvency Practice Schedule (Corporations)* consolidated and substantially aligned and simplified the remuneration rules relating to external administrators including administrators and liquidators. The remuneration rules for liquidators are discussed at [32.270].

External administrators are entitled to receive remuneration for necessary work properly performed by them in relation to the external administration: *Insolvency Practice Schedule (Corporations)*, s 60-5(1). The amount of remuneration is usually set under a remuneration determination made by resolution of the creditors or the committee of inspection (if there is one). The court may make a remuneration determination if



the creditors or a committee of inspection do not do so: *Insolvency Practice Schedule (Corporations)*, s 60-10. A determination may either specify the amount of remuneration or a method for working out an amount of remuneration: *Insolvency Practice Schedule (Corporations)*, s 60-10(3). A determination may specify that the external administrator is entitled to receive remuneration worked out wholly or partly on a time-cost basis. In such cases, the determination must include a cap on the amount of remuneration that the administrator is entitled to receive: *Insolvency Practice Schedule (Corporations)*, s 60-10(4).

If no remuneration determination is made, the administrator is entitled to receive reasonable remuneration for the work, not exceeding the maximum default amount: *Insolvency Practice Schedule (Corporations)*, s 60-5(2). In the case of administrators appointed during the financial year beginning 1 July 2016, the maximum default amount is \$5,000 (excluding GST). The maximum default amount is indexed for CPI increases for administrators appointed in subsequent years.

Power of the court to review or fix administrator's remuneration.

Section 60-11 of the *Insolvency Practice Schedule (Corporations)* gives the court the power to review a remuneration determination on the application of ASIC, a person with a financial interest in the external administration or an officer of the company. Remuneration is limited to work that is performed by the administrator in that capacity and not work carried out pre-appointment: *Skafcorp Ltd v Jarol* [2002] NSWSC 1183. After reviewing the determination, the court must affirm it, or vary it, or set the determination aside and substitute another remuneration determination. Section 60-12 of the *Insolvency Practice Schedule (Corporations)* lists a range of relevant factors courts should consider when setting or reviewing the remuneration determinations including the quality and complexity of the work and the extent to which the administrator is required to accept an unusually high level of risk or responsibility.

## Removal and replacement of administrator

**[31.115]** An administrator's appointment cannot be revoked: s 449A. This helps to ensure the independence of an administrator. Section 90-35(1) of the *Insolvency Practice Schedule (Corporations)* permits creditors to remove and then replace an external administrator at any time during an administration. The external administrator's removal does not take effect until another person is appointed as external administrator: *Insolvency Practice Schedule (Corporations)*, s 90-35(2). The court also has wide powers under s 447A that include the removal of an administrator.

If the administrator of a company dies, becomes prohibited from continuing to act or resigns, someone else may be appointed by the directors under s 436A, a liquidator under s 436B or a person entitled to enforce a security interest in the whole of the company's property under s 436C depending on who initiated the original appointment: s 449C. Where the office of administrator of a DOCA becomes similarly vacant, the court may order the appointment of a replacement: *Insolvency Practice Schedule (Corporations)*, s 90-15(3)(c).

## Meetings of creditors

### First creditors' meeting

**[31.120]** Soon after the commencement of voluntary administration an administrator must convene a first meeting of creditors: s 436E(1). At the first creditors' meeting, creditors may determine whether:

- to appoint a committee of inspection (this committee was once called a committee of creditors); and
- if so, who are to be the committee's members.

Under s 80-20 of the *Insolvency Practice Schedule (Corporations)*, a creditor representing at least 10 per cent in value of the creditors may appoint a person as a member of the committee of inspection. Such a creditor may also remove their representative on the committee and appoint another person. Employees representing at least 50 per cent in value of employee entitlements also have the right to appoint a member of the committee to represent the employees: *Insolvency Practice Schedule (Corporations)*, s 80-25.

Creditors may resolve at the first creditors' meeting to remove and replace an administrator: s 436E(4). For example, creditors may decide at an early stage in the voluntary administration to replace an administrator they perceive lacks independence.

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| Committee of inspection. |
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According to s 80-35 of the *Insolvency Practice Schedule (Corporations)* the functions of the committee of inspection include:

- to advise and assist the external administrator;
- to give directions to the external administrator; and
- to monitor the conduct of the external administration.

An external administrator must have regard to any directions given by the committee but is not required to comply with such directions: *Insolvency Practice Schedule (Corporations)*, s 80-35(2). If an external administrator does not comply with a direction, the administrator must make a written record of that fact, along with the reasons for not complying with the direction.

Under s 80-40 of the *Insolvency Practice Schedule (Corporations)*, the committee of inspection may request the external administrator to give information or provide a report or produce a document. A committee of inspection may also obtain specialist advice or assistance in relation to the conduct of the external administration: *Insolvency Practice Schedule (Corporations)*, s 80-50.

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| Timing requirements. |
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The administrator must convene the first creditors' meeting which must be held within eight business days after the beginning of the administration and give notice of at least

five business days before the meeting: s 436E. Notice of the meeting must be given in writing to as many creditors as is reasonably practicable and must be published in the prescribed manner: s 436E(3). “Publication in the prescribed manner” requires the administrator to lodge the notice electronically with ASIC for publication on ASIC’s publication website. Defects of a procedural nature may be validated under s 1322(4) if the substantial requirements have been satisfied and no substantial injustice has been caused: *Re Vanfox Pty Ltd* [1995] 2 Qd R 445.

## Meeting to decide the company’s future

### *Time of the meeting*

[31.125] The administrator must convene a meeting of the company’s creditors within the “convening period”: s 439A(1). The convening period is the period of 20 business days beginning on the day after the administration begins: s 439A(5). The convening period is 25 business days if the administration begins in December or less than 25 days before Good Friday: s 439A(5)(a). According to s 75-10 of the *Insolvency Practice Rules (Corporations) 2016*, the administrator must give notice in writing of the meeting to as many of the persons as reasonably practicable appearing in the company’s books or otherwise to be creditors of the company. Under s 75-30 of the *Insolvency Practice Rules (Corporations) 2016*, the administrator must convene the meeting at the time and place that the administrator thinks are most convenient for the majority of those entitled to receive notice of the meeting. The administrator must lodge a notice of the meeting with ASIC: *Insolvency Practice Rules (Corporations) 2016*, s 75-40. The notice of meeting must be lodged at least five business days before the meeting is held: *Insolvency Practice Rules (Corporations) 2016*, s 75-40(3)(a).

### *Extensions and adjournments*

[31.140] Where a company’s affairs are particularly complex it may be necessary to lengthen the time it is in voluntary administration. This can be done in either one of the two ways. The court may extend the convening period or the creditors may resolve to adjourn the creditors’ meeting.

Power of the court to extend convening period.

The court may extend the convening period on an application made either during or after the convening period: s 439A(6). Administrators generally apply for extensions of the convening period if they need more time to carry out their investigations where the company’s affairs are particularly complex or to gain time to finalise protracted negotiations about the terms of a DOCA. The court will grant an extension only if it is satisfied that the extension is in the best interests of the creditors: s 439A(7). When considering a request for an extension, the court is concerned to ensure that it does not unduly lengthen a voluntary administration as the moratorium may adversely affect the interests of creditors: *Re Lehman Brothers Australia Ltd* [2008] NSWSC 1132. On the other hand, an extension may be in the best interests of the creditors because it maximises the chances of the continued existence of the company or its business.

An extension of the convening period for a period of six months in *Re Harrison's Pharmacy Pty Ltd (Administrators Appointed) (Receivers and Managers Appointed)* [2013] FCA 458 was justified because the extension gave the administrator the ability to sell the businesses operated by the companies in administration as a going concern and this outcome was seen to be in the best interests of the creditors.

A creditors' meeting may be adjourned from time to time, but the periods of adjournment must not exceed 45 business days: *Insolvency Practice Rules (Corporations)*, s 75-140. Even though an adjournment lengthens the period the company is in voluntary administration, the ability to adjourn for a short period enables the finalisation of the terms of a complex DOCA.

If a resolution on the future of the company has not been passed within the convening period or a meeting fails to pass a resolution, the administration comes to an end and control of the company reverts to the directors: s 435C(3). This limited time frame puts pressure on creditors to come to an agreement rather than allow control of the company to return to the directors. The end of the administration also enables creditors to enforce their rights. Thus, secured creditors could exercise their security over the company's assets.

The court has power under s 447A to order that the time limit be exceeded where this is necessary to determine whether a DOCA could be successful and is not used as a delaying tactic against creditors. The court must consider whether it is in everyone's interest to have the administration continue, rather than have the company wound up: *Cawthorn v Keira Constructions Pty Ltd* (1994) 33 NSWLR 607.

## *The administrator's report*

**[31.145]** To assist creditors in making an informed decision about how to vote when deciding the company's future, the *Corporations Act* requires an administrator to give them various statements and reports which are collectively referred to as the administrator's report. Section 75-225 of the *Insolvency Practice Rules (Corporations) 2016* requires the notice of the meeting of creditors that decides the company's future to include a statement of the administrator's opinion on whether it would be in the creditors' interests for:

- the company to execute a DOCA; or
- the company to be wound up; or
- the administration to end.

While administrators must give reasons for their statements of opinion on the possible future outcomes for the company, these do not have to be in detail. Their statement must compare their favoured option with the other two alternatives. To minimise the risk of something being overlooked, administrators are required to deal separately with each of the three different possible outcomes: *Deputy Commissioner of Taxation v Comcorp Australia Ltd* [1996] FCA 848.

If a DOCA is recommended, administrators must not only explain why they favour this option, s 75-225 of the *Insolvency Practice Rules (Corporations) 2016* also requires administrators to give creditors a statement setting out the material details of the proposed deed. Where a proposed deed will alter employees' statutory priorities on a

winding-up, the administrators must also advise them whether the proposed alteration would be likely to result in the same or a better outcome for employees than would result from an immediate winding-up: s 444DA.

Creditors may also determine the administrator's remuneration at their meeting. To assist them in making an informed assessment whether the proposed remuneration is reasonable, s 75-45 of the *Insolvency Practice Rules (Corporations) 2016* requires administrators to give creditors (or a committee of inspection, if any) a report setting out such matters as will enable the creditors or committee of inspection to make an informed assessment as to whether the proposed remuneration is reasonable. Among other matters, the remuneration report must set out a summary description of the major tasks performed, or to be performed, by the administrator as well as the costs associated with each of those major tasks.

As well as giving creditors the administrator's opinion on which of the three possible outcomes for the company's future best serves their interests, s 75-225 of the *Insolvency Practice Rules (Corporations) 2016* also requires the notice convening the creditors' meeting to include a report by the administrator about the company's business, property, affairs and financial circumstances.

Section 75-225(3) of the *Insolvency Practice Rules (Corporations) 2016* requires an administrator's report to specify whether there are any transactions that appear to be voidable transactions recoverable by a liquidator and any other information known to the administrators as will enable the creditors to make an informed decision about each of the three possible outcomes for the company. Though it is not prescribed, an administrator should also indicate whether directors might be liable for insolvent trading should the company be placed in liquidation. Such information is relevant to creditors in assessing the relative merits of a winding-up compared to entering a DOCA.

The Australian Restructuring Insolvency and Turnaround Association's *Code of Professional Practice* (4th ed, 2020) provides guidance to administrators in fulfilling their statutory responsibilities in preparing s 439A reports, including that they should deal with the estimated return from a winding-up, information about suspected offences, the effect on employees, any proposal for a DOCA and other material information relevant to the creditors' decision-making.

## What decisions can creditors make?

**[31.155]** Under s 439C, the creditors may resolve that one of three steps be taken:

- the company execute a DOCA as specified in the resolution (even if it differs from a proposed deed details of which accompanied the notice of meeting); or
- the administration should end; or
- the company be wound up.

## Voting at creditors' meetings

**[31.160]** The *Insolvency Practice Rules (Corporations) 2016* sets out procedural matters such as which creditors are entitled to vote and the required majorities necessary to pass

resolutions at creditors' meetings. Under s 75-85(3), a creditor is entitled to vote only if the creditor's debt has been admitted wholly or in part by the administrator.

A creditor must not vote in respect of an unliquidated debt or claim or a contingent debt or claim: *Insolvency Practice Rules (Corporations) 2016*, s 75-85(4).

Unless a poll is demanded, resolutions at creditors' meetings are passed by a simple majority of those present and voting in favour on the voices. Under s 75-115 of the *Insolvency Practice Rules (Corporations) 2016*, a creditors' resolution is passed by:

- a majority of creditors voting (whether in person, by proxy or by attorney); and
- a majority in value of creditors voting (whether in person, by proxy or by attorney).

If there is a deadlock between the majority in number and majority in value of creditors voting, the resolution is not passed. In cases of deadlock in the voting, the chair of a creditors' meeting (usually the administrator) has a casting vote and can vote either in favour of, or against the resolution: *Insolvency Practice Rules (Corporations)*, s 75-115(3).

If creditors give an administrator general proxies with discretion on how to vote, the administrator is entitled to use those proxy votes to vote against a motion to remove the administrator: *Re Builders Associated Pty Ltd* [2001] NSWSC 626.

Occasionally, there may be concern that decisions made at creditors' meetings may be influenced by creditors who are either insiders or associated with insiders. Section 75-41 of the *Insolvency Practice Schedule (Corporations)* is designed to prevent such creditors from exercising an unfair influence over creditors' meetings.

Under s 75-41 of the *Insolvency Practice Schedule (Corporations)*, the court may on the application of a creditor, the external administrator or ASIC, set aside a resolution passed at a meeting of creditors. The court also has the power to order the reconvening of creditors' meetings and remove the voting rights of a "related creditor". A "related creditor" is a "related entity of the company" to whom a debt is owed: *Insolvency Practice Schedule (Corporations)*, s 75-41(4). Section 9 defines "related entity" in broad terms. It includes a director or member of the company and relatives of directors and members, as well as related companies.

The court can only make an order setting aside a resolution if the resolution was carried by the votes of related creditors and the resolution is contrary to the interests of the creditors as a whole or prejudices the interests of the creditors who voted against it: *Insolvency Practice Schedule (Corporations)*, s 75-41(1).

Power of the court to set aside resolutions.

Section 75-42 of the *Insolvency Practice Schedule (Corporations)* gives the court the power to set aside or vary a resolution that is passed on the casting vote of the person who chaired the meeting. This enables the court to review decisions of the chairman.

*Cresvale Far East Ltd v Cresvale Securities Ltd* (2001) 19 ACLC 659

**[31.165]** The administrator, who chaired a creditors' meeting, exercised a casting vote to defeat a resolution for his removal as administrator in circumstances where a majority of creditors by number voted against the resolution, but a majority of creditors in value voted in favour of the resolution. The court held that while there was no general rule that administrators should exercise their casting vote to prefer the view of the majority in value over the view of the majority in number, the court would take into account any large disproportion between the values of the debts of the numerical minority and the numerical majority. It was not appropriate for the administrator to use his casting vote in order to defeat a resolution for his removal, particularly in circumstances where the largest creditor in value had twice attempted to remove him from office.

## Effect of administration

**[31.170]** While a company is under administration, the administrator controls its business, property and affairs. The administrator may perform the functions or exercise the powers that the company or its officers could perform or exercise if the company were not under administration: s 437A. The administrator is taken to act as the company's agent: s 437B. This means that the administrator's actions as an agent generally bind the company.

Officers of the company lose their rights to exercise their powers as officers while a company is under administration: s 198G(1). Officers however, are not removed from office and may be allowed by the administrator to participate in management: s 198G(6).

Shareholders are excluded from any role during an administration: *Brash Holdings Ltd v Shafir* (1994) 12 ACLC 619.

Where a company is under administration, its property can only be dealt with by the administrator or with the administrator's written consent or by order of the court. Any other transaction or dealing is void: s 437D.

An officer who breaches s 437D by purporting to enter into a void transaction or dealing on the company's behalf or is in any other way knowingly concerned in, or party to, the transaction or dealing is guilty of an offence: s 437D(5). Where an officer is found guilty of breaching s 437D and the court is satisfied that the company or another person suffered loss or damage as a result, the court may order the officer to pay compensation, whether or not a penalty is imposed: s 437E(1).

The court may relieve an officer from liability to pay compensation under s 437E in the circumstances set out in s 1318. This section is discussed at [20.30], and provides that an officer may be relieved from liability where they acted honestly and ought fairly to be excused.



Once the administration of a company begins, any transfer of shares or alteration in the status of shareholders is void except where the administrator consents or the court authorises the transfer or alteration: s 437F(1) and (8). Administrators have the power to consent to a transfer of shares in a company in administration or alter the status of shareholders if the administrator is satisfied that it is in the best interests of creditors as a whole to do so: s 437F(2) and (9). The ability to apply to the court is only available to prospective transferors, transferees or creditors where the administrator withholds consent to the transfer or alteration to the status of members.

The acts and things done in good faith by an administrator are valid and effectual and are not liable to be set aside in a winding-up of the company: s 451C. This means that payments made during an administration within six months of the commencement of winding-up are not voidable as unfair preferences.

If a company is required to do some act within a particular period or before a particular time and this is prevented by the legislation, the period is extended or the time is deferred according to how long the act is prevented from being done by the legislation: s 451D. The extension or deferment of time applies to requirements of any law or under contracts. This provision acknowledges that Pt 5.3A may prejudice the rights of creditors in certain circumstances where a moratorium is imposed and so time does not run where a restraint on action results from the operation of the legislation. In *Milankov Nominees Pty Ltd v Roycol Ltd* (1994) 52 FCR 378 the six-month period applicable to applications to wind up a company in insolvency was extended to exclude the period during which a company was under administration.

The company must set out in all its public documents and negotiable instruments the words “administrator appointed” or “subject to deed of company arrangement”, as the case may be: s 450E. The court may grant leave to dispense with the use of the words “subject to deed of company arrangement” on public documents: s 450E(2). In granting leave, the court must be satisfied that the absence of the words will not result in any significant risk to the interests of the company’s creditors: s 450E(5).

A failure to give the required notice does not affect the validity of any act or omission, except so far as the court otherwise orders: s 450F.

## **Moratorium on claims against the company and its directors**

### **Purpose of moratorium**

**[31.175]** The voluntary administration process enables creditors to consider and vote on the future of the company. During voluntary administration the company is protected from actions that may be taken against it by individual creditors or others such as lessors. Such actions may undermine the position of the company to the detriment of a majority of creditors. For this reason, ss 440A–440JA impose a moratorium or stay of proceedings against the company and guarantors of its debts.



## Stay of proceedings

**[31.180]** From the time of appointment of the administrator, a civil proceeding cannot be brought against the company or in relation to any of its property except with the administrator's written consent or the leave of the court: s 440D. This provision is an important protection for the company and gives the administrator and creditors breathing space to consider the appropriate course of action. The moratorium does not prevent criminal proceedings and certain prescribed proceedings being brought.

Section 440D does not stay an appeal by the company against a judgment obtained prior to the commencement of administration. The appeal is not a proceeding against a company for the purposes of s 440D: *Uranna Pty Ltd v Tsang Chi Thug* (1997) 15 ACLC 443.

If the court grants leave to proceed with an action, such leave only authorises the prosecution of an action either against the company while it is under administration or against the administrator. After a DOCA is executed, a further grant of leave is required under s 444E(3): *Roder Zelt Und Hallenkonstruktionen GmbH v Rosedown Park Pty Ltd* (1995) 57 FCR 216.

In addition to the general stay of proceedings against the company, the legislation also restricts the rights of a judgment creditor to enforce a judgment against a company under administration: s 440F. This is also necessary to preserve the company's financial position during the administration.

Once a court officer such as a sheriff or registrar receives written notice of the fact that a company is under administration, the court officer cannot take further enforcement action and must hand over any property of the company in her or his possession to the administrator: s 440G. A person who buys property in good faith under a sale under a process of execution receives good title to the property: s 440G(8).

## Winding-up cannot proceed

**[31.185]** A company under administration cannot be wound up voluntarily except as provided under s 446A: s 440A(1). The court will adjourn an application for an order that a company be wound up and will not appoint a provisional liquidator if it is satisfied that it is in the interests of the creditors for the company to continue under administration rather than be wound up or have a provisional liquidator appointed: s 440A(2) and (3).

## Security interests unenforceable

**[31.190]** During the administration of a company, a secured party cannot enforce their security interest in the company's property except with the administrator's written consent or with the leave of the court: s 440B. This general rule seeks to preserve the company's business and its continued existence by preventing a secured party from taking control of the company's assets by appointing a receiver or mortgagee in possession or agent and thereby preventing the administration from proceeding. Leave is not required under s 440B if the secured party had begun court proceedings to enforce the security interest prior

to the commencement of administration. However, leave to continue the proceedings is required under s 440D: *BBC Hardware Ltd v GT Homes Pty Ltd* [1997] 2 Qd R 123.

A secured party can give notice to a company under the terms of a security agreement: s 441E. Although the secured party cannot enforce the security interest during the administration because of s 440B, the giving of notice will allow for prompt enforcement as soon as the administration ends. Similarly, notice can also be given by a lessor or owner of property used by the company: s 441J.

Under s 440B a person who holds company property as security under a lien or pledge is entitled to retain possession of the property after the company enters administration. However, that person will not be able to sell that property during the voluntary administration without the consent of the administrator or leave of the court.

Certain secured creditors and others are entitled to protection from the general moratorium rules, and there are provisions that seek to balance the interests of particular creditors against the general objects of the legislation. These exceptions are discussed at [31.205]–[31.230].

## Owners and lessors cannot recover property

**[31.195]** In addition to restrictions on secured parties enforcing security interest in the company's property, owners and lessors of property used by the company also cannot take possession or otherwise recover the property without the administrator's written consent or the leave of the court: s 440B. This provision aims to protect property that is necessary for the company's continued existence so that the administration can continue. Such property includes goods sold under retention of title clauses.

This general rule is subject to similar exceptions as apply to enable the enforcement of security interests over the company's property. For example, a lessor who has already taken steps to repossess property before the appointment of the administrator can enforce rights under the lease: s 441F.

## Guarantor directors

**[31.200]** Directors often guarantee their company's debts to creditors. If creditors were able to enforce directors' guarantees when the company went into administration, it would effectively discourage directors from appointing an administrator because it would immediately trigger personal liability under the guarantee. The moratorium provisions therefore prevent a creditor enforcing a guarantee against a director, spouse or relative of a director in respect of a liability of the company: s 440J(1). This stay is subject to leave of the court or an order of the court to preserve the assets of the director during the administration or other order under s 1323: s 440J(2).

Leave of the court under s 440J(1) will not be granted unless there is something more than the guarantor being denied the benefit of the guarantee. This is especially so where the administration would be impeded and implementation of the DOCA prejudiced: *Re Grenadier Constructions No 2 Pty Ltd* (1993) 12 ACLC 460.

Section 440J applies only to proceedings relating to enforcement of guarantees. It does not prevent a creditor from issuing a bankruptcy notice against a guarantor director:

*Re Behan* (1995) 13 ACLC 1644. Section 440J also does not prevent a creditor commencing court proceedings to enforce a guarantee against a director where the legal action commenced before the company entered voluntary administration: *Mizuho Bank Ltd v Ackroyd* [2016] NSWSC 1148.

## Ipsso facto clauses

[31.201] Ipsso facto clauses were described in the Explanatory Memorandum to the legislation which introduced s 451E. Ipsso facto clauses:

allow one party to terminate or modify the contract solely due to the appointment of formal insolvency proceedings, such as the appointment of a voluntary administrator. This type of termination can occur regardless of the continued performance of the counterparty of its obligations under the contract.

The operation of ipso facto provisions can thus reduce the scope for a successful restructure, destroy the enterprise value of a business entering formal administration, or prevent the sale of the business as a going concern.

Section 451E(1) makes an ipso facto clause unenforceable against a company just because the company enters into external administration. The unenforceability of ipso facto clauses will only operate from the time the company enters into voluntary administration until administration ends unless:

- the administration ends because the company is being wound up, in which case the right will not be enforceable until the time when the affairs of the company are fully wound up; or
- where the company applies to the court to extend the period for which the ipso facto rights will not be enforceable:
  - either the application is withdrawn or the court rejects the application; or
  - the court order extending the period ceases to apply.

The court may extend the period for which an ipso facto clause is not enforceable in several instances including if the court is satisfied that doing so would be in the interests of justice.

## Exceptions to the moratorium provisions

[31.205] There are several sections that protect the rights of certain secured creditors and lessors of property to the company while the moratorium operates. These protections constitute exceptions to the general rules discussed at [31.175]–[31.201], which are aimed at enabling the company's business to continue in accordance with the objects of the legislation stated in s 435A.

## Security interest in the whole of company's property

[31.210] A secured party who has a security interest in the whole, or substantially the whole, of the property of a company under administration may enforce the security interest

within a “decision period”, defined in s 9 as being 13 business days after administration begins or 13 business days after the secured party was given notice of the appointment of an administrator: s 441A. The administrator must give notice of appointment to secured parties with a security interest in all or nearly all of the company’s property under s 450A(3). The moratorium provisions that would otherwise prevent this enforcement, ss 198G, 440B, 440F or 440G, are specifically excluded: s 441A(3) and (4).

This exception recognises that a creditor with a security interest in the whole, or substantially the whole, of a company’s property is in a better position because, unlike other secured creditors, the moratorium does not stay their ability to immediately enforce their security interest and appoint a receiver or otherwise take possession of the secured property. A receiver appointed by a creditor with a security interest in the whole, or substantially the whole, of a company’s property is capable of achieving an orderly administration in the same way as a voluntary administrator.

One uncertainty with this exception is that the expression “substantially the whole” of the property of a company is not defined in the legislation. This may result in disputes where a secured creditor seeks to come within the exception and enforce rights independently of the administration.

## **Secured creditor takes possession before commencement of administration**

**[31.215]** Similar protection is afforded where a receiver, or other person who has entered into possession or assumed control of the property of the company enforces a security interest before the administrator was appointed. The security interest may continue to be enforced after the administration has begun: s 441B. The moratorium provisions that would otherwise prevent this, ss 198G, 437D, 440B or 440G, are excluded: s 441B(2) and (3).

Where a secured creditor has started to exercise rights under a security agreement to sell property before the appointment of an administrator, the sale process may continue after the administration has begun. The moratorium provisions are again excluded: s 441B(1).

This exception recognises that where a secured creditor takes action before the directors appoint an administrator, the creditor should not be impeded by the administrator. This encourages directors to appoint an administrator before the company defaults under a security interest over its property.

## **Enforcement of rights by owners and lessors before commencement of administration**

**[31.220]** The enforcement of rights commenced before the beginning of the administration by the owner or lessor of property used by the company can also continue after the administrator has been appointed: s 441F. This is despite s 440B, which is discussed at [31.190].

## Perishable goods

**[31.225]** A creditor holding security over perishable goods may enforce a charge in relation to those goods despite the appointment of an administrator: s 441C. The general moratorium provisions do not apply because the creditor could be harshly affected by a delay.

## Leave of the court

**[31.230]** Certain of the exceptions to the moratorium provisions are subject to the power of the court. The court may order a secured party, receiver or other person to refrain from performing a function or exercising a power that would otherwise be permissible under s 441B(1): s 441D. The administrator may apply for such an order, which will only be made if the court is satisfied that the administrator proposes to act in a way that will adequately protect the secured party's interests. The power of the court under s 441D does not extend to limit the power of a secured party with a security interest in the whole, or substantially the whole, of the company's property under s 441A: s 441D(1).

The court may similarly order that an owner or lessor of property used by the company refrain from enforcing rights that would otherwise be enforceable under ss 441F and 441G: s 441H. The court must also be satisfied that the interests of the owner or lessor will be adequately protected.

# Deed of company arrangement

## Purpose of DOCA

**[31.235]** A DOCA is one of the three possible outcomes for a company that enters voluntary administration. The s 435A objects of the voluntary administration scheme – to save insolvent companies or their businesses or achieve a better return for their creditors than liquidation – are largely achieved by DOCA.

A company becomes subject to a DOCA in the following manner. As discussed at [31.145]–[31.155], one of the key tasks of a voluntary administrator is to report to creditors on whether it would be in their interests that the company executes a DOCA. Other interested parties, such as directors or major shareholders, may also propose DOCA. If creditors vote in favour of a proposed company arrangement and the company and the voluntary administrator executes the deed, voluntary administration ends: s 435C(2)(a). The company's voluntary administrator becomes the administrator of the deed unless the creditors appoint someone else: s 444A(2).

The information provided to creditors at the second creditors' meeting means that creditors have the opportunity to assess whether the company's liquidation or a DOCA produces a better outcome for them. Their analysis involves an evaluation of the likelihood of a liquidator increasing the amount of the company's assets available for distribution to creditors by successful proceedings for breach of fiduciary or statutory

duties, or insolvent trading against directors or recovery of unfair preferences and uncommercial transactions.

In some cases, directors may be prepared to forego any security interests they may have or to contribute to funds available for distribution to creditors in a DOCA from their own personal resources in order to avoid potentially higher claims against themselves if the company were liquidated. This is likely to be the case if, prior to the commencement of voluntary administration, directors have failed to prevent insolvent trading, have received unfair preferences or have breached their fiduciary duties by not taking creditors' interests into account. In addition, directors may be willing to contribute to a DOCA to regain control over the company's business or purchase some or all of its assets, perhaps for a higher price than would be paid by outsiders. Directors may be in a better position to utilise the company's carry forward tax losses than third party purchasers of the company's shares.

Creditors who supplied goods and services to a company prior to its voluntary administration may be induced to vote in favour of a deed if this results in the company continuing as a customer. Creditors may also vote in favour of a deed if they perceive that the company can trade its way out of financial trouble with more competent management provided by the deed administrator.

If the administrator proposes a DOCA, a statement setting out its details must be sent to creditors with the notice of the creditors' meeting convened under s 439A.

## Terms of DOCA

[31.240] The *Corporations Act* imposes few restrictions as to the terms of a DOCA so as to enable the arrangement to meet the particular needs and circumstances of the company and its various creditors.

DOCA often have the following features:

- provision for a moratorium under which the company has additional time to pay debts incurred prior to the commencement of voluntary administration. The company, under the control of the deed administrator, is permitted to continue operating its business;
- provision for a compromise under which the creditors agree to accept payment of a lesser amount in final settlement of their debts;
- a combination of a moratorium and compromise with creditors;
- specify the company's property and an orderly sale of all the company's property over an agreed period of time; and
- differential treatment of creditors where for example some creditors receive more than others because they will maintain an ongoing relationship as creditors of the company.

A DOCA usually involves the reorganisation of a financially-distressed company's business ("a reorganisation deed"), a "going concern" sale of the company's business ("going concern sale deed") or a gradual sale of the company's property ("sale deed"). In a reorganisation deed, the company continues to operate but with the deed administrator overseeing its management for a specified period of time. To solve the

company's liquidity problems, shareholders, directors or others may agree to contribute additional funds as either equity or debt capital. If a reorganisation deed achieves its purpose, the deed terminates under s 445C(c) and the company is rehabilitated and survives as a viable legal entity. In a going concern sale deed, the deed administrator attempts to sell the company's business as a going concern to new owners which may ensure the survival of the company's business. Going concern sale deeds typically provide for the distribution of the proceeds of the sale of business to the company's creditors. Sale deeds involve the deed administrator selling all the company's property. Such deeds allow the company's property to be sold gradually over an agreed period of time rather than being sold quickly at "fire sale" prices as would occur in a liquidation. Once the property is sold and its proceeds distributed to creditors, the deed terminates and because the company is left as an empty shell, it is often then wound up and deregistered.

**[31.250]** If the company's creditors resolve that the company execute a DOCA, they must appoint a person to be the deed administrator: s 444A(2). This will usually be the initial administrator who is familiar with the circumstances of the company. The deed administrator must prepare the instrument setting out the terms of the deed: s 444A(3). There are certain requirements regarding the contents of the deed set out in s 444A(4). These include:

- the property of the company available to pay creditors' claims;
- the nature and duration of any moratorium period;
- the extent to which the company is released from its debts;
- any conditions for the deed to come into operation or to continue in operation;
- the circumstances in which the deed terminates;
- the priorities among creditors bound by the deed; and
- the day on or before which admissible claims must have arisen.

Unless expressly excluded, the property of the company available to pay creditors' claims includes compensation payable by a director to the company arising from a successful action brought by ASIC under the civil penalty provisions. The order for compensation does not have to be made before the DOCA is executed. It is sufficient that the asset, being the right to claim the compensation, exists at the time of distribution to creditors: *Elliott v Water Wheel Holdings Ltd* [2004] FCAFC 253.

Further prescribed provisions are taken to be included in the deed unless excluded: s 444A(5). These prescribed provisions are set out in the *Corporations Regulations 2001* (Cth) (*Corporations Regulations*), Sch 8A, and provide for various matters, such as the making of claims, priorities of claims, discharge of debts and appointment of a committee of inspection.

## Execution by creditors and company

**[31.255]** The company must execute the instrument that sets out the terms of the DOCA within 15 business days after the meeting of creditors or such further time as the court allows: s 444B(2). The board of the company may by resolution authorise the execution of the deed: s 444B(3). The administrator must also execute the deed: s 444B(5).



Execution by the company, which is not in compliance with the company's constitution, may still be validly executed. A DOCA does not necessarily have to be executed as a deed: *MYT Engineering Pty Ltd v Mulcon Pty Ltd* [1999] HCA 24.

**[31.265]** If a company fails to execute the deed within the prescribed time, it is deemed to have entered into a creditors' voluntary winding-up and the administrator is deemed to have been appointed as liquidator: s 446A(1). The transition into liquidation is discussed at [31.370].

Failure to execute deed.

Upon execution of the deed, the administration comes to an end under s 435C(2)(a) and the statutory moratorium in place during the administration is replaced by the provisions of the deed and certain statutory restrictions.

As soon as practicable after execution of a DOCA, the administrator must send notice of this to all creditors and lodge a copy of the deed with ASIC: s 450B.

## Effect of DOCA

**[31.270]** If a company's creditors resolve that the company execute a DOCA, creditors and others are bound by the deed even before it is executed: s 444C.

### *Unsecured creditors*

**[31.275]** A DOCA binds all unsecured creditors of the company so far as concerns claims arising on or before the day specified in the deed: s 444D(1). A DOCA cannot, however, limit the rights of creditors to make claims against third parties: *Lehman Brothers Holdings Inc v City of Swan* [2010] HCA 11. In that case creditors of Lehman Brothers Australia voted in favour of a deed that was passed primarily due to the votes of two associated Lehman Brothers companies. The High Court held that s 444D(1) did not relate to debts of third parties and therefore provisions in the deed that purported to prevent Lehman Brothers Australia's creditors from pursuing claims against the two associated Lehman Brothers companies were invalid.

*Brash Holdings Ltd v Katile Pty Ltd* [1996] 1 VR 24

**[31.280]** This case considered the meaning of "creditors" for the purposes of s 444D(1). Companies in the Brashs group applied to the court under s 447A for a declaration that a DOCA was binding on current and contingent creditors. In particular, the administrators sought to bind lessors of premises rented by the companies in respect of future rent and outgoings that arose after the date specified in the deed.

It was held that "creditors" extended beyond creditors whose claims arose on or before the date specified in the deed. It meant all creditors for the time being of the company as understood in the context of other references to "creditors" in Pt 5.3A and who are creditors for the purposes of a winding-up under s 553. The reference to "claims arising on or before the day specified in the deed" in s 444D(1) is for the



purpose of fixing a date as at which the existence of the claim is to be determined. It does not exclude future debts or claims and has similar effect to s 553 in relation to the “relevant date” in a winding-up.

**[31.285]** The Australian Taxation Office is also bound by a deed, even though it was not a party to it: *Dexcam Australia Pty Ltd v Deputy Commissioner of Taxation* [2002] FCA 820.

Guarantors of a company's debts are regarded as contingent creditors and are therefore bound by a DOCA: *Re Zambena Pty Ltd* (1995) 13 ACLC 1020.

### *Secured creditors*

**[31.295]** A secured creditor may realise or otherwise enforce or deal with the security unless that creditor has agreed to be bound by the deed or the court limits the rights of the secured creditor under s 444F: s 444D(2). Such an order may only be made if the dealing with the security would have a material adverse effect on achieving the purposes of the deed and the creditor's interests will be adequately protected. The court may similarly order that an owner of property not take possession of it.

### *Owners and lessors*

**[31.300]** Owners and lessors of property are generally not affected by s 444D(1) which provides that all creditors are bound by a DOCA: s 444D(3). The exclusion of owners and lessors from being bound by a DOCA is subject to the following three exceptions:

- where the DOCA provides that the owner or lessor is bound by it and the owner or lessor voted in favour of the deed (s 444D(3)(a));
- the court orders that an owner or lessor is bound by the DOCA (s 444D(3)(b)); and
- where the property is claimed under a PPSA retention of title clause (s 444D(3A)).

### *Prevention of winding-up applications and other proceedings*

**[31.305]** While the deed is in force, creditors and other persons bound by it are prevented from applying to wind up the company, beginning or proceeding with an action against the company or in relation to its property or enforcing a court order against the company or its property: s 444E. These prohibitions are subject to the leave of the court. The court may exercise its discretion under s 444E(3) to grant leave to bring proceedings against a company subject to a DOCA. In *Phoenix Institute of Australia Pty Ltd v Australian Competition and Consumer Commission* [2017] FCAFC 155, the relevant considerations the court took into account in deciding whether to grant leave were the significant public interest in the proceedings involving financial consequences for a large number of students who were liable to become indebted to the government, general deterrence to other education providers and the effects of substantial delay in awaiting the termination of the deed.

The court will not grant leave to proceed against a company subject to a DOCA if it would be futile to do so. In *Chief Commissioner of State Revenue v CCM Holdings Trust Pty Ltd* [2014] NSWCA 42, the Chief Commissioner of State Revenue, an unsecured creditor, sought leave to proceed with an appeal against his assessment of stamp duty. The company owed a large amount to secured creditors who were in the process of selling

the secured property. The court refused to grant leave to proceed with the appeal because even if it were successful, it was very uncertain whether there would be any surplus available for distribution to unsecured creditors after the secured debts was paid.

## *Company and its officers*

**[31.310]** A DOCA is binding upon the company, its officers and shareholders and the deed's administrator: s 444G. The company is released from a debt only in so far as the deed provides for the release and the particular creditor is bound by the deed: s 444H. A DOCA cannot operate to discharge the personal debts of the company's directors. It can only discharge debts of the company: *Re Andersens Home Furnishing Co Pty Ltd* (1996) 14 ACLC 1710.

A creditor's right to enforce a guarantee or indemnity is unaffected by acceptance of the terms of a DOCA: s 444J.

Section 444GA(1) permits a deed administrator to transfer shares in a company with either the written consent of shareholders or leave of the court. In granting leave, the court must be satisfied that the share transfer will not unfairly prejudice the interests of the shareholders: s 444GA(3). The term "unfairly prejudicial" includes whether there was a prospect of the shares obtaining some value within a reasonable time: *Re Lewis* [2014] FCA 53.

## *Employees*

**[31.315]** A DOCA must contain a provision which enables employee creditors whose claims would be entitled to priority over other unsecured debts and claims in a liquidation, to have at least an equal priority under the deed: s 444DA(1). This requirement may be waived by a meeting of employee creditors or by the court: s 444DA(2). The court may approve the non-inclusion of an eligible employee priority provision if it is satisfied that the non-inclusion of the provision would likely result in the same or a better outcome for eligible employees as a whole than would be the result from an immediate winding-up of the company: s 444DA(5). The factors a court may take into account in exercising its discretion could include the amounts employees are likely to receive under a DOCA if the priority provision was not included compared with the likely payment to employees in a winding-up, the likelihood that the company would continue to operate under the deed so employees would continue their employment and whether eligible employees had agreed to, or not protested against, the resolution to execute the deed under which the priority to eligible employees provision was excluded: *Richard Albarran, Brent Kijurna and Cameron Shaw as Joint and Several Administrators of Cooper & Oxley Builders Pty Ltd* [2018] WASC 161. The priorities of employees in relation to other unsecured creditors in a liquidation are discussed at [32.675].

## *Public notice of administration*

**[31.320]** Section 450E(1) and (2) requires a company that is under administration or has executed a deed of company administration that has not terminated, to publicise that it has either appointed an administrator or is subject to a DOCA. The expressions "administrator appointed" or "subject to deed of company arrangement", as the case may be, must be

set out after the company's name in its public documents, cheques or other negotiable instruments. Section 450E(4) gives a deed administrator or any interested person the ability to apply to the court for an exemption from the requirement to indicate on its public documents that the company is subject to a deed. The court must be satisfied that dispensing with the expression "subject to deed of company arrangement" is beneficial to the company: *Re TMPL Pty Ltd* [2009] NSWSC 818. The granting of leave may reduce what otherwise may be adverse effects on the company's goodwill and reputation that may affect its ability to continue trading and the administrator's ability to rehabilitate the company.

## Powers of the court to limit rights of secured creditors, owners and lessors

[31.325] Secured creditors and owners and lessors of property used by the company may generally enforce their rights after the deed comes into effect, except insofar as they have agreed to be bound by the deed or the court orders under s 444F.

The court's power to limit the rights of secured creditors, owners and lessors is important in some circumstances to prevent a dissident secured creditor or lessor from enforcing rights under a charge or lease where this would have a material adverse effect on achieving the purposes of the deed. This would be the case where the company is prevented from carrying on its business. On the other hand, the court will only make such an order if it is satisfied that the creditor's or lessor's interests will be adequately protected under the deed or the order: s 444F(3) and (5). This may involve paying out the creditor or granting further security over other assets owned by the company.

An application for such an order may only be made by the administrator of the company or the deed's administrator, as the case may be: s 444F(7).

## Variation and termination of DOCA

[31.340] Creditors of a company subject to a DOCA have the power to vary the terms of the deed: s 445A. They may also have the power to terminate a deed and resolve that the company be wound up: s 445E.

### Variation

[31.345] It is open to a meeting of creditors convened to pass a resolution varying a deed as long as the notice of the meeting sets out the proposed variation: s 445A. This enables the company's creditors to vary a deed where circumstances have changed. Creditors who oppose a variation of the deed may apply to the court for an order cancelling the variation. The court has wide powers in dealing with such an application: s 445B.

### Termination

[31.350] A DOCA terminates:

- when the court so orders under s 445D;
- the creditors pass a resolution to that effect in accordance with s 445E;

- the deed specifies the circumstances in which it is to terminate and those circumstances exist (s 445C); or
- the administrator of the deed executes a notice of termination of the deed in accordance with s 445FA.

The court may also order that the deed or a provision of it is void: s 445G.

|                                            |
|--------------------------------------------|
| Termination of deed by order of the court. |
|--------------------------------------------|

The court may terminate a DOCA under s 445D on the application of a creditor, the company, ASIC or any other interested person in a variety of circumstances where the court is satisfied that:

- information given to the administrator or creditors about the company's financial position was false or misleading and could reasonably be expected to have been material to creditors in deciding whether to vote in favour of the resolution that the company execute the deed (s 445D(1)(a)); or
- such information was contained in a document that accompanied a notice of the meeting at which the resolution was passed (s 445D(1)(b)); or
- there was an omission from such a document and the omission can reasonably be expected to have been material to such creditors in so deciding (s 445D(1)(c)); or
- there has been a material contravention of the deed by a person bound by it (s 445D(1)(d)); or
- effect cannot be given to the deed without injustice or undue delay (s 445D(1)(e)); or
- the deed or a provision of it involves, an act or omission that is oppressive or unfairly prejudicial to, or unfairly discriminatory against, one or more creditors; or contrary to the interests of the creditors of the company as a whole (s 445D(1)(f)); or
- the deed should be terminated for some other reason (s 445D(1)(g)).

Where the court makes an order terminating a DOCA under s 445D, the company is taken to have passed a special resolution under s 491 that the company be wound up voluntarily: s 446AA(2).

*Deputy Commissioner of Taxation v Woodings* (1995) 13 WAR 189

**[31.355]** The court suggested that a DOCA could be terminated in circumstances where creditors did not know of a director's previous involvements with insolvent companies and voting at the creditors' meeting was improperly influenced by offers to some creditors to pay their debts in full.

*TNT Building Trades Pty Ltd v Benelong Developments Pty Ltd* [2012] NSWSC 766

**[31.357]** A DOCA that was found to be misleading and to contain material omissions was not set aside because the court was not satisfied that a winding-up would allow a more favourable outcome to creditors than the proposed deed. In determining

that the deed should not be set aside on the ground that it was unfairly prejudicial for the purposes of s 445D(1)(f) the court took into consideration a comparison of the proposed return to creditors under the DOCA and the likely return to creditors on a winding-up.

The court may set aside a deed under s 445D in the public interest even if creditors may be better off under the deed than in a liquidation.

*ASIC v Midland Hwy Pty Ltd* [2015] FCA 1360

**[31.359]** The court decided to set aside the deed in this case and ordered the company be wound up even though the creditors voted overwhelmingly for the deed. The reasons for this decision were as follows:

- the company was insolvent and had been used and controlled by shadowy figures and entities. It had little if any assets and substantial liabilities;
- the proposed deed would not restore the company to a position where it would be able to trade. If the deed were implemented the company would have remained in substance a shell corporation. It was not in the public interest for such a corporation to continue in existence to the detriment of future creditors;
- there were numerous transactions involving substantial sums that required full investigation by a liquidator and, if appropriate, recovery proceedings;
- the primary purpose or effect of the deed was to hinder a full investigation of the various entities associated with the company and ultimately to quarantine them from recovery proceedings by a liquidator; and
- the propounder of the deed was an entity of questionable financial standing and it was doubtful that it had the capacity to carry through the transactions the deed contemplated.

**[31.360]** A meeting of creditors may be convened to pass a resolution terminating the deed and, where the notice of meeting sets out a proposed resolution that the company be wound up, the creditors may also pass a resolution to this effect: s 445E.

The creditors' meeting to consider whether to terminate or vary the deed may be convened by the administrator of the deed and must be convened if so directed in writing by creditors whose claims comprise at least 25 per cent in value of the creditors or more than 10 per cent in value of the creditors where security for the cost of holding the meeting is given to the external administrator before the meeting is convened: *Insolvency Practice Schedule (Corporations)*, s 75-15(1).

The convenor of a meeting must give notice of the meeting of not less than 10 days and the notice must set out the purpose for which the meeting is being convened: *Insolvency Practice Rules (Corporations)*, s 75-15 and 20. Notice must be lodged and sent to each of the

company's creditors where the creditors resolve to terminate the deed under s 445C(b) (s 450D) and where the company fails to execute a DOCA within the 15 business days prescribed by s 444B(2): s 450C.

To alleviate concerns that a relatively small number of creditors could force a deed administrator to convene a meeting at which a majority of creditors resolve to terminate the deed and thereby create uncertainty as to the rehabilitation of the company, s 445CA restricts the right of creditors to terminate a DOCA to situations where there has been a breach of the deed and the breach has not been rectified before the creditors' resolution to terminate the deed has been passed.

Under s 445FA a deed administrator must lodge a notice of termination of the deed with ASIC within 28 days of the deed being terminated because it has achieved its purpose. This ensures the public record is updated.

### *Invalidation of DOCA*

[31.365] The court may declare a DOCA to be void where it was entered into in contravention of the legislation: s 445G. The application for such an order may be made by the administrator, a member or creditor of the company or ASIC.

The court may make an order declaring the whole of the deed or a provision of it to be void or not void: s 445G(2). The court may declare the deed or a provision of it valid despite a contravention of the legislation, where it is satisfied that the legislation was substantially complied with and no injustice would result for anyone bound by the deed: s 445G(3). If the court declares a provision of the deed to be void, it may vary the deed only with the consent of the administrator: s 445G(4).

Where a deed is terminated or declared to be void, parties who previously acted in reliance upon the deed are not affected by the termination or avoidance: s 445H.

## **Transition from administration to winding-up**

[31.370] The *Corporations Act* provides for a smooth transition from administration to winding-up in insolvency. At various stages while a company is under voluntary administration or subject to a DOCA, the company's creditors may resolve that the company be wound up in insolvency. Such a resolution may be passed either at the creditors' meeting convened under s 439A to decide the company's future or at a meeting convened to terminate a DOCA. If creditors pass a resolution that the company be wound up in insolvency at either of these meetings, the company is deemed to have entered into a creditors' voluntary winding-up and the administrator is deemed to have been appointed a liquidator: s 446A. Similarly, if the court orders the termination of a DOCA under s 445D (see [31.350]), the company is taken to have passed a special resolution under s 491 that it be wound up voluntarily.

The administrator is also taken to have been appointed as the liquidator where the company under administration fails to execute the instrument setting out the terms of the deed agreed upon by the creditors within 15 business days after the creditors'

meeting, as required by s 444B(2). If the company executes a DOCA, an application to the court is required to stay or terminate the winding-up. Section 482(1A) allows the deed administrator to also apply for a stay or termination of the winding-up. An order under s 482 may also be made where it can be established that the company is solvent. This would be unusual because the circumstances that led to the initial appointment of the administrator and the subsequent deemed appointment of the liquidator are usually indicative of insolvency.

## Powers of the court

**[31.375]** The court has an important supervisory role to play in the administration process. It is also given wide powers so as to enable a balance to be struck between the interests of particular creditors whose rights are suspended and the objects of the legislation.

The court has a general power under s 447A to make such orders as it thinks appropriate about how the legislation is to operate in relation to a particular company. Such an order may be sought by a wide range of applicants, including the company, a creditor, the administrator, ASIC or any other interested person.

Section 447A was described by the Full Court of the Supreme Court of Victoria in *Brash Holdings Ltd v Katile Pty Ltd* [1996] 1 VR 24 as:

an unusual section, which evidently proceeds on the view that Pt 5.3A is inadequate in the provision which it otherwise makes for the new form of administration and that it is therefore necessary to enable gaps in the Part to be filled by the exercise by the court of wide powers to make such orders as it thinks appropriate about how the Part is to operate in relation to a particular company. It seems clear enough that s 447A(1) is intended to empower the court to make orders which alter what would otherwise be the operation of the Part in relation to a particular company.

This indicates that the discretion of the court under s 447A is not confined to gaps in the legislation but extends to altering what appear to be mandatory requirements. In *Re Brashs Pty Ltd* (1995) 13 ACLC 110 Hayne J suggested that, in appropriate circumstances, an order may be made dispensing with the requirement under s 450E(2) that a company set out the expression “subject to deed of company arrangement” in its public documents.

The discretion in s 447A was relied upon by the court to alter the operation of s 443A(1) in *Re Gould Bros & Co Pty Ltd* [2012] FCA 285. Section 443A(1) provides that the administrator is personally liable for debts incurred in the course of the administration. In this case the administrator successfully sought permission to borrow funds from the shareholders for the purpose of enabling the company to continue to operate while the administrator investigated whether the business and/or assets could be sold as a going concern. The court ordered that if the administrators’ indemnity under s 443B was insufficient to meet the repayment of the shareholders’ loans, the administrators would not be personally liable to repay the debt to the extent of that insufficiency.



*Australasian Memory Pty Ltd v Brien* [2000] HCA 30

[31.380] The High Court held that s 447A conferred a wide power on the court to make orders which had the effect of remedying irregularities by varying the statutory timetable for meetings of creditors. This was despite the existence of provision for the variation of meeting times contained in s 439A(6). Section 447A therefore permitted the making of orders which altered the way in which Pt 5.3A operated in relation to a particular company, even where the company had gone into liquidation.

[31.385] The court may order, under s 447A, that a resolution of creditors as to the future of the company under s 439C be set aside. An order may be made for winding-up the company where this is in the public interest: *Deputy Commissioner of Taxation v Woodings* (1995) 13 WAR 189.

The court may make an order protecting the interests of a company's creditors on the application of ASIC. It may make an order to protect an individual creditor's interests on the application of the creditor: s 447B. This power of the court may be exercised before a DOCA is entered into.

The court may declare whether the appointment of the administrator was valid: s 447C. Section 447A allows the court to declare valid an otherwise invalid appointment: *NAB v Horne* [2011] VSCA 280. The administrator may apply to the court for directions about a matter connected with the administrator's functions and powers or the operation of the DOCA in the same way as a liquidator or other person with a financial interest. This is discussed at [32.295]. As with applications by liquidators and receivers, the court will not give directions to an administrator as to a decision which is wholly business or commercial in nature. There must be an issue as to propriety or reasonableness of the administrator's actions or decision: *Re Ansett Australia Ltd* [2006] FCA 277.

The court has powers to inquire and make orders as it thinks fit in relation to the external administration of a company: *Insolvency Practice Schedule (Corporations)*, s 90-15. The power to make orders may be exercised on the court's own initiative or on the application of persons specified in s 90-20. These include a person with a financial interest such as a creditor, ASIC or an officer of the company. The court may make orders determining any question arising in the external administration, terminating or appointing an administrator or in relation to remuneration. In making an order, the court may take various matters into account including whether the administrator has breached their duties.

The court also has a general power under s 1322(4) to validate any act that has contravened the *Corporations Act*. The court shall not make such an order unless it is satisfied that no substantial injustice would be caused to any person: s 1322(6). In *Brien v Australasian Memory Pty Ltd* (1997) 142 FLR 242 it was held at first instance that s 1322(4) could be used to validate the appointment of a liquidator where the appointment was made at a creditors' meeting held outside the period required by s 439A(2).



## Restructuring process

### Aims of restructuring

[31.390] Amendments made in 2020 inserted Pt 5.3B into the *Corporations Act* which facilitate restructuring insolvent small companies. According to s 452A, the object of Pt 5.3B is to provide for a restructuring process for eligible companies that allows the companies:

- (a) to retain control of the business, property and affairs while developing a plan to restructure with the assistance of a restructuring practitioner; and
- (b) to enter into a restructuring plan with creditors.

The Explanatory Memorandum to the legislation which inserted the restructuring provisions, observed that the formal restructuring process for eligible companies provides an alternative to the one-size-fits-all voluntary administration scheme for small non-complex businesses. “The ultimate aim of restructuring is to have a plan in place for the company to repay its existing debts thereby enabling the company to stay in business and avoid being wound up.”

The restructuring process has two distinct phases. The first phase begins with the appointment of a restructuring practitioner. The second phase occurs when the company enters a restructuring plan with creditors. To publicise that a company has entered a restructuring process it must set out in its public documents the expression “restructuring practitioner appointed” after the company’s name: s 457B.

### Appointment of restructuring practitioner

[31.395] Under s 453A(a), the restructuring of a company begins when a restructuring practitioner for the company is appointed under s 453B. Within five business days after restructuring begins, directors must give the restructuring practitioner a declaration: reg 5.3B49(1). The declaration must state whether, in the directors’ opinion, there are reasonable grounds to believe that the company has entered a transaction that would be voidable under ss 588FE(2C) and 588(2D) (voidable uncommercial transactions, unfair loans and unreasonable director-related transactions) if the company were wound up. The declaration must also state whether, in the directors’ opinion, there are reasonable grounds to believe that the eligibility criteria for restructuring were met at the time the restructuring began and set out the reasons for that opinion.

Restructuring ends in the circumstances prescribed by the regulations: s 453A(b). The end of restructuring is discussed at [31.475].

A company’s directors appoint a restructuring practitioner by passing a resolution to that effect (s 453B(1)(b)) and resolving that in their opinion, the company is insolvent or is likely to become insolvent at some future time. A restructuring practitioner cannot be appointed if the company has already commenced restructuring or another form of external administration: s 453B(2). A restructuring practitioner must be a registered liquidator: s 456B.

As soon as practicable after being appointed, a restructuring practitioner must make a declaration of relevant relationships, lodge a copy of the declaration with ASIC and distribute copies of the declaration to as many of the company's creditors as reasonably practicable: s 453D.

## Eligibility for restructuring

**[31.400]** Restructuring may only be initiated for a company that satisfies certain eligibility criteria on the day the restructuring practitioner is appointed. Section 453C(1)(a) leaves it to the regulations to specify an eligibility test based on the liabilities of the company. Under reg 5.3B.03(1) a company satisfies the eligibility test if its total liabilities on the day restructuring begins do not exceed \$1 million.

To ensure that restructuring is not used to facilitate phoenix activity, restructuring cannot be used if a current director or a person who was a director within the preceding 12 months, had been a director of another company that has been under restructuring or has been the subject of a simplified liquidation process within the previous seven years: s 453C(1)(b) and (c) and reg 5.3B.03(2) and (3).

## Role of restructuring practitioner during restructuring

**[31.405]** Unlike a voluntary administrator, who takes complete control of a company, directors retain control while a company is under restructuring. The function of a restructuring practitioner during the restructuring phase of the scheme is limited to giving advice on matters relating to the restructuring such as assisting in the preparation of a restructuring plan and making a declaration to creditors in relation to the proposed plan: s 453E(1).

Directors of a company under restructuring are required to give the restructuring practitioner information about the company's business, property and affairs and allow the restructuring practitioner to inspect and take copies of the company's books: s 453F. The restructuring practitioner also has the right to inspect and make copies of the company's books held by another person: s 453G.

Under s 453J(1) the restructuring practitioner may terminate the restructuring if the restructuring practitioner believes on reasonable grounds that:

- the company does not meet the eligibility criteria for restructuring; or
- it would not be in the interests of the creditors to make a restructuring plan; or
- it would be in the interests of the creditors for the restructuring to end; or
- it would be in the interests of the creditors for the company to be wound up; or
- any other grounds prescribed by the regulations.

The restructuring practitioner terminates the restructuring by giving notice in writing to the company and as many of the creditors as reasonably practicable: s 453J(3).

## Who may be a restructuring practitioner?

**[31.410]** A restructuring practitioner must be a registered liquidator: s 456B. To ensure independence, s 456C specifies that persons connected with the company must not act as a restructuring practitioner for the company or for a restructuring plan, except with leave of the court. For example, a person must not act as a restructuring practitioner for a company if that person is indebted to the company for an amount exceeding \$5,000, is a director, secretary, senior manager, employee or auditor of the company.

## Effect of restructuring

### On the company, directors and members

**[31.415]** While a company is under restructuring, its directors have control of the company's business, property and affairs: s 453K. Even though directors control the company, they must obtain the restructuring practitioner's consent if the directors purport to enter into a transaction, or other dealing, on behalf of the company, outside the company's ordinary course of business: s 453L(2). The restructuring practitioner may only give consent if the restructuring practitioner believes on reasonable grounds that it would be in the interests of the creditors for the company to enter into the transaction or dealing: s 453L(6).

Directors who contravene s 453L commit an offence and may also be personally liable to the company, or another person who suffered loss or damage, because of the contravention: s 453M.

The insolvent trading provisions of s 588G do not apply to a director in relation to a company debt incurred during restructuring if the debt was incurred in the ordinary course of business or with the consent of the restructuring practitioner: s 588GAAB. A director is also given temporary relief from contravening the insolvent trading provisions in relation to a company debt incurred in the ordinary course of business while the company is taking reasonable steps to appoint a restructuring practitioner before the debt was incurred: s 588GAAC.

While a company is under restructuring, its members cannot transfer their shares without either the written consent of the restructuring practitioner or the court authorising the transfer: s 453P(1). The consent to a transfer of shares may only be given if the restructuring practitioner believes on reasonable grounds that the transfer is in the best interests of the company's creditors as a whole: s 453P(2).

Under s 453P(8) and (9) an alteration of the status of members while the company is under restructuring is void except if the restructuring practitioner consents to the alteration in writing. The restructuring practitioner must refuse to consent if the alteration would contravene the variation of class rights provisions of Pt 2F.2. Variation of class rights is discussed at [8.155]–[8.195]. A member or creditor may apply to the court for an order authorising an alteration if the restructuring practitioner refuses

to consent: s 453P(1). The court may authorise the alteration if it is satisfied that the alteration is in the best interests of creditors as a whole and the alteration does not contravene Pt 2F.2.

## On creditors

**[31.420]** As is the case with voluntary administration, there is a moratorium on claims against a company and its directors during the first phase of restructuring. For example:

- A hearing of a winding-up application is adjourned if the court is satisfied that it is in the interests of the company's creditors for the restructuring to continue rather than the company be wound up: s 453Q.
- A court proceeding against the company, in relation to any of its property, cannot begin or proceed except with the written consent of the restructuring practitioner or leave of the court: s 453S.
- No enforcement process in relation to property of the company can begin or proceed except with the leave of the court: s 453T.
- A guarantee of a liability of the company cannot be triggered against a director or spouse or relative of a director: s 453W.
- Secured creditors cannot enforce their security interests, and lessors of property used by the company cannot take back possession of the property without the written consent of the restructuring practitioner or leave of the court: s 453R.

There are several exceptions to the moratorium provisions (see ss 454A–454M) which are consistent with equivalent exceptions to the moratorium provisions under the voluntary administration scheme. The exceptions to the moratorium provisions are discussed at [31.205]–[31.225].

## On employees

**[31.425]** Before a restructuring plan is made, the company must have paid all its employee entitlements and substantially complied with its taxation reporting obligations: reg 5.3B.24. The requirement to have paid all employee entitlements does not require payment of amounts which may be owed but are not yet payable.

# Restructuring plan

## Proposing a restructuring plan

**[31.430]** The directors of a company may propose a restructuring plan to the creditors: s 455A(1). As discussed at [31.405] the restructuring practitioner assists with the preparation of the restructuring plan: s 453E(1). The company is taken to be insolvent once the plan is proposed to creditors: s 455A(2).

A restructuring plan can be proposed to creditors if certain requirements in the *Corporations Regulations* are satisfied. Under reg 5.3B.15 the plan must identify and specify how the company's property is to be dealt with. The plan must also provide for the remuneration of the restructuring practitioner for the plan. The plan must not provide

for the transfer of property (other than money) to a creditor or provide for the company to make payments under the plan in respect of an admissible debt or claim after three years from the day the plan is made. A restructuring proposal statement must contain a schedule of debts and claims and be in the prescribed form: reg 5.3B.16.

**[31.435]** The company must execute the restructuring plan during the “proposal period” which is 20 business days from the day the restructuring process began: reg 5.3B.17(1). The restructuring practitioner, on application by the company, may extend the proposal period by no more than 10 business days if the restructuring practitioner is satisfied on reasonable grounds that more time is reasonably required in the circumstances: reg 5.3B.17(2). While the restructuring practitioner may not extend the proposal period more than once, the court, on application by the company, may order further extensions: reg 5.3B.17(4). Under reg 5.3B.18 the restructuring practitioner must prepare and sign a declaration that states if the restructuring practitioner believes on reasonable grounds that the eligibility criteria for restructuring are met and that if the restructuring is made, the company is likely to discharge the obligations created by the plan as and when they become due and payable.

## Standard terms of a restructuring plan

**[31.440]** In addition to the requirements of a restructuring plan contained in regs 5.3B.15 and 5.3B.16 referred to at [31.430], reg 5.3B.27(1) sets out several standard terms that must be included in a restructuring plan. These include that all admissible debts and claims rank equally; that if the total amount paid by the company is insufficient to meet those debts and claims in full, they are paid proportionately; and that the amount of an admissible debt or claim is ascertained as at the time immediately before restructuring began.

## Accepting a proposal for a restructuring plan

**[31.445]** The restructuring practitioner must give to as many of the company’s affected creditors as reasonably practicable, copies of the restructuring plan, restructuring proposal, the restructuring plan standard terms and the restructuring practitioner’s declaration: reg 5.3B.21(1)(a). The restructuring practitioner must ask each affected creditor to reply in writing whether or not they accept the restructuring plan: reg 5.3B.21(1)(b). Regulation 5.3B.21(1)(c) requires creditors to respond before the end of the “acceptance period” which is 15 business days beginning on the day the restructuring practitioner gives the proposed plan and other required documents to creditors. The acceptance period may be extended for a further five business days if the restructuring practitioner notifies creditors, recommending a variation of the schedule of debts and claims, because of disagreement by a creditor concerning the amount of the creditor’s admissible debts or claim. The acceptance period may also be extended for such other period as the Court orders.

A proposed restructuring plan is accepted if a majority in value of the affected creditors notify the restructuring practitioner of their acceptance by no later than the acceptance period: reg 5.3B.25(1). The value of a creditor’s admissible debts or claims is worked out by reference to the value at the time restructuring began: reg 5.3B(2).

## Effect of a restructuring plan

**[31.450]** A restructuring plan binds creditors who have admissible debts or claims, the company, its officers and members and the restructuring practitioner: reg 5.3B.29(2). Secured creditors are generally able to enforce their security interest after a restructuring plan has been made: reg 5.3B.29(4). Exceptions arise where the secured creditor has agreed to be bound by the plan: reg 5.3B.29(3)(b) and reg 5.3B.29(4)(a), or the court makes an order preventing the secured creditor dealing with its security interest: reg 5.3B.29(4)(b). Where the debt of a creditor is partially secured and partially unsecured, the plan is binding on the creditor only to the extent of the value of the unsecured part of the debt: reg 5.3B.29(3)(a). Similarly, a restructuring plan does not affect a right of an owner or lessor of property unless the owner or lessor has accepted the proposal to make the plan which affects that right or the court so orders: reg 5.3B.29(5).

A person bound by a restructuring plan cannot make a winding-up application on the basis of an admissible debt or claim or proceed with an application made before the plan became binding on that person: reg 5.3B.30(2). A person bound by a plan also cannot begin or proceed with any legal proceeding or enforcement action against the company in relation to any of its property to recover an admissible debt or claim except with leave of the court: reg 5.3B.30(3).

## Functions of a plan's restructuring practitioner

**[31.455]** Regulation 5.3B.37 specifies the functions of a plan's restructuring practitioner. Under that regulation the practitioner's function is to receive money from, and hold money on trust for, the company. The restructuring practitioner must also pay money to creditors in accordance with the plan, including the proceeds from the sale of the company's property if the sale is requested by the company's directors.

A practitioner must not dispose of company property subject to a security interest or an owner's or lessor's property used or occupied by or in the possession of the company: reg 5.3B.39(1). This does not prevent a disposal in the ordinary course of the company's business or with the written consent of the secured party, owner or lessor or with leave of the court: reg 5.3B.39(2).

## Terminating a restructuring plan

**[31.460]** Under reg 5.3B.31(1)(a) a restructuring plan terminates if:

- the company's obligations under the plan have been fulfilled;
- the obligations of any other party to the plan have been fulfilled; and
- all admissible debts or claims have been dealt with in accordance with the plan.

Where a plan terminates under reg 5.3B.31(1)(a) the company is released from all admissible debts or claims: reg 5.3B.31(2).

The court may also order a plan's termination provided certain conditions are satisfied: reg 5.3B.31(1)(b). A court may order termination if the plan is expressed to be subject to the occurrence of a specified event within a specified period of no longer than 10 business days after the day on which the plan is made and the event does not occur

within that period or if there has been a contravention of the plan by a person bound by the plan and the contravention has not been rectified within the period of 30 business days: reg 5.3B.31(1)(c), (d), (e) and (f). A plan also terminates on the day a voluntary administrator, a liquidator or provisional liquidator is appointed: reg 5.3B.31(1)(e) and (f).

If a plan terminates because of the happening of an event mentioned in reg 5.3B.31(1)(b), (c), (d), (e) or (f) any admissible debt or claim that has not been dealt with in accordance with the plan is taken to be due and payable on the business day after the day on which the termination occurs: reg 5.3B.31(3).

If the debt restructuring process or plan is terminated, existing insolvency processes, such as voluntary administration or liquidation can be used by the company and third parties.

## Tutorial questions

1. About a year ago, McMahon Industries Pty Ltd leased a shop at a shopping mall owned by Whitlam Shopping Centre Ltd. The monthly rent was \$10,000. Bill and Sonia, the sole directors of McMahon Industries, entered into a contract with Whitlam Shopping Centre Ltd under which they guaranteed to pay the rent if their company failed to do so.

As it was in financial difficulties, McMahon Industries Pty Ltd had not paid the monthly rent on its shop for the last three months. Whitlam Shopping Centre's credit manager, Margaret, heard that last week Bill and Sonia had put their company into voluntary administration.

Advise Margaret whether Whitlam Shopping Centre can immediately start court action to evict McMahon Industries from the shop for non-payment of rent and whether it can sue Bill and Sonia under their guarantee.

2. Homer Pty Ltd borrowed \$500,000 from the Springfield Bank and granted it a security interest in some of its plant and equipment. Homer Pty Ltd failed to pay the last two interest instalments. The other day the bank was notified that the directors of Homer Pty Ltd had appointed a voluntary administrator.

Advise whether the Springfield Bank is legally entitled to immediately seize the plant and equipment subject to the security interest. Would your answer be different if the Springfield Bank's security interest covered all the assets of Homer Pty Ltd?

3. Vandalay Chocolate Sprouts Pty Ltd, which operated its business from a factory it rented from Industrial Park Ltd, had been experiencing extreme financial difficulties and its financial records were a hopeless mess. It was continually late in paying debts owed to its suppliers and employees' wages. With Christmas coming up, its directors were uncertain whether the company would be able to pay its employees their holiday pay entitlements.

The company's main creditors were:

- its bank, which is owed \$1 million. This loan was unsecured but was guaranteed by the directors of Vandalay Chocolate Sprouts Pty Ltd;



- Industrial Park Ltd, which was owed \$75,000 arrears of rent; and
- its employees, who were owed \$350,000 unpaid wages.

About three months ago the company was paid \$100,000 from one of its customers. This was deposited into the company's bank account, reducing the amount due to the bank.

How would each of the creditors referred to above be affected if Vandalay Chocolate Sprouts Pty Ltd were placed in voluntary administration?

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.
- For further corporations law links and material, please refer to the Understanding Company Law website at <http://www.uclaw.com.au>.



## Chapter 32

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# Liquidation

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## Key points

- Liquidation (also called “winding-up”) is the process under which the affairs of a company are wound up, its assets collected and sold, its debts paid and the surplus (if any) distributed among its shareholders. Upon completion of the liquidation, the company is deregistered.
- The *Corporations Act* provides for two types of liquidation: compulsory liquidation and voluntary liquidation. The common feature of all liquidations is the appointment of a qualified, independent insolvency practitioner as the liquidator.
- A compulsory winding-up is by order of the court on the application of a creditor or other eligible person. The liquidator is appointed by the court.
- There are a number of grounds for a compulsory liquidation, but the most common is that the company is insolvent. Such compulsory liquidations are referred to as a “winding-up in insolvency”.
- Winding-up in insolvency is usually initiated by a creditor and the winding-up is ordered by the court. The most common way in which a creditor shows that a debtor company is insolvent is by a failure to comply with a statutory demand.
- There two types of voluntary liquidations: a members' voluntary winding-up and a creditors' voluntary winding-up. A members' voluntary winding-up is initiated by a special resolution of the members and does not involve a court application. If the company is solvent, the members choose the

liquidator. If the company is insolvent, the voluntary winding-up becomes a creditors' voluntary winding-up and the creditors may replace the liquidator appointed by the members with their own choice as liquidator. A creditors' voluntary winding-up is also one of the outcomes of a company's voluntary administration.

- A liquidator has wide powers as an agent of the company and under the *Corporations Act*. These powers are used for the purpose of winding-up the company and distributing its assets.
- Liquidators owe duties similar to the duties of directors. They also owe further duties in relation to the winding-up of the company. These include duties to collect, preserve and realise assets in the interests of creditors. Liquidators must also report breaches of the law to ASIC.
- The recovery of assets of the company includes legal actions brought against directors in breach of their duties or who engaged in insolvent trading. Liquidators may also take action to avoid certain transactions that took place before winding-up commenced. They are of three main types known as antecedent transactions: unfair preferences, uncommercial transactions and unfair loans.
- The liquidator is given the ability to avoid these antecedent transactions because they diminish the funds available to unsecured creditors or give a preference or advantage to a creditor over other creditors.
- The *pari passu* rule provides that, except for certain stated priorities, all unsecured creditors are ranked equally in the distribution of assets. Unsecured creditors who have priority include the liquidator and the costs of the winding-up and, to some extent, employees.
- The new simplified liquidation process is available to eligible small companies that have resolved to be wound up in a creditors' voluntary wind-up. This process allows for simpler, faster and lower cost liquidations for small companies as an alternative to the existing liquidation processes.

## What is liquidation?

**[32.05]** Liquidation (also called “winding-up”) is a form of external administration that ultimately results in the company being deregistered and ceasing to exist as a legal entity.

Liquidation is the process under which the company’s affairs are wound up, its property sold, debts owed to its creditors repaid to the extent possible and any surplus distributed among its shareholders.

During the liquidation process, the company remains in existence as a legal entity under the control of a registered liquidator who is a qualified, independent insolvency practitioner. The requirements for registration as a liquidator are discussed at [32.225]. The essential tasks of a liquidator are to sell the company’s property and pay the debts of creditors. Any surplus after creditors are paid is distributed to shareholders. Deregistration is the final step in the liquidation of a company.

The most likely reason that a company may be placed in liquidation is that it is insolvent. This means that it is unable to pay its debts. In such cases, liquidation is the process whereby the company’s assets are realised and distributed to creditors in payment of the debts due to them.

Liquidation of insolvent companies is similar to bankruptcy of individuals. However, the terms “liquidation” and “winding-up” are not to be confused with “bankruptcy”. In Australia, the term “bankruptcy” only applies to individuals and is governed by the *Bankruptcy Act 1966* (Cth), whereas companies are wound up or liquidated under Pts 5.4–5.9 of the *Corporations Act* and the *Insolvency Practice Schedule*.

There are three broad aims of the liquidation of insolvent companies.

The liquidation of insolvent companies has three broad aims to ensure that:

- creditors, particularly unsecured creditors, share equally and fairly in the distribution of an insolvent company’s insufficient assets;
- hopelessly insolvent companies cease trading for the good of the wider business community; and
- there is an investigation into an insolvent company’s affairs prior to the commencement of the winding-up for the purpose of discovering the reasons for the insolvency.

Insolvent companies may be placed in liquidation in one of two ways:

- compulsory liquidation or a “winding-up in insolvency” where creditors (or other eligible applicants, such as a director, ASIC) or a shareholder) obtain a court order that the company be put into liquidation; or
- creditors’ voluntary winding-up which does not require a court order and may come about in a number of ways. For example, the members may pass a special resolution to wind up an insolvent company as discussed at [32.195], a voluntary administration may turn into a creditors’ voluntary winding-up in the circumstances discussed at [31.155] and [31.370] or a small eligible company that has resolved to be wound up may enter the simplified liquidation process. This is discussed at [32.712].

While insolvency is the most common reason for winding-up a company, it is not the only one as solvent companies may also be wound up for a variety of reasons. For example, the shareholders may decide to wind up their company by way of a members' voluntary winding-up because it no longer serves a purpose and the shareholders wish to distribute its assets. This is discussed at [32.190]. As seen at [24.280] and [24.330]–[24.435], the court may also order a winding-up to end oppression of members under s 232 or because it is just and equitable to do so under s 461(1)(k).

## Compulsory winding-up in insolvency

[32.10] Part 5.4 of the *Corporations Act*, ss 459A–459T, adopts the phrase “winding-up in insolvency” to emphasise the distinction between the compulsory liquidation of solvent and insolvent companies. Compulsory liquidations of solvent companies usually involve disputes between shareholders. This is discussed at [24.330]–[24.435].

The court may order that a company be wound up on the ground that it is insolvent.

Section 459A enables the court to order that an insolvent company be wound up in insolvency on the application of a creditor or any one or more of the persons listed in s 459P(1). Section 459P is discussed at [32.20].

Section 459B also allows a court to order that a company be wound up in insolvency if it is satisfied that the company is insolvent on an application for winding-up that has been brought by a member who has made an application for a remedy under s 233, the oppression remedy or by ASIC under s 464 where it has formed the conclusion that the company is insolvent.

## Applications for winding-up

[32.15] A winding-up in insolvency is initiated when an eligible applicant under s 459P(1), such as a creditor, files with the court an application to wind up the company. Sections 459P–459T contain rules concerning the form of an application for winding-up in insolvency and the notice that must be given of it.

### *Permitted applicants*

[32.20] Only the persons listed in s 459P are permitted to file an application for a court order under s 459A that a company be wound up in insolvency. These persons include the company, a creditor (including a secured creditor or a contingent or prospective creditor), a director or ASIC.

### *Creditors*

[32.25] In the most usual case, a creditor files the application to wind up the company in insolvency. A creditor is a person who is owed a debt by the company that is still unpaid at the date of the application for winding-up: *Re William Hockley Ltd* [1962] 1 WLR 555.



A contingent or prospective creditor may also apply for a compulsory winding-up: s 459P(1)(b). A “contingent creditor” is a person to whom a debt is owed, payment of which is only due on the occurrence of some future event that may or may not occur. For example, in *Community Development Pty Ltd v Engwirda Construction Co* (1969) 120 CLR 455, the debt of a contingent creditor only became payable upon the successful outcome of arbitration proceedings.

**[32.40]** A “prospective creditor” is a creditor to whom a debt is due but not immediately payable. For example, a person who sells goods on the basis of payment in 30 days after delivery is a prospective creditor of the buyer for the debt during the 30-day period.

The question of a person’s standing as a creditor usually arises when the company disputes the existence of the debt. Disputed debts are discussed at [32.135]–[32.150].

### *Leave of court*

**[32.45]** Some of the eligible applicants listed in s 459P(1) can only apply for a winding-up if they have first obtained leave of the court: s 459P(2). The court may grant leave only if it is satisfied that there is a *prima facie* case that the company is insolvent: s 459P(3). These eligible applicants include a contingent or prospective creditor, a director or ASIC. The requirement that prior leave of the court must be obtained prevents winding-up applications being brought to harass and pressure a debtor company.

### *Abuse of process*

**[32.50]** The court has a discretion whether or not to order that a company be wound up. It will not do so where the application is made for an improper purpose or is an abuse of process. The court also has power to grant an injunction to prevent the filing of an application as an abuse of process. This may occur when it appears that the application on its face does not allege the existence of insolvency.

### *Procedure*

**[32.55]** An application for winding-up must be advertised and gazetted under the applicable court rules. This serves as notice to the public that there is reason to suspect the named company is insolvent. Section 459T permits an applicant to file a single application to wind up two or more companies in insolvency if they are joint debtors, whether or not they are partners.

Most creditors’ applications for a winding-up in insolvency rely on a company’s failure to comply with a statutory demand that has been served on the company. Section 459Q sets out the requirements that must be complied with in the applications. It requires the application for winding-up to set out particulars of service of the demand and of the company’s failure to comply with it: s 459Q(a). A copy of the demand must be attached to the application: s 459Q(b)(i). If the court has varied the demand under s 459H(4) because there has been a dispute or offsetting claim, a copy of the court order must be attached to the application. Unless the debt is a judgment debt, the application must be accompanied by an affidavit verifying the debt and it must comply with the relevant court rules: s 459Q(c). Statutory demands are discussed at [32.70]–[32.150].

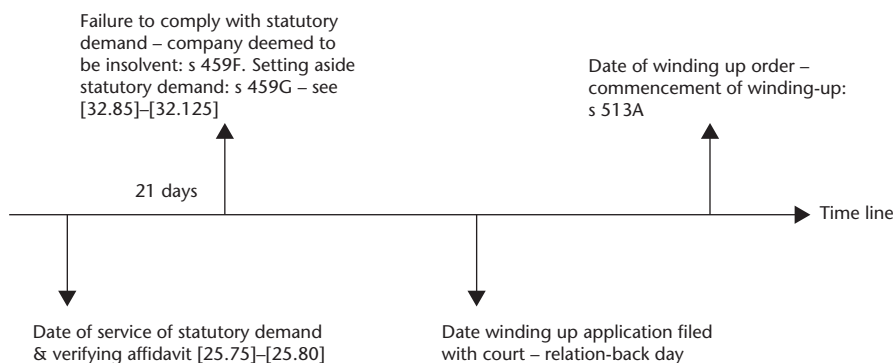
In order to ensure a prompt process, s 459R requires an application for a winding-up in insolvency to be determined within six months of it being filed with the court. The court has power to extend the period within which an application must be determined if it is satisfied that special circumstances exist that justify an extension: s 459R(2). Applications not determined within the time limit specified by s 459R must be dismissed: s 459R(3).

Applicants must advertise that they have filed an application and also notify ASIC, meaning a winding-up application becomes public knowledge before the court makes its decision.

Where the court grants the application and makes an order winding-up the company, the winding-up is taken to have commenced at the time stated by s 513A. This will usually be on the day the order was made. Winding-up may also be taken to have commenced when a resolution was previously passed to voluntarily wind up the company, an administrator was appointed or a deed of company arrangement was executed.

Figure 32.1 illustrates the sequence of events from service of a statutory demand to a court order that a company be wound up in insolvency.

**Figure 32.1: Winding-up in insolvency procedure**



## What is insolvency?

**[32.60]** The consideration of whether a company is insolvent arises where an application is made to wind up a company in insolvency. The question of insolvency may also arise in relation to recovery of insolvent transactions, discussed at [32.585], and under the insolvent trading provision s 588G discussed at [18.100]–[18.240].

A company is insolvent if it is unable to pay its debts as and when they become due and payable.

Section 95A defines “insolvency”. Under s 95A(1), a person is solvent if the person is able to pay all their debts as and when they become due and payable. A person who cannot do this is insolvent: s 95A(2).

This definition adopts a cash flow test rather than a balance sheet test of insolvency: *Melbase Corporation Pty Ltd v Segenhoe Ltd* (1995) 13 ACLC 823. The mere fact that assets exceed liabilities does not necessarily establish solvency. However, it is relevant to consider the extent of assets, the available credit and future events: *Leslie v Howship Holdings Pty Ltd* (1997) 15 ACLC 459.

The courts have developed a number of principles applicable to the determination of whether a company is insolvent:

- It is necessary to determine when the company's creditors have to be paid and when debts owing to the company are due: *Calzaturificio Zenith Pty Ltd v NSW Leather & Trading Co Pty Ltd* [1970] VR 605. The debtor's financial position should be looked at in its entirety. Evidence of a temporary lack of liquidity does not necessarily mean a company is insolvent: *Sandell v Porter* (1966) 115 CLR 666. Therefore a company is not insolvent just because on a particular day or for a short period afterwards the company was unable to pay its debts as and when they became due and payable, from readily available liquid assets: *Downey v Aira Pty Ltd* (1996) 14 ACLC 1068. However, cash resources must be readily realised while continuing the business. If the company has ceased trading or payment of debts requires a company to sell its plant and equipment so that its main business is brought to a stop or a receiver has taken possession of all or most of its assets, these circumstances indicate the existence of insolvency and not just a temporary lack of liquidity: *Re Timbatec Pty Ltd* [1974] 1 NSWLR 613.
- A debt is regarded as payable on the date specified in the contract unless there is proof of an express or implied agreement for an extension of time, there is a course of conduct giving rise to an estoppel preventing the creditor from relying on the stipulated time for payment or there is a well-established and recognised practice in the particular industry, or as between the company and its creditors generally, that debts are generally payable after contract dates or only on demand. Where such assertions are made, it is for the debtor company to show satisfactory evidence. Generally, evidence of a company's insolvency is largely a question of fact to be decided as a matter of commercial reality in the light of all the circumstances. This includes taking into account the reality that debtors will often delay payments to creditors for as long as possible and creditors will not always insist on payment strictly in accordance with contractual terms: *Southern Cross Interiors Pty Ltd v Deputy Commissioner of Taxation* [2001] NSWSC 621.
- The court may take into account the company's contingent and prospective liabilities: s 459D(1). This does not, however, limit the matters that may be considered: s 459D(2). Contingent and prospective liabilities have similar meanings as in "contingent and prospective creditors" in s 459P(1)(b). This is discussed at [32.25]–[32.40]. The court should only have regard to present or contingent liquidated debts and should not take into account potential future claims for unliquidated damages: *Box Valley Pty Ltd v Kidd* [2006] NSWCA 26.

|                            |
|----------------------------|
| Indications of insolvency. |
|----------------------------|

The 14 indicators of insolvency are set out in *ASIC v Plymin* [2003] VSC 123 at [18.140]. These include:

1. continuing losses;
2. liquidity ratios below one;
3. overdue commonwealth and state taxes; and
4. poor relationship with present bank including inability to borrow further funds.

## Presumptions of insolvency

**[32.65]** In order to assist applicants to prove the existence of insolvency, the *Corporations Act* provides for several presumptions of insolvency, the most important of which is the statutory demand procedure.

The court may presume that a company is insolvent in certain circumstances.

Section 459C(2) sets out the circumstances in which the court may presume that a company is insolvent. The s 459C(2) presumptions of insolvency apply unless the contrary is proved. If the presumptions do not apply, an applicant can still prove insolvency using the s 95A test.

The presumptions of insolvency contained in s 588E do not apply for purposes of determining whether a company should be wound up in insolvency, but are relevant for insolvent trading proceedings discussed at [18.145] and the voidable antecedent transactions provisions discussed at [32.585].

The court must presume that the company is insolvent if any one of the events set out in s 459C(2) occurred during or after the three months ending on the day when the application was made. These include:

- the company failed to comply with a statutory demand;
- a person entered into possession, or assumed control, of the company's property for such a purpose; or
- a person was appointed so as to enter into possession or assume control (whether as agent for the secured party or for the company).

## Statutory demands

**[32.70]** The most common way that creditors prove a company is insolvent is to rely on the presumption of insolvency contained in s 459C(2)(a) where the company failed to comply with a statutory demand.

A company is presumed to be insolvent if it fails to comply with a statutory demand.

Section 459E allows a creditor to serve a demand on a company relating to a debt that is due and payable where the amount of the debt is at least the “statutory minimum”.

**Table 32.1: Time frames to comply with a statutory demand**

|                                             |                                                                             |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              |
|---------------------------------------------|-----------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Issue statutory demand                      | Section 459E<br>Regulation 5.4.01AAA of the <i>Corporations Regulations</i> | Statutory minimum \$4,000                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
|                                             | Section 459E(2)                                                             | <p>Statutory demand must:</p> <ul style="list-style-type: none"> <li>• specify the amount of the debt;</li> <li>• require the company to pay the amount of the debt or secure or compound for that amount to the creditor's reasonable satisfaction within 21 days after the demand is served on the company;</li> <li>• be in writing;</li> <li>• be in the prescribed form (<i>Corporations Regulations</i>, Form 509H, Sch 2-Forms); and</li> <li>• be signed by or on behalf of the creditor.</li> </ul> |
| Setting aside                               | Section 459G<br>Section 459G(3)                                             | <p>Application may only be made within 21 days after service of the statutory demand.</p> <p>Must contain supporting affidavit setting out the reasons why it should be set aside (<i>Infratel Networks Pty Ltd v Gundry's Telco &amp; Rigging Pty Ltd</i> [2012] NSWCA 365).</p> <p>The court cannot grant an extension of time once the period for compliance with a statutory demand has expired (<i>Aussie Vic Plant Hire Pty Ltd v Esanda Finance Corporation Ltd</i> [2008] HCA 9).</p>                |
| Period for compliance with statutory demand | Section 459F(2)(b)<br>Section 459F(2)(a)(ii)                                | <p>21 days after the demand is served, presumption of insolvency if failure to comply (s 459F)</p> <p>If the company has applied to the court for an order to set aside a demand, the period for compliance ends seven days after the application is finally determined.</p>                                                                                                                                                                                                                                 |

## Service

**[32.75]** A statutory demand is served on a company by leaving it at, or posting it to, the company's registered office: s 109X(1)(a). Service is also effective if a copy of a statutory demand is delivered personally to a director who resides in Australia: s 109X(1)(b). A statutory demand sent through the post is taken to have been delivered in the ordinary course of the post: *Acts Interpretation Act 1901* (Cth), s 29. Under s 160 of the *Evidence Act 1995* (Cth), it is presumed that a correctly addressed posted article was received on the fourth working day after having been posted. A working day excludes a Saturday or a Sunday or a public or a bank holiday. The same requirements for service also apply to an application by a debtor company to set aside a statutory demand under s 459G. This is discussed at [32.85].

## Verifying affidavit

**[32.80]** A statutory demand must be accompanied by an affidavit verifying that the debt is due and payable by the company: s 459E(3). A verifying affidavit must be served on the company at the same time as the demand: *Victor Tunevitsch Pty Ltd v Farrow Mortgage Services Pty Ltd* (1994) 117 FLR 330. The verifying affidavit verifies the debt claimed in the sense of formally confirming that it is due and payable: *AZED Developments Pty Ltd v Frederick & Co Ltd* (1994) 12 ACLC 949. The affidavit does not have to prove or demonstrate by evidence that the debt is due.

The affidavit must be made by a person who could depose to their knowledge of the indebtedness of the company: s 459E(3)(b). A verifying affidavit is not required if the debt demanded is a judgment debt.

## Setting aside

**[32.85]** Section 459G allows a company to apply to the court for an order setting aside a statutory demand that has been served on it. The application must comply with the requirements set out in Table 32.1.

### Extension of time for application

**[32.90]** In *Aussie Vic Plant Hire Pty Ltd v Esanda Finance Corporation Ltd* [2008] HCA 9, the High Court held that the court did not have power to grant an extension of time once the period for compliance with a statutory demand has expired. Once this time expires, the recipient is taken to have failed to comply with the demand. If a company wishes to appeal a refusal to set the demand aside, either an extension of the period must be obtained, or the appeal must be determined before the expiry of the period.

### Defective demands

**[32.95]** A company served with a statutory demand may apply to have it set aside under s 459J(1) because it contains a defect which will cause substantial injustice unless the demand is set aside or there is some other reason to set aside the demand. A statutory demand will not be set aside just because of a defect: s 459J(2). The word "defect" is defined in s 9 to include:

- an irregularity;
- a misstatement of an amount or total;
- a misdescription of a debt or other matter; and
- a misdescription of a person or entity.

A statutory demand does not contain a defect merely because the company disputes the existence or amount of the debt demanded. Section 459H, discussed at [32.135]–[32.150], deals with disputed debts.

Solvency, in itself, does not constitute a reason to set aside a demand. The solvency of the company is to be determined in winding-up proceedings and not while considering whether a demand should be set aside: *Chippendale Printing Co Pty Ltd v Deputy Commissioner of Taxation* (1995) 55 FCR 562.

*Topfelt Pty Ltd v State Bank of New South Wales* (1994) 47 FCR 226

**[32.100]** The bank served a demand in which it required payment of a specified amount “together with interest from [a specified date] to date and continuing”. The Federal Court held that the demand was defective in a number of respects and set it aside under s 459J on the grounds that the defects caused substantial injustice. It did not specify the applicable interest rate or a daily figure calculated by reference to the rate. The demand also did not specify the amount of interest claimed at the date of the demand. A company that receives a statutory demand claiming interest should not have to make further inquiries to ascertain the amount of interest that the creditor claimed was payable.

**[32.105]** A statutory demand is defective if it “is so vague or ambiguous that it fails to identify, to a reasonable person in the shoes of a director of the debtor company, the general nature of the debt to a sufficient degree that the director can assess whether there is a genuine dispute as to the existence or amount of the debt or an offsetting claim”: *LSI Australia Pty Ltd v LSI Consulting Pty Ltd* [2007] NSWSC 1406. Further, a statutory demand that refers to multiple debts but fails to specify the individual amounts of each debt is also defective and may cause substantial injustice if the debtor can identify and know the amount claimed to be owing only from its own information and records: *Delta Beta Pty Ltd v Everhard Vissers* [1996] FCA 330.

*B & M Quality Constructions Pty Ltd v WG Brady Pty Ltd* (1994) 116 FLR 218

**[32.110]** A statutory demand contained a defect because it incorrectly referred to the creditor as “WG Brady Pty Ltd”, a non-existent company. The correct name of the creditor was W & J Brady Pty Ltd.

**[32.115]** A company served with a statutory demand may seek to have it set it aside for some reason, other than that it contains a defect: s 459J(1)(b).

## Effect of setting aside

[32.125] Section 459K provides that a statutory demand has no effect where it has been set aside pursuant to an order under either s 459H or 459J. It cannot be used as a basis for establishing the presumption of insolvency under s 459C.

## *Restrictions on opposing winding-up application*

[32.130] Under s 459S(1)(a), a company may not, without leave of the court, oppose an application for the company to be wound up in insolvency on a ground that the company relied on for purposes of an application by it to set aside the demand. This prevents the same issues being litigated twice. A court must not grant leave under s 459S(1) unless it is satisfied that the ground for opposing the winding-up application is material to proving that the company is solvent: s 459S(2).

## *Disputed debts*

[32.135] In some cases, creditors serve statutory demands to pressure debtor companies into paying genuinely disputed debts. In other cases, debtor companies try to delay paying by asserting they have a dispute about the debt even though this claim has no genuine merit. A winding-up hearing is not the appropriate forum for deciding the merits of disputed debts.

As discussed at [32.85], under s 459G a company served with a statutory demand has 21 days to file and serve an application to set aside the demand. Section 459H sets out the requirements for setting aside a statutory demand where there is a genuine dispute concerning the amount claimed in the demand.

## The substantiated amount

[32.140] A debtor company may dispute the amount demanded for a number of reasons. It may dispute either the existence or the amount of the debt. Alternatively, it may have an offsetting claim against the creditor. In any of these situations, s 459H requires the court to calculate the “substantiated amount”.

The substantiated amount is defined in s 459H(2) as the “admitted total” less the “offsetting total”. The “admitted total” is the total admitted amount of the debts to which the demand relates. The “offsetting total” is the total amount of the company’s offsetting claims. An offsetting claim is a genuine claim that the company has against the creditor by way of counterclaim, set-off or cross-demand (even if it does not arise out of the same transaction or circumstances as the debt to which the demand relates): s 459H(5). A cross-demand includes any claim for damages that is capable of quantification including unliquidated damages.

## Genuine disputes

[32.150] The debtor company has the onus of convincing the court that the dispute or offsetting claim is genuine. To be accepted as “genuine”, a dispute or offsetting claim must be shown to be both real, have some merit, and be plausible, as well as authentic, not spurious or artificial or have been “manufactured or got up”: *Viva Olives Pty Ltd v Origin Olives Australasia Pty Ltd* [2012] FCA 545. In determining an application under



s 459G, the court seeks to identify whether a genuine dispute or offsetting claim exists, not to determine any such dispute or claim: *Bendigo and Adelaide Bank Ltd v Pekell Delaire Holdings Pty Ltd* [2017] VSCA 51.

Under the *Income Tax Assessment Act 1997* (Cth), a debtor company becomes liable for tax when the amount payable has been assessed, the assessment has been served on the taxpayer and the prescribed period has expired. The lodgment of an objection to the assessment does not constitute a genuine dispute for the purposes of s 459H (*Hoare Bros Pty Ltd v Deputy Commissioner of Taxation* (1996) 62 FCR 302), nor does a pending appeal against a judgment debt (*Barclays Australia (Finance) Ltd v Mike Gaffikin Marine Pty Ltd* (1996) 14 ACLC 1367).

## Compulsory winding-up on grounds other than insolvency

**[32.155]** The requirements for the winding-up of a company by the court on grounds other than insolvency are contained in Pt 5.4A: ss 461–464. Section 461(1) sets out the grounds for compulsory winding-up of solvent companies: see [32.180]. Only the persons listed in s 462(2) are permitted to apply for winding-up on those grounds and have the onus of establishing that one of the s 461(1) grounds applies. Even if a ground is established, the court has a discretion not to make the winding-up order.

Winding-up by order of the court is taken to commence at the time specified in s 513A. This will usually be on the day the order is made.

### Who may apply?

**[32.160]** Only the persons specified in s 462(2) can apply to the court to have a company compulsorily wound up on grounds other than insolvency. The persons who can apply to the court to have a company wound up on the grounds referred to in s 461(1) include the company, a creditor (including a contingent or prospective creditor) of the company, a contributory (usually a shareholder), a liquidator appointed in a voluntary winding-up or ASIC pursuant to s 464, discussed at [28.45].

### The company

**[32.165]** Section 462(2)(a) permits the company to apply to have itself compulsorily wound up. An application by the company on any ground other than s 461(1)(a) must generally be approved by an ordinary resolution of the general meeting: *Re Woulfe & Son Pty Ltd* [1972] QWN 50.

An application by a company for its compulsory winding-up is quite rare. If the members wish to liquidate their company, they usually do so by a voluntary winding-up. A voluntary winding-up does not involve a court hearing and so is cheaper and quicker. Further, in a members' voluntary winding-up, the members appoint the liquidator and have greater supervisory powers over the conduct of the liquidation. On the other hand, a voluntary winding-up can only be initiated by a special resolution that requires a three-quarters majority vote in favour, whereas an application by a company on any ground other than under s 461(1)(a) only requires an ordinary resolution.

## Creditors

**[32.170]** Creditors, asserting that the company is insolvent, present the vast majority of applications for compulsory winding-up under s 459A. This is detailed at [32.10]–[32.55]. Section 462(2)(b) permits a creditor, a contingent creditor or a prospective creditor to apply for a compulsory winding-up on grounds other than insolvency, as set out in s 461(1). However, this is unusual as creditors generally seek to have a company wound up in insolvency. Where an application is brought to wind up the company on a ground other than insolvency, the court may order that it be wound up in insolvency: s 459B.

## Contributories

**[32.175]** A contributory may apply to have the company compulsorily wound up on any of the grounds referred to in s 461(1): s 462(2)(c). Section 9 defines a “contributory” to include:

- a person liable as a member or past member to contribute to the property of the company if it is wound up;
- a holder of fully paid shares in a company; and
- a member of a no liability company.

This definition of contributory, in the case of a company limited by shares, includes persons who at the commencement of the winding-up held either fully paid or partly paid shares, even though, strictly speaking, only a holder of partly paid shares is liable to contribute an amount on the winding-up. Not only must contributories hold the shares, their names must also be entered in the register of members. Membership is discussed in Chapter 9.

Under ss 515 and 522, past members may also be liable to contribute to the property of a company if they were members within one year of the commencement of winding-up and the present members are unable to satisfy the full extent of their liabilities. Past members will not be liable for debts of the company incurred after they ceased to be members: s 520.

A deceased contributory’s personal representative is, by virtue of s 528, also liable to contribute to the property of the company on a winding-up. Accordingly, a personal representative is also included within the definition of “contributory”, even though not registered as a member.

## Grounds for winding-up

**[32.180]** Under s 461, the grounds for a compulsory winding-up other than in insolvency include where:

- the directors have acted in the 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: s 461(1)(e). This ground is discussed at [24.410]–[24.415];
- ASIC has stated in a report prepared pursuant to Div 1 of Pt 3 of the *ASIC Act* that it is of the opinion that a company should be wound up because it cannot pay its debts or

it is in the interests of the public, the shareholders or the creditors: *Corporations Act*, s 461(1)(h). This ground is discussed at [28.45]; and

- the court is of the opinion that it is just and equitable that the company be wound up: s 461(1)(k). This ground is discussed at [24.360]–[24.435] in the context of members' remedies.

*In the matter of Catombal Investments Pty Ltd* [2012] NSWSC 775, Brereton J identified circumstances where the just and equitable ground has been applied:

- the substratum of the company has failed;
- management of the company's affairs are in deadlock or disagreement;
- the company's formation involved fraud;
- there has been misconduct on behalf of the company's directors;
- there is "constitutional or administrative vacuum" in the company's management; and
- there is public interest, fairness, confidence and commercial morality.

## Voluntary winding-up

**[32.185]** There are two forms of voluntary winding-up:

- members' voluntary winding-up; and
- creditors' voluntary winding-up.

Sections 495 and 496 deal with members' voluntary winding-up and ss 497–500 deal with creditors' voluntary winding-up. Sections 490–494 and 501–512 contain provisions applicable to both forms of voluntary winding-up. The applicable form of voluntary winding-up depends upon whether the company is solvent or insolvent. Both types of voluntary winding-up are initiated by a special resolution of shareholders, hence they are "voluntary" and do not involve court proceedings.

Unless the court grants leave, a company cannot resolve that it be wound up voluntarily if an application for its winding-up in insolvency has already been filed: s 490. Leave will only be granted under s 490(1) if a voluntary winding-up would be preferable from the point of view of saving costs or other reasons and does not disadvantage creditors.

### Members' voluntary winding-up

**[32.190]** Members may wish to wind up a solvent company where the company no longer serves its purpose and its members want to close it down to distribute its assets. A members' voluntary winding-up is initiated when the members pass a special resolution to that effect (s 491) and can only proceed as a members' voluntary winding-up if the company is solvent. The members in general meeting then appoint a registered liquidator: s 495.

A members' voluntary winding-up requires a special resolution and that the company is solvent.

Before a members' voluntary winding-up can proceed, the directors must make a written declaration to the effect that they have made an inquiry into the affairs of the company

and are of the opinion that it will be able to pay its debts in full within a period of 12 months after the commencement of the winding-up: s 494(1). This declaration of solvency must have attached to it a statement of affairs of the company containing the information specified in s 494(2).

If the company is solvent and the directors intend making a declaration of solvency, it must be made and lodged with ASIC before the date on which the notices of the meeting at which the resolution for winding-up is to be proposed are sent out: s 494(3). Directors are guilty of a criminal offence if they make a declaration of solvency without reasonable grounds: s 494(4).

If the members pass the necessary resolution to voluntarily wind up the company, they appoint the liquidator, fix the liquidator's remuneration and have supervisory powers over the liquidator's conduct of the liquidation.

## Creditors' voluntary winding-up

[32.195] A creditors' voluntary winding-up occurs when the members wish to bring the company's activities to a close because the company is insolvent. This type of winding-up does not involve court proceedings. Because creditors are paid ahead of shareholders, it is the creditors who appoint the liquidator and fix the liquidator's remuneration: *Insolvency Practice Schedule (Corporations) 2016*, s 60-10(1).

The *Corporations Act* provides for a smooth transition from voluntary administration to a creditors' voluntary winding-up. This is discussed at [31.370]. A company in voluntary administration may enter into a creditors' voluntary winding-up in a number of different ways. Under s 439C, creditors of a company in voluntary administration may resolve at the second creditors' meeting that the company be wound up. Creditors may also pass a resolution to terminate a deed of company arrangement and wind-up the company: s 445E. A company is deemed to have entered into a creditors' voluntary winding-up if the company fails to execute the deed within the prescribed time, usually 15 business days after the creditors' meeting: s 446A(1).

A creditors' voluntary winding-up may also stem from a members' voluntary winding-up where:

- the directors do not provide the shareholders with a declaration of solvency as required by s 494;
- the directors form the view that the company is unable to pay its debts; or
- the liquidator appointed by the members forms the opinion that the company is insolvent, even though the directors made a solvency declaration.

A simplified liquidation process was introduced in 2020 for eligible small companies in a creditors' voluntary winding-up. It is a modified version of a creditors' voluntary winding-up, providing for a less complex, quicker and cheaper liquidation process that is intended to result in greater returns to creditors and employees of incorporated small businesses. The simplified liquidation process and criteria for eligibility is further discussed at [32.712].

## Effect of winding-up

### Creditors

**[32.200]** One of the major aims of the liquidation procedure is to ensure unsecured creditors share equally in the distribution of the company's assets. This requires unsecured creditors to lose their usual right to bring individual legal proceedings to enforce payment of their debts after liquidation commences. The liquidator then acts for the body of unsecured creditors and has the power to bring legal proceedings in the name of the company to enforce the creditors' rights collectively.

After the date of commencement of winding-up, legal proceedings cannot be brought against the company without leave of the court: ss 471B and 500(2). Leave may be granted where there is a serious or substantial question to be tried and the granting of leave is in the interests of justice.

**[32.203]** After the commencement of the winding-up, creditors cannot enforce any judgment or orders they have obtained (ss 468(4) and 500(1)) and any disposition of the company's property, other than those made by the liquidator, is void unless the court orders otherwise: s 468(1).

Generally, a compulsory winding-up commences on the day of the court's winding-up order.

It is therefore important to determine the time of commencement of winding-up.

As a general rule, a compulsory winding-up is taken to have begun or commenced on the day the court order was made: s 513A(e). However, in some situations a court-ordered winding-up is taken to have commenced before the court order was made. For example, if the company was under voluntary administration or subject to a deed of company arrangement that had not terminated before the court order, the winding-up is taken to commence on the date the administration began: s 513A(b) and (d).

A voluntary winding-up generally commences on the date the winding-up resolution was passed.

A voluntary winding-up generally commences at the time the resolution for voluntary winding-up is passed: s 513B(e). If the company was under voluntary administration or subject to a deed of company arrangement that had not terminated before the resolution, the commencement of winding-up is taken to be the day of appointment of the administrator: s 513B(b) and (d).

Secured creditors retain their ability to enforce their security interest even though the company's liquidation has commenced: s 471C. This enables secured creditors to appoint a receiver after commencement of winding-up.

## The company

**[32.205]** Even though a company continues to exist as a legal entity after winding-up commences, it is prevented from carrying on its business after the winding-up order except for the purpose of the winding-up. The company's property continues to belong to it, and is not transferred to the liquidator, but its powers to deal with its property are severely restricted: s 468.

A company continues to exist as a legal entity after winding-up commences.

While a company is in the process of being wound up, all its public documents and negotiable instruments must have the words “in liquidation” set out after its name: s 541. Public documents include every:

- business letter;
- statement of account;
- invoice; and
- order for goods or services.

Once winding-up commences, the company's affairs are controlled by its liquidator.

In both a winding-up in insolvency and other compulsory winding-up, the directors lose their powers to manage the company's affairs. The company's affairs are controlled by its liquidator, whose powers and duties are discussed at [32.275]–[32.380].

With the commencement of winding-up, shareholders lose their rights to transfer shares, and their rights can no longer be varied: s 468A(1). Shareholders cannot pass special resolutions and therefore cannot resolve to change the company's name after winding-up commences: *Re HDT Special Vehicles (Aust) Pty Ltd* (1991) 9 ACLC 1336. With the leave of the court under s 471B, a member may bring an action in the name of a company in liquidation. In *Eros Cinema Pty Ltd v Nassar* (1996) 133 FLR 34, a shareholder brought a breach of duty claim against the liquidator and a director to whom the liquidator had sold the assets of the company at an alleged undervalue. Derivative actions are discussed at [24.285]–[24.300].

## Employees

**[32.210]** In the case of a compulsory winding-up, publication of the winding-up order serves as a notice of dismissal to the company employees: *Re General Rolling Stock Co* (1872) 7 Ch App 646. While the authorities are divided, it seems that a voluntary liquidation does not necessarily operate to dismiss the company's employees: *Re Matthew Bros Ltd* [1962] VR 262.

## Receivers

**[32.215]** A company may be in liquidation and receivership at the same time. Creditors may apply to wind up a company on the ground of insolvency even though a secured

creditor had previously appointed a receiver. Similarly, a secured creditor may appoint a receiver even though the company is being wound up. A liquidator's role is to primarily act in the interests of unsecured creditors, while the receiver acts for the appointing secured creditor.

The receiver's power to take possession of, and sell, the secured property of the company is not affected by the liquidation. Similarly, a receiver may bring a legal action in the name of the company where this is in relation to the secured property: *Gough's Garages Ltd v Pugsley* [1930] 1 KB 615. The effect of liquidation on a receiver is discussed at [30.120].

While a receiver's right to take possession and sell the secured property continues despite the liquidation of the company, liquidation terminates the receiver's position as agent for the company: *Visbord v Federal Commissioner of Taxation* (1943) 68 CLR 354. A receiver may, however, continue to carry on the company's business with either the liquidator's consent or court approval: s 420C.

## Termination of winding-up

**[32.217]** At any time during a winding-up the court may order that the winding-up be stayed indefinitely or for a limited time or be terminated. The liquidator, a creditor or a contributory may make an application for a stay or termination order. If the company is subject to a deed of company arrangement, the application can be made by the deed administrator: s 482(1) and (1A). The court may require the liquidator to provide a report before making an order: s 482(2). Where an application under s 482 is made in relation to a company subject to a deed of company arrangement, the court must take a number of matters into account such as any report of a liquidator or administrator alleging that an officer of the company has engaged in misconduct, the decision of the company's creditors that the company execute a deed of company arrangement and whether the deed of company arrangement is likely to result in the company becoming or remaining insolvent: s 482(2A).

In making an order to stay or terminate a winding-up the court must be satisfied that the company is solvent and it would be in the public interest and not detrimental to commercial morality. The court primarily considers the future of the company and the risk to future creditors. Previous instances of non-compliance or breach by a company and its directors might be serious enough that the court could not have confidence that a company would act properly in the future as a "good corporate citizen": *Sevior v Morgan* [2012] VSC 480.

## Liquidators

### Appointment

**[32.220]** In a compulsory winding-up, a registered liquidator is appointed by order of the court when it makes the order for winding-up: s 472. In a members' voluntary winding-up, the liquidator is appointed by a general meeting of members: s 495. The person must be a registered liquidator and is usually appointed at the meeting that places the



company in voluntary liquidation. Prior to the appointment, the company must obtain the liquidator's consent in writing.

The method of appointment of a liquidator in a creditors' voluntary winding-up depends on how the liquidation came about. Where a creditors' voluntary winding-up stems from a creditors' winding-up resolution in a voluntary administration, the administrator becomes the liquidator. When a members' voluntary winding-up converts to a creditors' voluntary winding-up because the company turns out to be insolvent, the liquidator must convene a creditors' meeting who may then appoint some other person to be liquidator in place of the person appointed by the members: s 496(5).

In some cases, the court may appoint a special purpose liquidator to oversee a particular aspect of a liquidation. A finding of an actual or perceived conflict is not required to justify the appointment of a special purpose liquidator to uphold the confidence of stakeholders: *Canavan v ICRA Rolleston Pty Ltd* [2022] QCA 110.

## Who may be appointed as a liquidator?

**[32.225]** A person must not consent to be appointed, and must not act, as a liquidator of a company unless that person is a registered liquidator: s 532(1). The requirement to be registered as a liquidator does not apply to a person appointed to be the liquidator in a members' voluntary winding-up of a proprietary company: s 532(4).

A person must lodge an application with ASIC to be a registered liquidator. The application is referred to a committee comprising an ASIC representative, a registered liquidator chosen by a prescribed industry body such as the Australian Restructuring Insolvency and Turnaround Association (ARITA) and a person appointed by the Minister. This committee assesses the application against specified criteria set out in s 20-1 of the *Insolvency Practice Rules (Corporations) 2016* which include requirements that the applicant has completed a tertiary qualification in commercial law and accounting, has completed further studies in insolvency practice, has been engaged in at least 4,000 hours of relevant employment at a senior level during the preceding five years and has demonstrated the capacity to perform satisfactorily as a registered liquidator.

Registration has effect for three years and is renewable on application to ASIC: *Insolvency Practice Schedule (Corporations)*, s 20-75.

Under s 15-1 of the *Insolvency Practice Schedule (Corporations)*, ASIC is required to establish and maintain a register of liquidators containing particulars of the persons registered.

## Cancellation and suspension of registration

**[32.230]** ASIC has the power to suspend or cancel a liquidator's registration in certain circumstances, including where the registered liquidator is convicted of an offence involving fraud or dishonesty: *Insolvency Practice Schedule (Corporations)*, ss 40-25 and 40-30.

ASIC also has the power to give a show-cause notice to a registered liquidator in prescribed circumstances: *Insolvency Practice Schedule (Corporations)*, s 40-40. These include where ASIC is of the opinion that:



- the liquidator has contravened a provision of the *Corporations Act*;
- the liquidator has failed to carry out adequately and properly perform the duties of a liquidator; or
- the liquidator is not a fit and proper person.

Under s 40-50 of the *Insolvency Practice Schedule (Corporations)*, ASIC may refer a registered liquidator to an ASIC convened Part 2 Disciplinary Committee if ASIC does not receive a timely explanation from the liquidator or ASIC is not satisfied by the explanation. The Disciplinary Committee can make a number of orders including deciding to suspend or cancel the liquidator's registration: *Insolvency Practice Schedule (Corporations)*, s 40-55.

Prescribed industry bodies, such as ARITA, have the right to notify ASIC if they suspect there are grounds for disciplinary action to be taken against a registered liquidator: *Insolvency Practice Schedule (Corporations)*, s 40-100. If the registration of a liquidator is cancelled or suspended, ASIC must appoint another registered liquidator to conduct the liquidation process of a company: *Insolvency Practice Schedule (Corporations)*, s 40-111.

The court also has broad powers to make such orders as it thinks fit in relation to a registered liquidator. The court may exercise this power on its own initiative, or on the application of ASIC or the registered liquidator.

## Persons disqualified from being liquidators

### *Statutory grounds*

**[32.235]** Under s 532(2), certain persons are disqualified from acting as liquidators without leave of the court. These include debtors and creditors of the company in liquidation or a related body corporate and officers or auditors of the company and their associates. Officers of a proprietary company in a members' voluntary winding-up are not disqualified.

### *Removal by court and creditors*

**[32.255]** The court has power to remove a liquidator under either s 45-1 or 90-15 of the *Insolvency Practice Schedule (Corporations)*. In exercising this power, the court considers whether the removal is in the best interests of creditors. Section 45-1 allows the court to make such orders as it thinks fit in relation to a registered liquidator. The court's power under this broad provision may be exercised on its own initiative or on application by ASIC or the registered liquidator. When making an order under s 45-1, the court must take into account a number of factors including the seriousness of the consequences of any action or failure to act by the registered liquidator, including the effect of that action or failure to act on public confidence in registered liquidators as a group: *Insolvency Practice Schedule (Corporations)*, s 45-1(4)(e).

Section 90-15 of the *Insolvency Practice Schedule (Corporations)* also gives the court broad powers to make such orders as it thinks fit in relation to the external administration of a company including an order replacing the external administrator. The court's power under s 90-15 may be exercised on its own initiative. An application for a s 90-15 court order may also be made by a range of eligible applicants including ASIC, a person with a financial interest in the external administration and a creditors' committee of inspection.

The *Insolvency Practice Schedule (Corporations)* gives creditors the ability to remove an external administrator and appoint a replacement without requiring a court order: *Insolvency Practice Schedule (Corporations)*, s 90-35. Where creditors do so, the former administrator may apply to the court to be reappointed: *Insolvency Practice Schedule (Corporations)*, s 90-35(4).

## Conflicts of interest

**[32.260]** The *Insolvency Practice Schedule (Corporations)* includes conflict of interest provisions applicable to registered liquidators and other external administrators. Section 60-20(1) of the *Insolvency Practice Schedule (Corporations)* provides the general rule that an external administrator must not directly or indirectly derive any profit or advantage from the external administration of the company. Contravention of s 60-20 is an offence of strict liability: s 60-20(6). The court has power to set aside a transaction or any other arrangement that contravenes the section: s 60-20(7).

Section 60-20(2) outlines the circumstances where an external administrator is taken to derive a profit or advantage from the external administration, including if the external administrator directly or indirectly derives a profit or advantage from a transaction (including a sale or purchase) entered into for, or on account of, the company.

Section 60-20 of the *Insolvency Practice Schedule (Corporations)* includes several exceptions. For example, the general rule in s 60-20 does not prevent an external administrator from recovering remuneration for necessary work properly performed in relation to the external administration as discussed at [32.270].

A person is disqualified from being appointed the liquidator of a particular company if there is a potential conflict between the person's private interests and the interests of the company.

## Remuneration

**[32.270]** External administrators are entitled to receive remuneration for necessary work properly performed by them in relation to the external administration: *Insolvency Practice Schedule (Corporations)*, s 60-5(1). The amount of remuneration is usually set under a remuneration determination made by resolution of the creditors or the committee of inspection, if there is one: *Insolvency Practice Schedule (Corporations)*, s 60-10(1). In the case of a company in a members' voluntary winding-up, the members by resolution make the remuneration determination: *Insolvency Practice Schedule (Corporations)*, s 60-10(2). The court may make a remuneration determination if the members or creditors or a committee of inspection do not do so.

A determination may specify remuneration either by specifying the amount of remuneration or by specifying a method for working out an amount of remuneration: *Insolvency Practice Schedule (Corporations)*, s 60-10(3). A determination may specify that the external administrator is entitled to receive remuneration worked out wholly or partly on a time-cost basis. In such cases, the determination must include a cap on the amount of remuneration that the administrator is entitled to receive: *Insolvency Practice Schedule (Corporations)*, s 60-10(4).

If no remuneration determination is made, the external administrator is entitled to receive reasonable remuneration for the work, not exceeding the maximum default amount of \$5,000: *Insolvency Practice Schedule (Corporations)*, s 60-5(2) and s 60-15.

Section 60-11 of the *Insolvency Practice Schedule (Corporations)* gives the court the power to review a remuneration determination on the application of ASIC, a person with a financial interest in the external administration or an officer of the company. After reviewing the determination, the court must affirm it, or vary it, or set the determination aside and substitute another remuneration determination. Section 60-12 of the *Insolvency Practice Schedule (Corporations)* lists a range of relevant factors courts should consider when setting or reviewing remuneration determinations. These factors include matters such as the quality and complexity of the work, the extent to which the external administrator is required to accept an unusually high level of risk or responsibility, the value and nature of property dealt with by the external administrator and the attributes and behaviour of the company's creditors.

Where remuneration is determined on a time-cost basis, the external administrator will be required to seek a cap on that portion of remuneration. The initial cap may be increased with the approval of the creditors, the committee of inspection or the court.

Under ss 90-23 and 90-24 of the *Insolvency Practice Schedule (Corporations)*, ASIC, the court, creditors or members are able to appoint a registered liquidator to review the external administration of the company. The review may include whether the remuneration of the external administrator is reasonable and whether costs and expenses have been properly incurred: s 90-26. Section 90-15(f) gives the court the power to require the external administrator to repay remuneration received to the company or the creditors.

Section 60-16 of the *Insolvency Practice Schedule (Corporations)* governs the remuneration of provisional liquidators. Provisional liquidation is discussed at [32.390]. Under s 60-16(1), a provisional liquidator is entitled to receive such remuneration, by way of percentage or otherwise, as is determined by the court. If no determination by the court is in force, a provisional liquidator's remuneration may be determined by agreement between the liquidator and the committee of inspection (if any) or by creditors.

External administrators may be able to claim remuneration for work done despite their appointments being invalid where the service provided conferred an incontrovertible benefit and it would be unconscionable to keep the benefit without paying a reasonable amount for it: *Re Kreab Gavin Anderson (Australia) Ltd (No 3)* [2017] FCA 1473.

## Powers of the liquidator

**[32.275]** The board of directors and the general meeting of members are regarded as the two principal organs of a company, as discussed at [5.10] and [12.80]–[12.95].

A liquidator assumes all the powers of the board.

While a company is under liquidation or other external administration, directors and other officers must not perform or exercise a function or power of that office unless

the external administrator or the court approves: s 198G. Even though the liquidator assumes all the powers of the board, external administration does not remove an officer of the company from office: s 198G(6).

Because liquidators are also regarded as agents of the company, their actions bind the company. Like other agents, liquidators are generally not personally liable for contracts made on behalf of the company.

## Statutory powers

**[32.280]** Apart from the liquidator's powers as an agent of the company, the *Corporations Act* gives liquidators broad powers. In the case of a compulsory winding-up, a liquidator has the powers granted by s 477. In addition, under s 488 and the rules and regulations of the *Corporations Act*, certain powers of the court are delegated to the liquidator.

A liquidator's powers under s 477 include the following:

- to carry on the business of the company so far as is necessary for the beneficial disposal or winding-up of that business;
- subject to the priorities set out in s 556, to pay any class of creditors in full;
- to bring or defend legal proceedings in the name of the company and to appoint a solicitor to assist the liquidator;
- to sell or otherwise dispose of all or any part of the company's property;
- to sign documents on the company's behalf and use its common seal for that purpose;
- to appoint an agent to do any business that the liquidator is unable to do or that it is unreasonable to expect the liquidator to do in person; and
- to do all such other things as are necessary for winding-up the affairs of the company and distributing its property.

In the case of a voluntary winding-up, a liquidator may exercise any of the powers given by s 477 to a liquidator appointed in a winding-up in insolvency or by the court: s 506.

## Sale of legal actions

**[32.285]** The power to sell part of the company's property includes the assignment of a chose in action, such as a right to bring a legal action. Section 100-5(1) of the *Insolvency Practice Schedule (Corporations)* specifically permits an external administrator to assign a right to sue but before doing so, written notice of the proposed assignment must be given to the creditors: *Insolvency Practice Schedule (Corporations)*, s 100-5(3).

A liquidator's power to sell the company's property also includes a liquidator obtaining funding for a legal action from an insurer or other third party in return for payment of part of the proceeds of the legal action if it is successful. In such cases, the liquidator should act bona fide in the interests of the company and keep creditors fully informed and obtain their consent: *Re Movitor Pty Ltd* (1996) 64 FCR 380.

## Supervision by court, ASIC and creditors

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|------------------------------------------------------|
| Court power to inquire into external administration. |
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**[32.290]** The *Insolvency Practice Schedule (Corporations)* gives the court broad powers to inquire into the external administration of a company. Section 90-5(1) of the *Insolvency Practice Schedule (Corporations)* gives the court power to inquire on its own initiative. For purposes of such an inquiry, the court may require the external administrator to give information, or provide a report or produce a document: *Insolvency Practice Schedule (Corporations)*, s 90-5(2). Under s 90-10 of the *Insolvency Practice Schedule (Corporations)*, those with a financial interest in the external administration, such as a creditor, or ASIC may also apply to the court to inquire into the external administration of a company and apply for a court order under s 90-15 of the *Insolvency Practice Schedule (Corporations)*.

Under s 90-15 of the *Insolvency Practice Schedule (Corporations)*, the court has a broad power to make such orders as it thinks fit in relation to the external administration of a company including any one or more of the following:

- an order replacing the external administrator; or
- an order in relation to any loss that the company has sustained because of a breach of duty by the external administrator; or
- an order in relation to remuneration, including an order requiring the external administrator to repay to the company or the creditors remuneration paid.

Special purpose liquidators.

The *Insolvency Practice Schedule (Corporations)* allows for the appointment of a registered liquidator to review an external administration. Such appointments may be made by ASIC, by the court or by creditors. The court has the power to appoint a special purpose liquidator as an additional liquidator for the purpose of conducting investigations and public examinations, commencing and pursuing any claims including obtaining legal advice and protecting the company's assets. In some cases obtaining a second opinion about the viability of a legal action or engaging a litigation funder may be beneficial to the external administration and take the burden of funding a legal action away from unsecured creditors: *Williams & Kersten Pty Ltd v Walton Construction (QLD) Pty Ltd* [2019] FCA 1201.

Appointment of liquidator to carry out a review.

Section 90-23(1) of the *Insolvency Practice Schedule (Corporations)* gives ASIC the ability to appoint a registered liquidator to carry out a review into a matter relating to the external administration of a company. Applications for an ASIC-initiated review may be made by a person with a financial interest in the external administration (such as a creditor) or an officer of the company: *Insolvency Practice Schedule (Corporations)*, s 90-23(2).

The court also has the power to appoint a registered liquidator to carry out a review: *Insolvency Practice Schedule (Corporations)*, s 90-23(6). Applications for court appointments of a reviewing liquidator may be made by ASIC or a person with a financial interest in the external administration. Creditors may also appoint a registered liquidator to carry out a review but such a review is limited to matters relating to the remuneration of the external administrator or a cost or expense incurred by the external administrator: *Insolvency Practice Schedule (Corporations)*, s 90-24.

### Liquidators' powers requiring court approval.

The s 477 powers discussed at [32.280] may generally be exercised without prior approval of the court or creditors (or committee of inspection, if any). Such approval is necessary only where a liquidator intends to compromise a debt due to the company exceeding \$20,000 (or other prescribed amount, if any) or where a liquidator intends to enter into a long-term commitment, such as a lease or creation of a security interest, exceeding three months: s 477(2A) and (2B). The court will consider the impact of the agreement on the duration of the liquidation and whether this impact is reasonable in the interests of the administration including whether it prejudices creditors: *Re Minken Pty Ltd* [2019] VSC 288. The approval of the court will be given if it is satisfied there was no bad faith, impropriety or error of law: *McDermott and Potts as Liquidators of Lonnex Pty Ltd* [2019] VSCA 23. The considerations a court will take into account in deciding whether to approve a compromise of debt or long-term agreement include whether creditors are opposed to court approval, the compromise is in the best interests of creditors or whether the liquidator made a proper assessment of the prospects of recovering the debt.

Long-term commitments requiring court approval include funding agreements whereby a liquidator obtains funding to pursue certain investigations or legal proceedings. Where the investigations and proceedings are unlikely to be resolved within three months, the liquidator must obtain the approval of the court under s 477(2B) before entering into the funding agreement. A liquidator may also obtain retrospective court approval under s 477(2B): *Chan v Four C Realty Pty Ltd (in liq) (No 2)* [2013] FCA 959; *Re Colorado Products Pty Ltd (in prov liq)* [2013] NSWSC 1613.

### Liquidators required to have regard to creditors' directions.

Liquidators exercise these powers by authority of the court, but s 85-5(2) of the *Insolvency Practice Schedule (Corporations)* requires them to have regard to any directions given by the creditors. Liquidators are not, however, bound to comply with such directions. The liquidator must make a written record if the liquidator does not comply with a direction: *Insolvency Practice Schedule (Corporations)*, s 85-5(3). If a committee of inspection has been set up, s 80-35 of the *Insolvency Practice Schedule (Corporations)* gives the committee the power to give directions to the external administrator and to monitor the conduct of the external administration.

### Delegation of court's powers to liquidator.

Under s 488(1), the *Insolvency Practice Rules (Corporations) 2016* contains rules enabling or requiring all or any of the powers and duties conferred or imposed on the court to be delegated to the liquidator as an officer of the court. The rules deal with matters such as holding and conducting meetings to ascertain the wishes of creditors and contributories and the payment, delivery, conveyance, surrender or transfer of money, property or books to the liquidator. Notwithstanding anything in the rules, the liquidator may distribute a surplus only with the court's special leave: s 488(2).

## *Application to court for directions*

**[32.295]** As noted at [32.290], s 90-15 of the *Insolvency Practice Schedule (Corporations)* gives the court the power to make any order it thinks fit in relation to the external administration of a company. A person with a financial interest in the external administration may apply to the court for an order. This includes the external administrator, the company and a creditor.

Liquidators may apply to the court for directions on matters of general administration.

The right to apply to the court for directions enables the liquidator to act in accordance with the directions without incurring liability to any of the persons whose interests may be affected.

The court's power to give directions is limited to matters of general administration and the manner in which the liquidator should act and does not extend to commercial decisions and deciding substantive questions against persons making proprietary claims. However, a liquidator is not prevented from seeking directions on an issue which may be or may become an adversarial issue in other proceedings: *Re Mento Developments (Aust) Pty Ltd* [2009] VSC 343.

## *Application to court to advantage certain creditors*

**[32.300]** Section 564 gives the court power to make orders it deems just to give an advantage to a particular creditor over others in cases where the creditor has assumed risk by giving an indemnity for the costs of litigation to recover property or has otherwise protected or preserved property or indemnified a liquidator with the result that expenses have been recovered. This section provides an incentive to creditors to give financial assistance or indemnities to liquidators to pursue asset recovery proceedings or to protect or preserve property. Such proceedings may include the recovery of unfair preferences from particular creditors or proceedings against directors for insolvent trading under s 588G or breach of fiduciary duty.

If creditors provide such assistance, the liquidator may apply to the court for an order that the contributing creditors receive a higher dividend from the company's assets than they would otherwise be entitled to. In exercising its discretion to determine how the funds should be distributed, the court takes into account considerations such as the amount of risk, the amount recovered and the proportion of debts of participating creditors: *Re Jacka Nominees Pty Ltd* (1996) 14 ACLC 633.

## *Access to books and information*

Liquidators have a statutory right of access to company books and records.

**[32.305]** Under ss 483(1) and 500(3), a liquidator may apply to the court for orders requiring certain persons to hand over books and records to which the company is prima facie entitled. Such persons include the company's officers, bankers, receiver or agent.



Section 477(3) gives liquidators a statutory right to inspect company books, even those held by a receiver or other person who has a lien over the company's books, such as an accountant. A person who refuses to allow the liquidator to inspect the books is guilty of an offence. Under s 1300(3), the liquidator can make copies and take extracts to ensure liquidators can quickly gain access to information for the purpose of determining whether legal proceedings should be brought in relation to transactions entered into by the company before the winding-up.

Officers have a duty to assist liquidators.

Section 530A imposes a positive duty on present and former officers of a company wound up in insolvency to do everything they possibly can to help in the winding-up.

In particular, under s 530A(1)(a), as soon as practicable after a winding-up order is made, each officer must deliver to the liquidator all the company's books in the officer's possession. If the officer knows the location of other company books, the officer must tell the liquidator where they are: s 530A(1)(b). An officer must provide information about the company and attend meetings of members or creditors: s 530A(2). In addition, under s 530A(5) an officer must, if required by the liquidator, divulge their residential and business addresses and keep the liquidator notified of changes of address.

Under s 530C, a liquidator may apply to the court for a warrant to search for and seize property or books of the company. The court may issue a warrant where it is satisfied that a person has removed or concealed the property or books. In *Cvitanovic v Kenna & Brown Pty Ltd* (1995) 13 ACLC 1654, it was held that the court would only order the issue of a warrant as a last resort after all other requests have been unsuccessful. Liquidators should not be encouraged to apply for warrants merely on the grounds of convenience.

### *Preventing absconding and removal of assets*

**[32.310]** Sections 486A and 486B give liquidators the power to apply for a variety of court orders to prevent officers and their related entities from absconding from Australia for the purpose of avoiding personal liability to the company. "Related entity" in relation to a body corporate is defined in s 9 to include a director, promoter, relative or de facto spouse of a director or promoter, a related body corporate and beneficiary of a trust of which the body corporate is a trustee.

Under s 486A(1), the court may, on the application of a liquidator or provisional liquidator, make orders such as appointing a receiver, prohibiting an officer or related entity of a company from taking or sending money or other property out of Australia or from leaving Australia without the court's consent.

A court may make a s 486A(1) order only if the company is being wound up in insolvency or otherwise by the court: s 486A(2)(a). The court must be satisfied that there is at least a prima facie case that the officer or related entity is or will become liable to pay money to the company or to account for property of the company: s 486A(2)(b). The court must also be satisfied that there is substantial evidence that the officer or related entity has concealed or removed money or other property, has tried or intends to do so,



or has tried or intends to leave Australia: s 486A(2)(c). The court will only make such an order if it is necessary or desirable to protect the company's rights.

In addition to the s 486A orders, s 486B allows the court, on the application of a liquidator, provisional liquidator or ASIC, to issue a warrant for a person to be arrested and brought before it. An arrest warrant may also be issued if the person has concealed or removed company property in order to prevent or delay the liquidator from taking possession or control: s 486B(1)(b)(ii). In addition, a person may be arrested and brought before the court if that person has destroyed, concealed or removed company books or is about to do so: s 486B(1)(b)(iii).

## Disclaimer

**[32.315]** A liquidator has the power to disclaim property of the company: s 568. This power enables a liquidator to terminate a company's property rights and liabilities where these are disadvantageous to the company and its creditors.

Liquidators may disclaim company property.

The purpose behind the power of disclaimer is to relieve the company of an asset that is really a liability. Under s 568(1), a liquidator may disclaim property of the company that consists of:

- land burdened with onerous covenants;
- shares;
- property that is unsaleable or not readily saleable, or where the costs of realisation could reasonably be expected to exceed the proceeds;
- property that may give rise to a liability or other onerous obligation, such as partly paid shares; or
- unprofitable contracts.

**[32.316]** A disclaimer has the effect of terminating the company's rights and liabilities in respect of the disclaimed property. The rights or liabilities of any other person are not affected by the disclaimer except so far as is necessary to release the company and its property from liability: s 568D(1).

*Willmot Growers Group Inc v Willmott Forests Ltd (in liq)* [2013] HCA 51

**[32.317]** The High Court held that where the liquidator of a lessor company disclaims a lease subject to a security interest held by a financier, both the lease and the financier's security interest are terminated.

Section 568D(1) is specifically designed to enable a liquidator to cease performing obligations and to achieve a release of the company in liquidation from its obligations. In this case, the lessor was under an obligation under the lease to provide the lessee with possession and quiet enjoyment. This was in the nature of

a liability and in order for the lessor to be released from this liability the interest of the lessee had to be extinguished. The liquidator of the insolvent lessor was therefore able to pass title in the property to a third party unencumbered by the lease. A person whose rights are affected by a disclaimer of property is taken to be a creditor of the company to the extent of any loss suffered and may prove such a loss as a debt in the winding-up: s 568D(2).

Power of the court to set aside a disclaimer.

The court may set aside the disclaimer and make further orders as it thinks appropriate: s 568B(2). A disclaimer may only be set aside if the court is satisfied that the disclaimer would cause prejudice to persons having interests in the property that are grossly out of proportion to the prejudice that setting aside the disclaimer would cause to the company's creditors: s 568B(3). Thus the court is required to balance the interests of owners of disclaimed property with the company's creditors. A disclaimer will only be set aside where the interests of the property owner are prejudiced to a considerable extent. Even then, the interests of other creditors must also be taken into account.

*The Australian Sawmilling Company Pty Ltd v EPA* [2021] VSCA 294

**[32.319]** The Court of Appeal set aside a liquidator's disclaimer of unsaleable land, to enable the Victorian Environment Protection Authority to claim payment for costs of remediation of contaminated land. The sole shareholder of the company, who was also a creditor, indemnified the liquidator against any shortfall in assets to meet the environmental liabilities.

It was held that the disclaimer would cause "immediate" rather than future potentialities or indirect consequences and significant prejudice to the EPA and the State, which was disproportionately greater than the prejudice that would be suffered by the company's creditors. The creditors suffered little or no loss because they were not going to receive any payment in any case. While the creditor who indemnified the liquidator would be liable under the indemnity, this was not suffering prejudice in its capacity as a creditor of the company, but as an indemnifier of any environmental liability. The Court of Appeal held that there were no specific criteria under the *Corporations Act* to determine whether a disclaimer should be set aside. The case confirmed that the courts can consider principles of environmental protection when determining whether a disclaimer should be set aside, notwithstanding that such principles are not prescribed under the *Corporations Act*.

A person with an interest in disclaimed property may apply to the court for an order setting aside the disclaimer after it has taken effect: s 568E(1). Such an order will only be made if it was unreasonable to expect that the application should have been made before the disclaimer took effect: s 568E(2). The court will only set aside a disclaimer if

it prejudices persons with an interest in the property to an extent that is grossly out of proportion to the prejudice caused to creditors if the disclaimer is set aside: s 568E(5).

## Duties of liquidators

### General duties

**[32.320]** A liquidator is an agent of the company. This agency relationship imposes upon the liquidator fiduciary duties and duties of care.

A liquidator owes fiduciary and statutory duties to the company.

These duties are similar to the duties imposed on directors of the company, discussed in Chapters 13–20. Section 9 includes a liquidator within the definition of “officer” (see [13.20]) for purposes of the duties and liabilities imposed by ss 180–184.

While liquidators owe similar duties to other officers, because of the nature of their position, they also have specific obligations related to their role. In *Re Partridge* [1961] SR (NSW) 622, the court described the main duties of a liquidator:

Speaking generally, the liquidator’s principal duties are to take possession of and protect the assets, to make lists of contributories, to have disputed cases adjudicated upon, to realise the assets and to apply the proceeds in due course of administration amongst the creditors and contributories.

Registered liquidators also have public responsibilities to investigate and report to ASIC suspected breaches of the *Corporations Act*.

According to Street J in *Re Allebart Pty Ltd* [1971] 1 NSWLR 24, they have “public responsibilities to investigate past activities connected with the company” and to discover breaches of the *Corporations Act* as well as “conduct falling short of the requisite standards of commercial morality”. Section 533, discussed at [32.375], requires liquidators to report suspected breaches of the *Corporations Act* to ASIC.

While liquidators control the management of the affairs and property of the company, they are nevertheless under a statutory duty to exercise a reasonable degree of care and diligence under s 180 as well as the s 181 duties to act in good faith and for a proper purpose.

Liquidators’ duty of care.

*Pace v Antlers Pty Ltd* (1998) 80 FCR 485

**[32.325]** A liquidator breached the duty of care and skill by failing to bring the company out of liquidation as soon as reasonably practicable after it had become solvent. This caused costs to be incurred in paying the liquidator and the liquidator failed to pay tax owing by the company with the result that penalty tax was imposed. Lindgren J of the Federal Court stated:

a liquidator must exhibit care (including diligence) and skill to an extent that is reasonable in all the circumstances. “All the circumstances” will include the facts that a liquidator is a person practising a profession, that a liquidator holds himself or herself out as having special qualifications, training and experience pertinent to the liquidator’s role and function, and that a liquidator is paid for liquidation work. “All the circumstances” will also include the fact that some decisions and courses of action which a liquidator is called upon to consider will be of a business or commercial character, as to which competent liquidators acting with due care, but always without the benefit of hindsight, may have differences of opinion.

**[32.335]** A liquidator is also required to act impartially in the conduct of the winding-up and comply with the provisions of the *Corporations Act*. If difficulties arise, the liquidator may apply to the court for an order to determine any question arising in the external administration of the company: *Insolvency Practice Schedule (Corporations)*, s 90-15.

## *Specific duties of liquidators*

### **Handling of funds**

**[32.340]** Liquidators and other external administrators must pay all money received by them in relation to the external administration into an “administration account” within five business days after receipt: *Insolvency Practice Schedule (Corporations)*, s 65-5(1). Contravention of this requirement is a criminal offence: s 65-5(3). An administration account is a bank account maintained in relation to the external administration: s 65-10. An external administrator must not pay any other money into the administration account for the company: s 65-15. Money must not be paid out of the administration account for a company otherwise than for purposes related to the external administration of the company: s 65-25. The court may give directions regarding the payment, deposit or custody of money, negotiable instruments and other securities that are payable to, or held by, an external administrator of a company: s 65-45.

### **Administration returns**

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| Annual administration return. |
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**[32.341]** Under s 70-5 of the *Insolvency Practice Schedule (Corporations)*, an external administrator must lodge with ASIC a return in the prescribed form in relation to the external administration. The return must be lodged within three months after the end of the year and annually thereafter: ss 70-5(3)–70-5(5).

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| End of administration return. |
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When an external administration of a company ends, s 70-6 requires the external administrator to lodge an end of administration return in the approved form with ASIC

within one month after the end of the external administration. ASIC must deregister the company three months after the end of administration return is lodged: s 509.

The external administrator must notify the following persons that an end of administration return has been lodged if the persons request such a notice:

- in a members' voluntary winding-up – the members of the company; and
- in a creditors' voluntary winding-up – the creditors; and
- in a court-ordered winding-up – the creditors; and
- if the external administrator is appointed as a provisional liquidator – the court; and
- if the company is under administration or has executed a deed of company arrangement – the company.

### Record-keeping

[32.342] Under s 70-10 of the *Insolvency Practice Schedule (Corporations)*, an external administrator must keep proper books that contain:

- entries or minutes of proceedings at meetings relating to the external administration of the company; and
- such other entries as are necessary to give a complete and correct record of the external administrator's administration of the company's affairs.

The books must be available at the external administrator's office for inspection by a creditor or contributory at all reasonable times: s 70-10.

Audit of administration books by ASIC and the court.

Sections 70-15 and 70-20 give ASIC or the court the right to have the annual administration return, end of administration return and the administration books audited by a registered company auditor.

### Giving information to creditors and others

[32.343] Section 70-40 of the *Insolvency Practice Schedule (Corporations)* gives creditors, who pass a resolution to that effect, the right to request the external administrator to give information, provide a report or produce a document. Sections 70-45–70-47 give similar rights to an individual creditor and members in a members' voluntary winding-up. The external administrator must comply with the request unless:

- the information, report or document is not relevant to the external administration of the company;
- the external administrator would breach his or her duties if the request was complied with; or
- it is otherwise not reasonable for the external administrator to comply with the request. The *Insolvency Practice Rules (Corporations)* may prescribe circumstances in which it is not reasonable to comply with a request.

Section 70-70 of the *Insolvency Practice Schedule (Corporations)* gives ASIC the power to direct that an external administrator complies with a request if the external administrator

refuses a request for information. Under s 70-90, the person who made the request for relevant information may apply to the court for an order requiring the external administrator to provide all or part of the relevant information requested. ASIC may also apply for a court order if the external administrator does not comply with an ASIC direction.

### **Acquaintance with the company's affairs**

**[32.350]** In order for liquidators to collect and preserve the assets of the company, they are required to acquaint themselves with the affairs of the company. Their sources of information include the company's records, the company's officers and employees. In a compulsory liquidation, s 475(1) requires persons who were the directors and secretary at the time of the winding-up order to submit a report to the liquidator in the prescribed form as to the affairs of the company. This report must be submitted not later than 10 business days after the making of the winding-up order.

Public examinations under ss 596A–596F and 597 are sometimes initiated by liquidators as a means of locating a company's assets and discovering information about transactions prior to the winding-up. This is discussed at [32.400]–[32.460].

### **Collecting the company's assets**

**[32.355]** As soon as practicable after appointment, a liquidator is required to take into personal custody or control all the property to which the company is, or appears to be, entitled: s 474(1). In certain circumstances, the liquidator can take legal action to recover property that the company disposed of before the commencement of winding-up. The liquidator may avoid certain antecedent transactions and dispositions made after the commencement of winding-up. This is discussed at [32.470]–[32.610].

Liquidators may sue directors who breach their duties.

The liquidator can take action on the company's behalf to recover property, profits or damages from directors or other officers who breached their duties to it prior to the commencement of winding-up. The duties of directors and the company's remedies for breach of those duties are discussed in Chapters 13–20.

The company's assets also include the amounts that contributories are liable to contribute on a winding-up. Under s 516, the holder of partly paid shares is liable to contribute the amount unpaid to the company when it is wound up. Persons who have ceased to be members within one year of the commencement of winding-up are also liable to contribute to the property of the company where the existing members are unable to satisfy the full extent of their liabilities. However, past members are not liable for the company's debts incurred after they ceased to be members.

### **Preserving assets**

**[32.360]** A liquidator is under a duty to preserve the company's assets until they can be sold. To achieve this end, a liquidator is permitted to carry on the business of the company: s 477(1)(a). This is especially important if this is the only means of preserving the goodwill of a company's business where the liquidator intends to sell the business

as a going concern. The business can only be carried on for the purpose of a beneficial winding-up and not with a view to its continuance: *Re Wreck Recovery & Salvage Co* (1880) 15 Ch D 353.

### Selling assets

[32.365] Because the purpose of a winding-up is to distribute the company's assets to creditors and contributories, the liquidator is under a duty to sell the company's assets. To this end, the liquidator is given powers to sell all the company's property and to execute documents in its name: s 477(2)(c) and (d). The liquidator, in exercising these powers, is under a duty to act in the best interests of the company in the same way as a director.

There is no specific duty to obtain the best possible price for assets the liquidator causes the company to sell as liquidators are entitled to consider a wide range of matters. The duties of liquidators are not owed to creditors and shareholders, but to the company: *Hausmann v Smith* [2006] NSWSC 682. A company's property does not always have to be sold in a winding-up. For example, the members may resolve to voluntarily wind up a solvent company for the sole purpose of dividing up its unrealised assets in specie among themselves.

### Distributing assets

[32.370] Liquidators are under a duty to repay the company's debts and to distribute any surplus assets among contributories. A liquidator has a duty to invite proof of claims by advertising. Even if a claimant does not respond to an advertisement for claims, the liquidator is still under a duty to inquire into all claims of which they are aware: *Harry Goudias Pty Ltd v Port Adelaide Freezers Pty Ltd* (1992) 10 ACLC 499. These duties are considered at [32.640]–[32.665].

### Reporting breaches of the law

[32.375] Liquidators are required to report suspected criminal activity in relation to the company or breaches of duty to ASIC as soon as practicable: s 533(1).

On receipt of a s 533 report, ASIC may decide to investigate the matters raised and launch prosecutions.

A s 533 report must be lodged if, in the course of winding-up, it appears to the liquidator that:

- a past or present officer, or a member or contributory, of the company may have been guilty of either a Commonwealth or State offence in relation to the company;
- a person who has taken part in the formation, promotion, administration, management or winding-up of the company:
  - may have misapplied or retained, or may have become liable or accountable for, any money or property of the company; or
  - may have been guilty of any negligence, default, breach of duty or breach of trust in relation to the company; or
- the company may be unable to pay its unsecured creditors more than 50 cents in the dollar.

The liquidators' duty to report breaches of the law often requires them to carry out an investigation which inevitably involves time and expense. Because these expenses are ordinarily funded from the company's assets, liquidators may be reluctant to carry out full investigations if the company has few assets and misconduct by directors and officers may not be investigated and not reported to ASIC.

Assetless Administration Fund to finance liquidators' investigations.

The Assetless Administration Fund is a mechanism designed to improve corporate conduct generally, improve returns for creditors and reduce the scope for phoenix activity. Phoenix companies are discussed at [18.55]. Where a liquidator of a company with few or no assets believes that director banning may be appropriate or there is evidence of possible offences or misconduct in relation to the *Corporations Act*, an application may be made to ASIC for funds to investigate and report on the causes of the company's failure and in some cases to enable a liquidator to take action to recover assets. A liquidator's report produced as a result of funding provided by the Assetless Administration Fund assists ASIC in deciding whether or not it should commence enforcement action against the company's officers.

### Deregistration

[32.380] After the company's property has been sold and the proceeds distributed to creditors and members, a liquidator may apply to the court for an order that the liquidator be released and that ASIC deregister the company: s 480. Deregistration is discussed at [32.770]–[32.795]. As soon as the affairs of the company are fully wound up, the liquidator must prepare and lodge with ASIC an end of administration return.

ASIC must deregister the company three months after the return is lodged: s 509. On the application by the liquidator or any other interested party, the court may order that ASIC deregister the company on a specified day: s 509(2).

### *Remedies for liquidators' breach of duty*

[32.385] The court is given power to remedy liquidators' breaches of duty under a number of different provisions.

Liquidators fall within the s 9 definition of "officer" and breach their duties under Ch 2D of the *Corporations Act* if they fail to act in good faith in the best interests of the company or fail to exercise their powers with reasonable care and diligence. The Ch 2D duties (in ss 180–183) are civil penalty provisions so that officers who breach the sections may be liable to disqualification, imposition of a pecuniary penalty, payment of compensation to the company or criminal liability. The civil penalty provisions are discussed at [19.120]–[19.150].

A liquidator may also be examined under ss 596A–596F and be liable under s 598. Examinations are discussed at [32.400]–[32.460].

As discussed at [32.290], ss 90-5–90-20 of the *Insolvency Practice Schedule (Corporations)* give the court the power to inquire into an external administration of a company, either on its own initiative, or on the application of the company, the external administrator,



ASIC, a creditor or another person with a financial interest in the company. The purpose of the court's power to inquire into the conduct of an external administrator has a regulatory, supervisory and disciplinary focus intended primarily to serve the public interest rather than to vindicate private rights or focus on particular decisions of the external administrator: *ASIC v Macks (No 2)* [2019] SASC 17. The court has wide powers to make such orders as it thinks fit, including an order replacing the external administrator, or orders dealing with losses resulting from an external administrator's breach of duty.

## Provisional liquidators

**[32.390]** A provisional liquidator is an interim appointment pending the determination of a winding-up application. The court has a wide power to appoint a registered liquidator to be a provisional liquidator at any time after the filing of a winding-up application and before the making of a winding-up order: s 472(2).

The appointment of a provisional liquidator before a winding-up application is determined is considered an intrusion into the affairs of the company and will not be done if other measures would be adequate to preserve the status quo. The court will only appoint a provisional liquidator if there is a reasonable likelihood of the winding-up application being ultimately successful: *Alessi v The Original Australian Art Co Pty Ltd* (1989) 7 ACLC 595. The appointment will then only be made if it serves a purpose; otherwise the appointment would add to the costs of winding-up: *Re T & L Trading (Aust) Pty Ltd* (1986) 10 ACLC 388. For example, an applicant may show that the appointment is needed in the public interest or to preserve the status quo or to protect the company's assets or affairs and there is a reasonable prospect that a winding-up order will be made on the application to wind up the company.

The court may appoint a provisional liquidator if the assets of a company are in jeopardy.

The usual reason for the appointment of a provisional liquidator is that the assets of a company are in jeopardy. This may occur where the company's assets have either been, or are being, dealt with in a manner that is detrimental to creditors or members if the company is ultimately wound up.

The role of a provisional liquidator is to prevent the company's assets being dissipated by its directors or shareholders after the filing of the winding-up application and before the application is heard. A member may seek the appointment of a provisional liquidator to safeguard assets where members are in dispute or the company's affairs were being conducted in a manner that was oppressive, unfairly prejudicial or unfairly discriminatory against a shareholder or contrary to the interests of members as a whole: *Champions Quarry Pty Ltd v GSQ Holdings Pty Ltd* [2019] FCA 459.

A creditor may seek the appointment of a provisional liquidator where a company is continuing to trade at a loss or is incurring further liability. A provisional liquidator may be appointed to protect creditors by enforcing a contractual right of the company.

Appointment where directors fail to act.

The company may apply for the appointment of a provisional liquidator if the directors are not prepared to continue to manage the company and this may place its assets in jeopardy. Directors may be reluctant to continue to act because of the possibility of incurring liability for insolvent trading under s 588G.

A provisional liquidator may be appointed where there has been non-compliance with legislation such as where meetings of directors or shareholders have not been held for some considerable time and meaningful information about the company's financial performance has been withheld from shareholders: *Champions Quarry Pty Ltd v GSQ Holdings Pty Ltd* [2019] FCA 459. A provisional liquidator may also be appointed if it is in the public interest to do so. This may arise where the *Corporations Act* has been contravened by the company and its directors and an independent investigation would be best carried out by a provisional liquidator: *ASIC v Planet Platinum Ltd* [2015] VSC 273.

#### Functions and powers of provisional liquidator.

Upon appointment, the provisional liquidator assumes control of the company's affairs and the directors lose their management powers. The directors retain residual powers, such as the power to oppose an application for a winding-up order. The appointment results in a stay of proceedings against the company, except by leave of the court: s 471B. A provisional liquidator may exercise such functions and powers as are conferred by the *Corporations Act*, court rules or the appointing order: s 472(3). The provisional liquidator is required to take control and custody of all the company's property: s 474(1). The powers of a provisional liquidator are generally limited to those necessary to maintain the status quo by preserving the company's assets prior to the determination of the winding-up application.

A provisional liquidator has certain statutory powers under s 472(4) and (5). These confer the powers to carry on the company's business and the powers of a liquidator under s 477(1)(d), (2) and (3). These powers include the power to initiate or defend legal proceedings in the name of the company, to sell or otherwise dispose of the company's assets, to act in the name of and on behalf of the company and to use the company's seal for these purposes. Provisional liquidators cannot exercise the power under s 477(2)(m), which empowers liquidators to do all such things as are necessary for winding-up the affairs of the company and distributing its property. Such a power is inappropriate for provisional liquidators.

Under s 60-16(1) of the *Insolvency Practice Schedule (Corporations)*, a provisional liquidator is entitled to receive such remuneration, by way of percentage or otherwise, as is determined by the court. If no determination by the court is in force, a provisional liquidator's remuneration may be determined by agreement between the liquidator and the committee of inspection (if any) or by creditors. The remuneration of liquidators is discussed at [32.270].

## Creditors' meetings

**[32.395]** Creditors' meetings provide creditors with the opportunity to pass resolutions on a range of matters relevant to the company's liquidation. For example, as discussed at

[32.270], under s 60-10 of the *Insolvency Practice Schedule (Corporations)*, a resolution of creditors may determine the amount of the external administrator's remuneration.

The external administrator of a company may convene a meeting of the creditors at any time: *Insolvency Practice Schedule (Corporations)*, s 75-10. The external administrator *must* convene a creditors' meeting if directed by resolution of a creditors meeting, the committee of inspection, at least 25 per cent in value of creditors or ASIC: *Insolvency Practice Schedule (Corporations)*, s 75-20.

The *Insolvency Practice Rules (Corporations) 2016* contains rules for creditors' meetings that set out the requirements for such matters as notice, agenda and voting.

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| Voting at creditors' meetings. |
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Resolutions at creditors' meetings are decided by a poll (if one is requested) or on the voices: *Insolvency Practice Rules (Corporations) 2016*, s 75-110). Under s 75-115(1) of the *Insolvency Practice Rules (Corporations) 2016*, if a poll is demanded, a creditors' resolution is passed if a majority in number (whether in person, by proxy or by attorney) vote in favour of the resolution *and* a majority in value of creditors voting (whether in person, by proxy or by attorney), vote in favour of the resolution. If a vote according to majority in number and value results in deadlock, the person presiding at the meeting may exercise a casting vote in favour or against the resolution: *Insolvency Practice Rules (Corporations) 2016*, s 75-115(3). Where the deadlocked resolution relates to the external administrator's remuneration, the resolution is not passed: *Insolvency Practice Rules (Corporations) 2016*, s 75-115(4).

On the application of ASIC or a voting creditor, the court has power to set aside or vary resolutions which are passed or not passed by the casting vote of the presiding person: *Insolvency Practice Schedule (Corporations)*, ss 75-42(4) and 75-43(4).

Section 75-40 of the *Insolvency Practice Schedule (Corporations)* allows creditors to make decisions by voting on a written proposal without a meeting. Section 75-130 of the *Insolvency Practice Rules (Corporations) 2016* provides rules in relation to approval of proposals without meetings.

Occasionally, decisions made at creditors' meetings may be influenced by creditors who are directors or members of the company in liquidation or relatives of directors or members and their related entities. Section 75-41 of the *Insolvency Practice Rules (Corporations) 2016* aims to prevent related creditors from exercising an unfair influence over creditors' meetings.

Under s 75-41 of the *Insolvency Practice Rules (Corporations) 2016*, the court may make certain orders if a resolution was either passed or not passed because of the votes of related creditors and the passing or failure to pass the resolution is contrary to the interests of the creditors as a group or has prejudiced the interests of the creditors who voted either against or for the resolution to an extent that is unreasonable. Section 75-41(3) of the *Insolvency Practice Rules (Corporations) 2016* specifies that the court may set aside a resolution or call another meeting at which the related creditor is precluded from voting. A creditor, the external administrator or ASIC can apply for s 75-41 court orders.

## Committees of inspection

**[32.396]** Under s 80-35 of the *Insolvency Practice Schedule (Corporations)*, a committee of inspection's functions includes:

- to advise and assist the external administrator;
- to give directions to the external administrator; and
- to monitor the conduct of the external administration.

Creditors may resolve to establish a committee of inspection and determine its membership: *Insolvency Practice Schedule (Corporations)*, ss 80-10 and 80-15. A creditor representing at least 10 per cent in value of the creditors is given the right to appoint a person as a member of the committee of inspection: s 80-20. Employees representing at least 50 per cent in value of entitlements owed to employees may also appoint a representative to be a member of the committee of inspection: *Insolvency Practice Schedule (Corporations)*, s 80-25.

A committee of inspection may request the external administrator to give it information, provide a report, or produce a document: *Insolvency Practice Schedule (Corporations)*, s 80-40. A committee of inspection may obtain such specialist advice or assistance it considers desirable in relation to the conduct of the external administration: *Insolvency Practice Schedule (Corporations)*, s 80-50. Members of a committee of inspection must not directly or indirectly derive any profit or advantage from the external administration: *Insolvency Practice Schedule (Corporations)*, s 80-55(1).

## Examinations

### Purpose

**[32.400]** Persons who may be able to provide information and assistance about insolvent companies can be summoned by the court to attend an examination of an inquisitorial nature under ss 596A and 596B.

The main purposes of such examinations are to facilitate the recovery of property belonging to the insolvent company, to discover whether conduct of the directors and officers of the company led to its insolvency and to investigate possible causes of action against third parties.

Examinations are sometimes necessary to enable a liquidator or other administrator to get in and maximise the assets of the company for the benefit of creditors. The liquidator comes to the company with little knowledge of its affairs and so is at a disadvantage in making informed decisions of a legal and commercial nature necessary to carry out the winding-up. The legislation seeks to redress this disadvantage. ASIC may also initiate and conduct examinations.

The *Corporations Act* distinguishes between examinations of an officer as defined in s 9 and examinations of other persons.

## Mandatory examination of officers

**[32.405]** Under s 596A, if an eligible person applies for a summons to examine an officer about a corporation's examinable affairs, the court must issue the summons without investigating the reasons why the application was made unless the predominant purpose of the applicant is an improper purpose or amounts to an abuse of process: *Carter v Gartner* [2003] FCA 653. "Eligible person" is defined in s 9 to include ASIC, a liquidator or administrator or a person, very often a creditor, authorised by ASIC to make an application. Where creditors apply to summon a person for examination, they are not limited to obtaining information relating to their own particular debt unless the court places such a limitation: *Re GVE Hampton Pty Ltd* [2020] FCA 1577. In the case of an application for the mandatory examination of a liquidator as an officer of a company, the court has power to permanently stay the examination summons if there has been an abuse of process, but this power will be exercised only in exceptional circumstances: *Walton v Gardiner* [1993] HCA 77.

"Examinable affairs" is broadly defined in s 9 to include the promotion, formation, management, administration or winding-up of the corporation. Also included are the business affairs of a connected entity (defined in s 64B) in so far as these are relevant.

## Examination of non-officers

**[32.410]** Under s 596B, if an eligible person applies for a summons to examine people other than officers, the court has a discretion and must first be satisfied either that:

- the person has taken part or been concerned in examinable affairs of the corporation and has been, or may have been, guilty of misconduct in relation to the corporation; or
- the person may be able to give information about the examinable affairs of the corporation.

In this context, "examinable affairs" includes information concerning the prospect of successfully bringing a legal action. This information would assist a liquidator to estimate the value of the legal action and decide whether to bring it. Such information would include details of insurance policies entered into by the company, and insurers could be examined despite the lack of a direct connection with the company in liquidation: *Re Interchase Corporation Ltd* (1996) 68 FCR 481.

Where an application is made under s 596B for the examination of a person other than an officer, an affidavit in support that complies with the court rules must be filed: s 596C. Affidavits are not available for public inspection unless the court orders otherwise.

## Provision of information

**[32.415]** The summons to a person to be examined under s 596A or 596B may require the examinee to produce specified books in their possession that relate to the corporation: s 596D(2).

Subject to some exceptions, notice that an examination is to be held must be given to the corporation's creditors and the liquidator or any other eligible applicant: s 596E. Creditors may take part in an examination and be represented by a lawyer. This is in addition to similar rights possessed by a liquidator, administrator or other eligible applicant and ASIC: s 597(5A).

The court may put or allow to be put such questions about the corporation or any of its "examinable affairs" as it thinks appropriate: s 597(5B). An examination is heard in public unless there are special circumstances: s 597(4). A person summoned under s 596A or 596B contravenes s 597(6) if they fail to attend. Section 597(7) requires an examinee to answer all questions on oath or affirmation and produce books required by the summons. Failure to comply with s 597 is an offence: s 1311 and Sch 3.

The court may direct a person to produce specified books in their possession that are relevant to the examination either at that person's examination or at the examination of any other person: s 597(9). This enables a liquidator to obtain production of books from third parties. A person directed to produce books at an examination must not, without reasonable excuse, refuse or fail to comply: s 597(10A).

A liquidator or other eligible applicant may require an examinable officer to supply an affidavit about a corporation's examinable affairs under s 597A as a cheaper alternative to conducting an examination. This requirement may be instead of, or in addition to attendance at an examination. The affidavit must contain information as specified by the court: s 597A(2). Failure to comply constitutes an offence.

## Separate legal actions

[32.420] Where separate civil proceedings have already commenced, a liquidator may gain an advantage in these proceedings by examining a witness before the hearing has commenced. The examination might be conducted as a rehearsal or the credit of the witness may be attacked. Although the liquidator is given an advantage, they are entitled to gain information that enables the liquidation to proceed more effectively. A purpose of an examination and a requirement that an examinee produce books is the implementation of a "system of discovery" in order to determine whether legal actions should be brought against the examinee or others.

## Legal professional privilege

[32.440] A person may refuse to answer questions or produce books at an examination if they claim legal professional privilege: *Re Transequity Ltd* [1991] Tas R 308. Legal professional privilege may be asserted where the purpose of the documents sought was to provide information to legal advisers to assist them in providing legal advice: *Hartogen Energy Ltd v Australian Gas Light Co* (1992) 36 FCR 557. Legal professional privilege protects confidentiality between legal adviser and client. It is the client who is entitled to the benefit of the confidentiality.

## Self-incrimination

[32.445] A person being examined must answer questions even if the answer may be self-incriminating: s 597(12). However, provided the examinee claims privilege, incriminating

answers are not admissible evidence in subsequent criminal proceedings or proceedings for the imposition of a penalty: s 597(12A).

## Powers of the court

**[32.450]** The court may give directions about an examination on several matters specified in s 596F. These include the matters to be inquired into, the procedure to be followed, who may be present and access to records of the examination.

**[32.460]** Where a person is summoned under s 596A or 596B or is required to file an affidavit under s 597A, and the court is satisfied that this is done without reasonable cause, the court may order that the person's costs be paid by the applicant or any person who took part in the examination: s 597B.

The court is given wide powers under s 598 to make such orders as it thinks appropriate where it is satisfied that:

- a person is guilty of fraud, negligence, default, breach of trust or breach of duty in relation to a corporation; and
- the corporation also suffered loss or damage as a result of the fraud, negligence, default, breach of trust or breach of duty.

The orders include an order directing a person to pay money or transfer property to the corporation, or to pay compensation to the corporation for loss or damage suffered by it. While these remedies are ostensibly for the benefit of the company, if it is insolvent, they are in effect remedies that benefit its creditors because successful s 598 cases increase the company's assets available for distribution to creditors.

## Recovery of assets

**[32.465]** Liquidators have a duty to collect the assets of the company available for distribution to creditors and members. The assets available include all property owned by the company at the date of commencement of the winding-up. In addition, the available assets include:

- amounts due from contributories pursuant to ss 515–526;
- compensation or profits recovered from officers in breach of fiduciary duties or Ch 2D;
- amounts recovered from directors who breach the duty to prevent insolvent trading (s 588G). This is discussed at [18.100]–[18.240];
- amounts recovered from defaulting officers pursuant to s 598 following an examination. Examinations are discussed at [32.400]–[32.460];
- amounts recovered from creditors and officers of an insolvent company who were parties to voidable antecedent transactions, discussed at [32.475]–[32.610]; and
- amounts recovered from “creditor-defeating dispositions” which involved illegal phoenix activity, discussed at [32.567].

## Void dispositions after commencement of winding-up

**[32.470]** The powers of a company to deal with its property after winding-up has commenced are limited by s 468(1). Under s 468(1), any disposition of property of a



company made after the commencement of winding-up is void unless the court orders otherwise. Dispositions made on the day winding-up commences are not dispositions of property *after* the commencement of winding-up and so are not caught by s 468(1): *Re Skypac Aviation Pty Ltd* [2019] NSWSC 291. Under s 513A, a court-ordered winding-up is generally taken to commence on the date of the winding-up order. A voluntary winding-up begins on the passing of the winding-up resolution: s 513B. In the case of a company under voluntary administration, its winding-up is taken to have commenced on the day the voluntary administration began: s 513C.

Disposals of company property after winding-up has commenced are void unless the court otherwise orders.

As with voidable antecedent transactions discussed at [32.475], the aim of s 468 is to ensure that all creditors share in the assets equally and in accordance with priorities under the *Corporations Act*. It generally prevents disposals of assets after winding-up has commenced, other than exempt disposals such as those made by the liquidator, an administrator or under a deed of company arrangement.

Disposition of property is given a wide meaning but requires “some change that takes out of the company at least the beneficial ownership in a corporate asset and passes it to someone else”: *Re Loteka Pty Ltd* [1990] 1 Qd R 322. It includes a sale of company property, payments of money and forgoing of rights. It does not include the exercise of a power of sale by a holder of a non-circulating security interest granted before the commencement of winding-up. Nor does it include dispositions of property by a receiver in the course of the receivership: *Wily v Commonwealth* (1996) 14 ACLC 863.

The court has a wide power to validate dispositions under s 468(3) that would otherwise be void dispositions. The court may permit part or all of the company’s business to be carried on and incidental acts to be done. The exercise of this discretion involves a balance of the interests of creditors that a distribution in accordance with the Act occurs and the benefit to all creditors of an orderly winding-up by allowing a company to continue to carry on its business in order to allow it to be sold as a going concern. This justifies the validation of payments to a creditor for the supply of goods after liquidation has commenced where the creditor acted in good faith, in the ordinary course of business or without knowledge of the winding-up proceedings. This is particularly the case where the disposition enabled the company to continue to carry on its business: *Prospect Electricity v Advanced Glass Technologies of Australia Pty Ltd* (1996) 14 ACLC 1721.

## Voidable antecedent transactions

[32.475] Certain transactions between an insolvent company and other persons entered into before the commencement of winding-up can have the effect of reducing the amount available for distribution to creditors when the company is wound up. These are referred to as “antecedent” transactions because they are entered into before the commencement of winding-up.



The court may order that certain pre-liquidation transactions that reduce the amount available for distribution to creditors are voidable.

The provisions of Div 2 of Pt 5.7B of the *Corporations Act* enable a liquidator to apply to the court for orders making such pre-liquidation transactions voidable and to recover the value of any property lost as a result of the transaction for the benefit of the general body of unsecured creditors of the company.

## Types of antecedent transactions

[32.480] Division 2 of Pt 5.7B (ss 588FA–588FJ) provides for the avoidance of a number of different types of antecedent transactions. These are:

- unfair preferences (s 588FA);
- uncommercial transactions (s 588FB);
- unfair loans (s 588FD);
- unreasonable director-related transactions (s 588FDA);
- transactions for the purpose of defeating creditors (s 588FE(5));
- creditor-defeating dispositions (s 588FE(6B));
- transactions that discharge a liability of guarantor-related entities (s 588FH); and
- invalidation of circulating security interests (s 588FJ).

In general terms, the antecedent transactions provisions follow a similar pattern. In order for a liquidator to avoid a transaction, the liquidator must prove each of the following:

- A particular transaction fits the applicable *Corporations Act* definition (for example, an unfair preference must satisfy the s 588FA definition).
- The company entered into an “insolvent transaction” as defined in s 588FC, meaning it was insolvent at the time of entering into the transaction or became insolvent because of the transaction.
- The insolvent transaction was entered into during a defined period applicable to the type of transaction before the winding-up began. This is a “voidable transaction” as defined in s 588FE.

Definition of “transaction”.

“Transaction” is broadly defined in s 9 to include a disposition of property, the grant of a security interest, making a payment, giving a guarantee and releasing or incurring an obligation. It includes arrangements which produce legal consequences under either contract law or equitable estoppel that change the rights, liabilities or property of the debtor company: *Bartercard Ltd v Wily* [2001] NSWCA 262. A transaction may consist of a series of events which are connected and discrete from other events. This may involve an order for supply of goods, delivery of the goods, delivery of an invoice, sending

of a cheque and payment of a cheque: *Mann v Sangria Pty Ltd* [2001] NSWSC 172. In considering the meaning of “transaction”, Black J in *Re Employ (No 96) Pty Ltd (in liq)* [2013] NSWSC 61 said:

The identification of the relevant transaction must have reference to the totality of the relationship between the parties and a series of dealings may constitute a transaction if they are connected in being directed to bring about a change in the company’s rights, liabilities or property.

## Unfair preferences

**[32.485]** Under s 588FA(1), a transaction is an unfair preference given by a company to a creditor if, and only if:

- the company and the creditor are parties to the transaction (even if someone else is also a party); and
- the transaction results in the creditor receiving from the company, in respect of a debt that the company owes to the creditor, more than the creditor would receive 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.

A company repaying all or part of a debt due to an unsecured creditor is an example of an unfair preference. To the extent that an unsecured debt is repaid prior to liquidation, the creditor is unfairly preferred over other unsecured creditors. If the repayment had not occurred and the company went into liquidation due to its insolvency, the unsecured creditor would have only been entitled to share *pari passu* with other creditors of equal rank. As a result of being repaid prior to liquidation, the repaid unsecured creditor receives an advantage over the company’s other unsecured creditors. This is contrary to the *pari passu* rule (discussed at [32.670]), which provides for equal treatment of creditors in a winding-up.

### Purpose of payment.

When deciding whether payment of a debt is an unfair preference, the courts look to the purpose of the payment in order to determine whether it has the effect of giving a creditor a preference, priority or advantage over other creditors. This requires considering the objective purpose and the context of the whole transaction in a business sense in order to look to the ultimate effect of the transaction. If the purpose was to mainly induce the creditor to provide further goods, the payment will not generally be regarded as a preference. If the sole purpose of the payment was to extinguish a debt, it is a preference. Payments are unfair preferences if the net effect of a series of transactions results in an overall improvement in the creditor’s position: *Airservices Australia v Ferrier* [1996] HCA 54.

### Third-party payments.

The question has arisen whether a payment of a company’s debt by a third party can amount to an unfair preference. Such a situation can arise in some cases where the

third party is a debtor of the insolvent company and makes payment to a creditor of the company to reduce its liability. A third-party payment to a creditor of an insolvent company is generally not an unfair preference because the payment is not received *from* the insolvent company's own money as required by s 588FA(1)(b). If the third party making the payment is a debtor of the insolvent company, the payment to a creditor would have the effect of reducing its debt and giving the creditor the benefit of the payment that the insolvent company was entitled to. In such a case, the payment would have reduced the company's assets, being the debt owed to it by the third party, and the payment could be seen as having been received from the insolvent company within the meaning of s 588FA(1)(b): *Cant v Mad Brothers Earthmoving Equipment Pty Ltd* [2020] VSCA 198.

Payment of rent.

**[32.500]** The payment of rent by a tenant company to its landlord is generally not an unfair preference: *Re Centaur Mining & Exploration Ltd* [2008] VSC 416. A transaction is an unfair preference if its ultimate effect is to disadvantage the other creditors. Non-payment of rent gives a landlord the right to repossess the rented property. The ultimate effect of paying rent is that it enables the tenant to retain possession of an asset of equal or greater value than the rent payment with the result that the tenant's other creditors are not disadvantaged.

*Ashala Model Agency Pty Ltd v Featherstone* [2016] QSC 121

**[32.502]** Featherstone was a de facto director and sole shareholder of a company. The company entered into a three-year lease of a building owned by Featherstone for use of its model agency business. The court was of the opinion that the rent under the lease was significantly higher than market rents for similar buildings. The lease was later varied so that the rent for the entire term of the lease was only payable when called. Featherstone called for full payment of the rent and used the money to buy an apartment for himself. The payment represented the company's entire cash resources and the company became insolvent with nothing left to pay debts owed to other creditors. It was held that the payment of the rent was an unfair preference between the company and Featherstone because he received more in respect of the rent than he would have received if he had proved for the rent in a winding-up. As a result of the rent payment, the company's debts to the ATO and other creditors remained unpaid.

The court also held that Featherstone's purpose in arranging for payment of the entire rent was to defeat, delay or interfere with creditors (particularly the ATO). The rent payments were also held to constitute an uncommercial transaction.

Running accounts.

**[32.503]** A running account arises where a particular transaction is considered as one of a series of transactions and not in isolation for the purposes of determining whether

that transaction is an unfair preference. Section 588FA(3) exempts running accounts and other similar transactions from being regarded as unfair preferences where they are an integral part of a continuing business relationship between a company and a creditor, with the expectation that further debits and credits will be recorded so that the balance of the account will fluctuate. The running account exemption seeks to balance the interests of the general body of unsecured creditors with those of a particular creditor carrying on a continuous business relationship with the insolvent company. Where goods or services are provided that are of equal or greater value to the insolvent company, there is no disadvantage to the other creditors and there may be an advantage from the continuation of the company's business.

Section 588FA(3)(c) requires all transactions forming part of the continuing Insolvency business relationship between the insolvent company and the creditor to be regarded as a single transaction. This single transaction may only be taken to be an unfair preference if it meets the general requirements of s 588FA(1): s 588FA(3)(d). In *Badenoch Integrated Logging Pty Ltd v Bryant* [2021] FCAFC 64 it was held that s 588FA adopts an "ultimate effect" test which requires consideration of the net effect of all the transactions forming part of the continuing business relationship. The court rejected the liquidator's claim which assessed the recoverable amount of an unfair preference on the basis of the company's "peak indebtedness", the largest amount of indebtedness in the running account, thereby maximising the amount of the preference.

**[32.515]** The court can make an order in relation to an unfair preference under s 588FF if it is an "insolvent transaction" as defined in s 588FC (see [32.585]) and a "voidable transaction" as defined in s 588FE where it was entered into within six months before the "relation-back day", usually the day the winding-up application was filed: s 588FE(2) (see [32.590]).

A creditor who gives up the benefit of an unfair preference may prove for the debt in the winding-up as if the transaction had not been entered into: s 588FI(3).

In certain circumstances, a transaction that is an unfair preference may also be an uncommercial transaction as defined in s 588FB (see [32.520]) or a transaction for the purpose of defeating, delaying or interfering with the rights of any of the company's creditors as defined in s 588FE(5): see [32.560].

## Uncommercial transactions

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| Definition of "uncommercial transaction". |
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**[32.520]** A transaction is an "uncommercial transaction", under s 588FB, if it may be expected that a reasonable person in the company's circumstances would not have entered into it having regard to:

- the benefits (if any) to the company of entering into the transaction;
- the detriment to the company of entering into the transaction;
- the respective benefits to other parties to the transaction of entering into it; and
- any other relevant matter.

The s 588FB definition requires a court to balance the benefit and detriment of a transaction of the company: *Lewis v Doran* [2005] NSWCA 243. Section 588FB imposes an objective test in determining whether a reasonable person would, on balance, consider a transaction of the company to be an uncommercial transaction: *Tosich Construction Pty Ltd v Tosich* [1997] FCA 979.

Unlike an unfair preference, an uncommercial transaction does not have to involve a transaction between the company and one of its creditors. It can be entered into by the company and any other person.

Section 588FB is aimed at preventing companies disposing of assets through transactions that result in the recipient, usually a director, relative or associated company, receiving a gift or obtaining a bargain of such magnitude that it could not be explained by normal commercial practice.

*Demondrille Nominees Pty Ltd v Shirlaw* (1997) 15 ACLC 1716

**[32.530]** A company owned by the directors of Cornelis Holdings Pty Ltd owed Demondrille \$120,000. In order to pay this debt, Cornelis, a building company, entered into a contract to sell one of its home units to Demondrille for \$180,000. The contract provided that Demondrille was deemed to have paid a \$120,000 deposit. When Cornelis was wound up, its liquidator sought an order that the contract was void. The Federal Court held that the contract was an uncommercial transaction under s 588FB because there was no benefit to Cornelis in crediting Demondrille with the \$120,000 deposit. The transaction entitled Demondrille to purchase a unit worth \$180,000 at an undervalue.

**[32.540]** Before a liquidator can obtain a court order regarding an uncommercial transaction, the liquidator must show that the uncommercial transaction was also an insolvent transaction as defined in s 588FC (see [32.585]) and a voidable transaction as defined in s 588FE: see [32.590]. These requirements also apply to unfair preferences. An uncommercial transaction is voidable if it was entered into within two years before the relation-back day and four years if the transaction was with a related entity of the company: s 588FE(3).

Uncommercial transactions and director liability.

The uncommercial transaction provisions in s 588FB are linked to the insolvent trading provisions in s 588G, discussed at [18.100]–[18.240]. Under s 588G(1A), a company is regarded as incurring a debt for the purposes of the insolvent trading provisions, by entering into an uncommercial transaction. This expands the avenues available to liquidators to recover funds where a company enters into an uncommercial transaction. They may set aside an uncommercial transaction under s 588FF and recover funds from the other party to the transaction. In addition, a liquidator may also recover compensation from directors for contravening s 588G.

Directors may also be personally liable where they arrange for their company to enter into an uncommercial transaction that prejudices the interests of the company's creditors in breach of their fiduciary and s 181 duties to act in good faith in the best interests of their company. The duty not to prejudice creditors' interests is discussed at [18.10]–[18.95].

## Unfair loans

**[32.545]** Section 588FD ensures that an insolvent company's unsecured creditors are not prejudiced by a pre-liquidation loan agreement under which the company is committed to excessively high interest rates.

Unfair loans commit the company to excessively high interest rates or charges.

A loan to a company is unfair under s 588FD if the interest on the loan is, or the charges in relation to the loan are, extortionate. Section 588FD(2) lists several factors to be considered in determining whether interest or charges are extortionate, including the risk assumed by the lender, the value of any security given for the loan, the amount of the loan and any other relevant matter.

Section 588FD applies to loans which are grossly unfair to the extent that no reasonable company would be likely to enter into such a contract. This may arise where the loan is a sham agreement entered into by an insolvent company with the intention of conferring an undue benefit on the lender.

An unfair loan is voidable if it was made any time before winding-up commenced: s 588FE(6).

## Unreasonable director-related transactions

**[32.550]** Section 588FDA permits liquidators to reclaim “unreasonable director-related transactions” entered into by companies prior to the company's liquidation.

Reclaiming unreasonable director-related transactions.

Under s 588FDA(1), a transaction of a company is an “unreasonable director-related transaction” if it is made to or for the benefit of a director of the company or to a “close associate of the director” and it may be expected that a reasonable person in the company's circumstances would not have entered into the transaction having regard to the circumstances. Whether a payment was unreasonable is determined by an objective standard and does not necessarily require impropriety. A transaction may benefit a director and still be for the benefit of the company: *Re Pulse Interactive Pty Ltd* [2019] NSWSC 22. Under s 9, “close associate of a director” means a relative or de facto spouse of a director as well as a relative of a director's spouse or de facto spouse.

The word “transaction” is defined broadly in s 588FDA(1)(a) and includes payments made by a company, dispositions of company property and issues of securities by the

company. Among other things, the word “transaction” also covers large bonus payments to directors just before the company goes into liquidation.

The expression “for the benefit of” a director or close associate in s 588FDA(1)(a) is given its ordinary meaning and includes both direct and indirect benefits. The liquidator bears the onus of proving the elements of s 588FDA: *Crowe-Maxwell v Frost* [2016] NSWCA 46.

A company does not have to be insolvent for an unreasonable director-related transaction to be voidable.

Under s 588FE(6A), an unreasonable director-related transaction is a voidable transaction (see [32.590]) if it was entered into, or given effect to, within four years of the “relation-back day” (usually the date of commencement of the company’s liquidation). Liquidators do not have to prove that an unreasonable director-related transaction is also an insolvent transaction (see [32.585]) in order for it to be voidable. Nor does the winding-up of the company have to be because of its insolvency. Uncommercial transactions are discussed at [32.520]–[32.540].

### *Transactions to defeat creditors*

**[32.560]** Where a company became a party to a transaction, the purpose of which, was to defeat, delay or interfere with the rights of any or all of its creditors on a winding-up of the company, the liquidator can avoid insolvent transactions (defined in s 588FC) entered into at any time during 10 years prior to the relation-back day (usually the date of commencement of the company’s liquidation): s 588FE(5).

### *Creditor-defeating dispositions*

**[32.567]** A creditor-defeating disposition arises where the consideration payable to a company for a disposition of property is less than its market value and the best price that was reasonably obtainable and the disposition had the effect of preventing, hindering or delaying the property from becoming available for the benefit of the company’s creditors in a winding-up: s 588FDB(1). This provision was introduced as part of the legislation aimed at combatting illegal phoenix companies. Phoenix companies are discussed at [18.55] onwards.

Creditor-defeating dispositions are voidable under s 588FE(6A) if at least one of the following applies:

- the company was insolvent during the year prior to commencement of winding-up;
- the company became insolvent because of the transaction during the year prior to commencement of winding-up; or
- an external administration of the company occurs as a result of the transaction which begins less than a year after the transaction.

Certain exceptions are made including when the transaction is entered into by a liquidator, administrator or court-approved process: s 588FE(6B)(c).

ASIC may make administrative orders to recover property transferred to a company in liquidation by voidable creditor-defeating dispositions: s 588FGAA(1). The company's liquidator may request ASIC to make such an order: s 588FGAA(2).

### *Transactions that discharge liability of guarantor-related entities*

**[32.570]** It is common business practice for a company's creditors to insist that its directors guarantee the company's debts. In order to escape personal liability under the guarantee, the directors have an incentive to repay such a creditor ahead of other creditors whose debts are not guaranteed. The effect of this repayment is to give the directors an unfair preference, as well as the creditor who received payment. Section 588FH deals with such situations and allows the liquidator to recover the value of a discharged personal liability under a guarantee from the guarantor director.

That section applies where a company entered into a transaction prior to its winding-up that had the effect of discharging a liability (whether under a guarantee or otherwise) of a related entity of the company and the transaction was:

- an insolvent transaction as defined in s 588FC (insolvent transactions are discussed at [32.585]); and
- a voidable transaction under s 588FE (voidable transactions are discussed at [32.590]).

The liquidator may recover an amount equal to the value of the liability that was discharged from the related entity: s 588FH(2). Section 588FH also applies where the guarantee or other liability is only partially discharged.

### *Invalid circulating security interests*

**[32.580]** Secured creditors are generally unaffected by the debtor company's liquidation. They are entitled to enforce their security interest over the secured assets. To the extent of the value of the property secured, their debt is repaid.

Section 588FJ deals specifically with the situation where the security interest takes the form of a circulating security interest. The nature of a circulating security interest is discussed at [11.75] and [11.105]–[11.120]. This section aims to prevent companies, on the verge of insolvency, securing past debts by granting circulating security interests over its assets in favour of particular creditors so as to remove those assets from the control of the liquidator. It provides that a circulating security interest created within six months before the relation-back day is void against the company's liquidator unless it is proved that the company was solvent immediately after the security interest was created: s 588FJ(1)–(3).

Section 588FJ(2) sets out circumstances where a circulating security interest will not be void. A security interest is not void if it secures a liability under a guarantee or an amount payable for property or services supplied to the company.



## *Insolvent transactions*

**[32.585]** Before a liquidator can avoid a transaction as an unfair preference or uncommercial transaction, the liquidator must establish that it was also an “insolvent transaction”.

A transaction is an insolvent transaction under s 588FC if it is either an unfair preference or an uncommercial transaction and:

- the transaction is entered into at a time when the company is insolvent; or
- the company becomes insolvent because of entering into the transaction.

The word “insolvent” is defined in s 95A. A company is insolvent if it is unable to pay all its debts as and when they become due and payable. The meaning of insolvency is discussed at [32.60].

Section 588E assists a liquidator in proving the company was insolvent at the time when a transaction was entered into by allowing the liquidator to make certain presumptions of insolvency. These presumptions can be rebutted by proof to the contrary: s 588E(9). The liquidator may, under s 588E(3), presume that if the company was insolvent at a particular time during the 12 months ending on the relation-back day, the company was insolvent throughout that period. In addition, under s 588E(4), a company is presumed to be insolvent if it has contravened s 286 by failing to keep and retain adequate financial records.

## *Voidable transactions*

**[32.590]** Insolvent transactions and unfair loans entered into during a specified period prior to the relation-back day are “voidable transactions”. This means that liquidators can apply to the court for orders enabling them to recover assets or other consideration as well as various other orders for the benefit of creditors.

Definition of “relation-back day”.

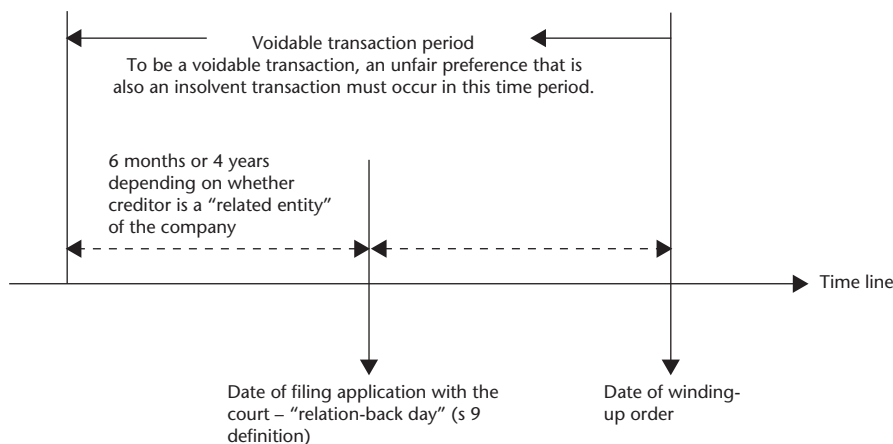
In the case of a court-ordered winding-up, the “relation-back day” is the day the winding-up application was filed with the court: s 9. In the case of a voluntary winding-up, the relation-back day is the day the shareholders pass the special resolution to wind up the company. Under ss 513A–513C, the relation-back day is an earlier date if the company was in voluntary administration or subject to a deed of company arrangement before being wound up.

Section 588FE specifies different time periods prior to the relation-back day depending on the type of transaction:

- An unfair preference that is an insolvent transaction is voidable under s 588FE(2) if it was entered into during the six months ending on the relation-back day or between

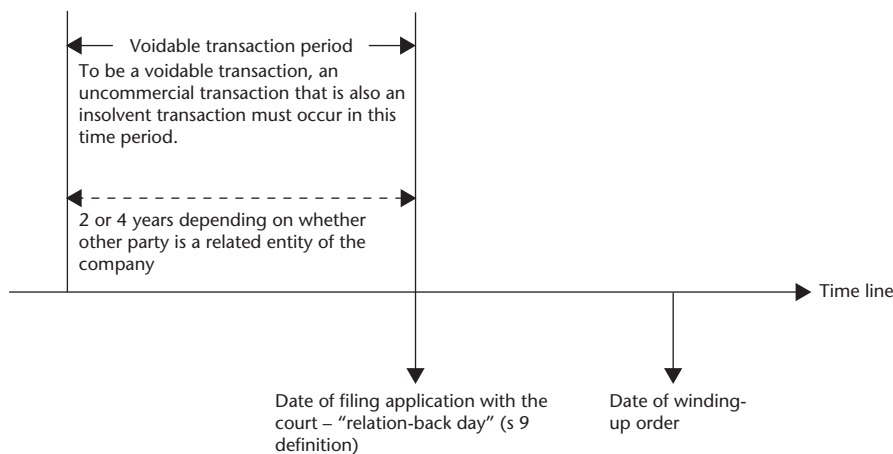
the relation-back day and the day the winding-up began. Figure 32.2 illustrates the voidable transaction period in the case of a company wound up in insolvency by order of the court.

**Figure 32.2: Voidable transaction period – unfair preferences**



- An uncommercial transaction that is an insolvent transaction is voidable under s 588FE(3) if it was entered into during or after the two years ending on the relation-back day. Figure 32.3 illustrates this in the case of a company wound up in insolvency by order of the court.

**Figure 32.3: Voidable transaction period – uncommercial transactions**



- An unreasonable director-related transaction is voidable under s 588FE(6A) if it was entered into during the four years ending on the relation-back day or between the relation-back day and the day the winding-up began.

- An insolvent transaction for the purpose of defeating creditors is voidable under s 588FE(5) during the 10 years ending on the relation-back day.
- An unfair loan to the company is voidable under s 588FE(6) if it was made at any time before the winding-up began.

If a “related entity” of a company is a party to an insolvent transaction, whether the transaction is an unfair preference or an uncommercial transaction, a longer time period applies. Under s 588FE(4), such an insolvent transaction is voidable if it was entered into during or after the four years ending on the relation-back day. The definition of “related entity” is contained in s 9 and is discussed at [32.570].

### *Court orders in relation to voidable transactions*

**[32.595]** Under s 588FF(1), a company’s liquidator may apply to the court for a variety of orders where a transaction is a voidable transaction as defined in s 588FE: see [32.590]. Orders that can be made under s 588FF(1) include releasing or discharging a debt incurred, or a security or guarantee given, by the company under or in connection with the transaction: s 588FF(1)(e). This is the most likely order in the case of an unfair loan.

In the case of an unfair preference that involves the payment of an outstanding debt by the company to a creditor, the order most likely to be made is an order directing the creditor to pay to the company an amount equal to some or all of the money that the company has paid under the transaction: s 588FF(1)(a). An order for the payment of interest may also be made: *New Cap Reinsurance Corporation Ltd v AE Grant, Lloyd’s Syndicate No 991* [2009] NSWSC 662.

An application for an order under s 588FF(1) must generally be made within three years after the relation-back day. A liquidator may apply to the court within this three-year period for an extension of time: s 588FF(3). The discretion of the court in ordering an extension of time must be exercised judicially by reference to all of the surrounding circumstances: *Re Octaviar Ltd* [2012] NSWSC 1460. The circumstances relevant to granting an extension order include the number and complexity of the transactions involved in the liquidation, the difficulties encountered by the liquidators in identifying potential defendants to claims and the fact that the creditor opposing the extension of time application had suffered little demonstrable prejudice. An application for an extension of time need not identify a particular voidable transaction: *Fortress Credit Corporation (Australia) II Pty Ltd v Fletcher* [2015] HCA 10.

Section 588FF seeks to prevent long delays in the commencement of proceedings involving voidable transactions and gives some protection to potential defendants from late claims. However, it also recognises that sometimes liquidators legitimately require further time to complete their investigations before being able to decide whether to pursue particular transactions.

### *Defences*

**[32.600]** Section 588FG provides defences to persons who might otherwise be subject to s 588FF orders. Section 588FG(2) protects persons who are parties to voidable transactions other than unfair loans to the company. Section 588FG(1) prevents the court from

making s 588FF orders prejudicing the right or interest of persons who are not parties to the transaction.

Court will not make orders that prejudice non-parties to a transaction.

*Re Pacific Hardware Brokers (Qld) Pty Ltd* (1998) 16 ACLC 442

**[32.605]** The sole director of a company used company funds to purchase a diamond ring that he gave to his fiancée on their engagement. The court held that the use of the company funds amounted to an uncommercial transaction, as the company derived no benefit from this use of its money. It was also both an insolvent transaction and a voidable transaction. The court ordered the director to pay the company the amount paid for the ring under s 588FF(1)(a). However, it held that the fiancée was not a party to the uncommercial transaction and therefore s 588FG(1) prevented the court from making an order against her for the recovery of the ring under s 588FF. The fiancée knew nothing of the company's business activities and believed that the director paid for the ring himself.

**[32.610]** Under s 588FG(2), a court must not make an s 588FF order prejudicing the right or interest of a person if it is proved that:

- the person became a party to the transaction in good faith (s 588FG(2)(a));
- at the time of becoming a party to the transaction, the person had no reasonable grounds for suspecting that the company was insolvent and a reasonable person in the person's circumstances would have no such grounds for so suspecting (s 588FG(2)(b)). The existence or otherwise of reasonable grounds to suspect insolvency is to be assessed by reference to the circumstances which existed at the time that the relevant payment was made (*Chicago Boot Co Pty Ltd v Davies & McIntosh as Joint & Several Liquidators of Harris Scarfe Ltd* [2011] SASFC 92); and
- the person has provided valuable consideration under the transaction or has changed their position in reliance on the transaction (s 588FG(2)(c)).

Test of "good faith".

The test of "good faith" in s 588FG(2)(a) is subjective and is satisfied if the creditor can prove that they did not believe that the company was insolvent or would become insolvent by paying the creditor. An objective consideration of all the circumstances is applied to determine whether a person had no reasonable grounds for suspecting insolvency for purposes of the s 588FG(2)(b) defence: *Downey v Aira Pty Ltd* (1996) 14 ACLC 1068. The defence will not be made out where the court is satisfied that a reasonable person in the creditor's position would have suspected that the debtor company was insolvent: *Roufeil v Gliderol International Pty Limited* [2011] FCA 847.

In *Mann v Sangria Pty Ltd* [2001] NSWSC 172, the court held that a creditor would have reasonable grounds for suspecting that a debtor company was insolvent in the following circumstances:

- inadequate explanations for non-payment by the debtor;
- reference to heavy financial involvement in an unrelated business as a reason for not paying;
- commencement of litigation for recovery of the debt;
- requests by the debtor for further time to pay;
- agreement to pay the debt by instalments over a two-year period;
- joining a director as guarantor for the debt and unsuccessfully seeking security; and
- the absence of transactions over a long period and arrangements for payment by post-dated cheque when transactions resumed.

|                                               |
|-----------------------------------------------|
| Reasonable grounds for suspecting insolvency. |
|-----------------------------------------------|

In *Burness v Supaproducts Pty Ltd* [2009] FCA 893, a case arising out of the insolvency of a company involved in the building industry, the court concluded that neither the creditor, nor a reasonable person in its circumstances, would have had reasonable grounds for suspecting that a debtor company was insolvent because of various factors including:

- the creditor continued to offer a credit limit of \$100,000 to the debtor company on payment terms of 30 days and it was unlikely that they would have done this if they suspected insolvency;
- the creditor only offered credit to certain customers, namely those that it felt were capable of discharging their debts;
- the commercial nature of the relationship between the creditor and the debtor company, and the fact that the relationship had been profitable for eight years, and that the creditor thought that it would remain so in the future;
- the fact that the creditor received post-dated cheques, some of which bounced, was not indicative of insolvency, because these occurrences were not uncommon in the building and construction industry. This was further supported by the fact that in the past, the debtor company promptly covered the payment of the dishonoured cheques.

### *Liability of directors to indemnify the Commissioner of Taxation*

**[32.615]** If a liquidator obtains a s 588FF order against the Commissioner of Taxation to recover a voidable transaction (such as an unfair preference), each director of the company at the time the payment was made to the Commissioner is liable to indemnify the Commissioner in respect of the loss arising from the s 588FF order: s 588FGA(2). The court may order that the directors pay the amount of the indemnity in the s 588FF proceedings brought against the Commissioner: s 588FGA(4).

The directors who are liable under s 588FGA have rights of recovery against the company and other directors as if the indemnity payment had arisen under a guarantee under which each director was jointly and severally liable: s 588FGA(5).

Directors have defences to these proceedings under s 588FGB. These defences are similar to the insolvent trading defences contained in s 588H (discussed at [18.170]–[18.215]):

- The director had reasonable grounds to expect and did expect that the company was solvent and would remain so after the payment. The defence requires a higher

degree of certainty than a mere hope, or possibility, or suspicion that the company is solvent. It requires an actual and reasonable expectation that the company was and would continue to be solvent (*Commissioner of Taxation v Venkatesh Paditham* [2010] FCA 334).

- The director reasonably believed that a competent and reliable person was responsible for providing adequate information that the company was solvent, this responsibility was being fulfilled and, on the basis of this information, the director expected that the company was solvent and would remain so after the payment.
- Because of illness or other good reason, the director did not take part in management when the payment was made.
- All reasonable steps were taken to prevent the company from making the payment or no such steps could have been taken. The types of steps which could be considered include any action taken with a view to appointing an administrator.

## Pooling

**[32.620]** The liquidation of insolvent companies that are part of a corporate group can involve complex issues. As discussed at [2.80], limited liability and the separate legal entity concept mean that the creditors of a particular group company in liquidation can only be paid from the available assets of that company. As a general rule, such creditors cannot access the assets of other group companies. Untangling the assets and liabilities of a number of insolvent group companies becomes extremely complex where their affairs have been intermingled prior to their respective liquidations.

The statutory “pooling” mechanism facilitates the external administration of corporate groups in liquidation.

The statutory “pooling” mechanism in Div 8 of Pt 5.6 facilitates the external administration of corporate groups in liquidation.

The effect of pooling in a liquidation is 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; and
- each debt payable by a company in the group to any other group company is extinguished.

The consequence of a winding-up on a pooled basis is that the companies in a group are wound up together as if they were one company and they are not regarded for this purpose as separate legal entities. There are two methods of pooling: voluntary pooling and court-ordered pooling.

Voluntary pooling.

Voluntary pooling requires the consent of “eligible unsecured creditors”, as defined in s 579Q, which excludes creditors that are companies in the pooled group.

A liquidator may make a determination that the winding-up of a related group of companies proceed on a pooled basis: s 571(1). Within five days after making a pooling determination, the liquidator must convene a meeting of eligible unsecured creditors: s 577(1A). The notice of meeting must be accompanied by the pooling determination, together with specified information that will assist creditors to make an informed decision about whether to approve the making of the determination: *Insolvency Practice Rules (Corporations) 2016*, s 75-180. A copy of the pooling determination must be lodged with ASIC: s 573. The eligible unsecured creditors may resolve to approve the making of the determination: s 577(1). Where the meeting does not resolve to approve the making of the determination, it is cancelled: s 577(3). The court has broad powers to vary or terminate a pooling determination: s 579A. External secured creditors are excluded from the pooling determination: s 571(9).

#### Court-ordered pooling.

Court-ordered pooling may occur on the application of a liquidator where there are two or more companies, each company in a group is being wound up and the companies are connected to each other either by being related to each other or they jointly own or operate particular property used in connection with a business. The court may order that the group is a pooled group if it is satisfied that it is just and equitable to do so: s 579E. A pooling order applies to debts and claims whether they are present or future, certain or contingent or ascertained or sounding only in damages: s 579E(3). The court must not make a pooling order if it is satisfied that the order would materially disadvantage an unsecured creditor of a company in the group and the creditor has not consented to the making of the order: s 579E(10).

In determining whether it is just and equitable to make a pooling order, the court must have regard to the matters set out in s 579E(12). These include the extent to which a company in the group and its officers or employees were involved in the management of any of the other companies in the group, the conduct of a company and its officers and employees towards the creditors of other companies in the group and the extent to which the business of the pooled companies was intermingled.

#### *Lofthouse v Environmental Consultants International Pty Ltd [2012] VSC 416*

**[32.621]** A number of companies carried on interconnected business in the forestry industry. One of these companies, ECI, had previously conducted all the businesses and after a restructure it remained the primary entity of the group of companies. All the companies went into liquidation and the liquidator successfully sought an order of the court that the companies be considered a pooled group under s 579E. The court found that ECI controlled the group's finances, entered into all employment contracts, leases and insurance contracts and there was a general view that the group's businesses were run as a single enterprise. The court considered it was just and equitable to make a pooling order in these circumstances. It was particularly significant that there was an intermingled relationship between the companies and they shared common directors and management whose actions contributed to the failure of the companies collectively.

A particular unsecured creditor of one of the companies would have been entitled to a distribution of 15 cents in the dollar if a pooling order was not made and only one cent in the dollar if the order was made. The court took this into account in determining if it was just and equitable to make the pooling order by considering the extent to which creditors would be advantaged or disadvantaged by the making of the pooling order. The court accepted evidence led by the liquidator that if a pooling order was not made, the cost of carrying out work to reconstruct the accounts of each of the various companies would erode the return to all creditors and negate any advantage they may otherwise enjoy.

**[32.622]** The court may also make ancillary orders in addition to approving the pooling determination, such as exempting specified debts from the determination, transferring property from one company to another or modifying the application of the *Corporations Act* in relation to winding-up: s 579G. Notice of a pooling order and a summary description must be given by the liquidator to each eligible unsecured creditor: s 579K.

## Protecting employee entitlements

**[32.625]** Part 5.8A (ss 596AA–596AI) of the *Corporations Act* is designed to protect the entitlements of a company's employees from agreements and transactions that are entered into with the intention of defeating the recovery of those entitlements: s 596AA(1).

Protection of employees from arrangements intended to defeat the recovery of their entitlements.

Part 5.8A attempts to protect employees' entitlements from attempts to restructure a group so as to ensure that an employer company in a group has no funds to meet employee entitlements, despite related companies having substantial assets. The problems facing employees' entitlements when groups are restructured were highlighted by the waterfront dispute in 1998 between Patrick Stevedores and the Maritime Union of Australia (MUA) which arose because of a restructure of the Patrick group of companies designed to facilitate the sacking of existing employees and their replacement with non-union employees. When the employees took industrial action and went on strike, their employer had insufficient funds to pay the employees' wages and was placed in voluntary administration: *Maritime Union of Australia v Patrick Stevedores No 1 Pty Ltd* (1988) 77 FCR 456. These problems prompted the introduction of Pt 5.8A (ss 596AA–596AI) into the *Corporations Act*.

**[32.635]** It is an offence for a person to enter into an agreement or transaction with the intention of either preventing the recovery of employees' entitlements or significantly reducing the amount of employees' entitlements: s 596AB(1). In addition, if a person contravenes s 596AB by incurring a debt, the incurring of the debt is linked to s 588G.

Employee entitlements include wages, employer superannuation contributions, amounts due for employees' leave of absence and retrenchment payments: s 596AA(2).



As well as being guilty of a criminal offence, a person who contravenes s 596AB(1) is liable to pay compensation if the company is being wound up and employees suffer loss or damage because of the contravention: s 596AC(1). The company's liquidator may initiate compensation claims and any amount recovered has priority under s 556(1)(e)–(h) and is regarded as a preferential debt that is owed to employees. Under s 596AC(3), employees may also sue for compensation if they have the liquidator's consent to do so, as required by s 596AF. Section 596AH allows employees to sue for compensation with prior court leave even if the liquidator does not consent. Their right to sue in such cases only arises three months after the liquidator is notified of the employees' intentions to sue.

**[32.636].** The Fair Entitlements Guarantee (FEG) scheme is an assistance program that provides a government-funded safety net to cover employee entitlements or redundancy pay of employees who lose their jobs because of an employer's insolvency. This scheme is discussed at [32.680]. Its main features include the following:

- the criminal offence provision in s 596AB is extended to include a person who enters into a transaction that avoids the payment of, or significantly reduces the amount of employee entitlements liabilities of a company where the person is “reckless” as to those possible outcomes rather than intentionally causing them;
- a civil recovery provision which is separated from the criminal offence provision s 596AB. The civil recovery provision will no longer require contravention of the criminal offence;
- civil recovery action will be able to be taken where persons are suspected of contravening the objective test of what a reasonable person would have known or been expected to have known in the circumstances about the agreements or transactions which have caused loss of employee entitlements; and
- an expanded range of persons able to bring civil recovery actions with the consent of the liquidator, including employees and the Australian Tax Office.

Liquidators, and specified others such as the Australian Tax Office, can seek “employee entitlements contribution orders” under s 588ZA that require solvent entities in a corporate group to contribute to the payment of outstanding employee entitlements owing by an insolvent member of that corporate group. The court may make such an order where it is just and equitable and the solvent group entities have benefitted from the labour of the employees of the insolvent entity on non-arm's-length terms.

## Division of assets

**[32.640]** One of the tasks of a liquidator is to sell the company's assets and divide the proceeds among those persons entitled to them. If the company is solvent, these persons are its creditors and shareholders, as discussed at [32.370].

Debts due to creditors are paid first and then the surplus (if any) is distributed among the shareholders.

It is a principle of insolvency law that debts due to a company's creditors are paid first and then the surplus (if any) is distributed among the shareholders. Distribution of the surplus to shareholders is discussed at [32.710]. The position of creditors who are also shareholders is discussed at [32.695]–[32.705]. If the company is insolvent, shareholders are highly unlikely to receive anything because usually there will be insufficient funds to meet the claims of all creditors in full.

The *Corporations Act* provides for an orderly procedure for dividing the company's assets among creditors. As discussed at [32.645]–[32.665], creditors must “prove” their debts to the liquidator in order to have any entitlements.

Secured creditors of an insolvent company rank ahead of unsecured creditors.

Secured creditors of an insolvent company are in a better position than its unsecured creditors. Secured creditors retain their pre-liquidation rights to take possession of the secured property, sell it and repay themselves out the sale proceeds. Thus, to the extent of the amount realised, secured creditors are unaffected by the liquidation of a debtor company. They do not have to stand in line with unsecured creditors to prove their debts. Any surplus after the secured debts are repaid is available to the liquidator for distribution to unsecured creditors.

The policy of the *Corporations Act* with respect to the debts due to unsecured creditors is that, unless otherwise provided, all provable debts rank equally and if there are insufficient funds available to meet them all in full, they are paid proportionately. Unsecured creditors with preferential debts are discussed at [32.675].

## Proofs of debts and claims

### *Provable debts*

**[32.645]** Creditors must satisfy the liquidator that they are owed money and provide the liquidator with a proof of debt to have any entitlements to share in the division of the company's assets. This enables the liquidator to ascertain the liabilities of the company in order to carry out the duty to discharge these liabilities under s 478(1)(a). The liquidator must decide whether to accept or reject a proof of debt.

If there are sufficient funds, a creditor whose proof of debt is admitted is then entitled to be repaid. Such repayments are referred to as “dividends”. If there are insufficient funds to pay all debts, creditors are paid a proportion of their debts.

Unprovable debts.

The holders of unprovable debts are not entitled to make a claim for those debts. Unprovable debts include debts that are unenforceable because they are based on illegal transactions or because the court action alleging that the debt is owed is issued after a statutory limitation period has expired. Claims in equity, such as an entitlement to

subrogated rights against the company in liquidation, may also not be provable or may be subject to equitable principles: *Re Trivan Pty Ltd* (1996) 134 FLR 368.

Under s 553(1), in a winding-up, all claims against the company (present or future, certain or contingent, ascertained or sounding only in damages) are admissible to proof against the company. This includes claims for damages for torts such as those the subject of the CAMAC report, *Longtail Liabilities: The Treatment of Unascertained Future Personal Injuries Claims* (2008) which arose from public concern about meeting the compensation claims of the large number of people who may suffer from asbestos-related diseases. Since it often takes many years for asbestos-related diseases to manifest themselves, a company dealing with asbestos or asbestos products is faced with the prospect of unascertained future claims for compensation by victims far into the future. These claims are referred to as “longtail” liabilities and the victims are referred to as unascertained future claimants (UFCs).

The *Longtail Liabilities* Report is on the CAMAC website and is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources>.

Section 554A, discussed at [32.655], sets out a mechanism for determining the value of debts and claims of uncertain value including claims for unliquidated damages in tort. Where the liquidator admits a debt or claim of uncertain value, the liquidator must make an estimate of value or refer the question to the court.

As a general rule, unpaid penalties and fines imposed on a company by a court in respect of an offence against a law are not admissible to proof against an insolvent company: s 553B. Section 553B(2) provides an exception to the general rule in respect of an amount payable under a pecuniary penalty order as defined in the *Proceeds of Crime Act 1987* (Cth).

### *Set-off of mutual debts*

**[32.650]** A person may be both a debtor and creditor of a company. Section 553C provides that where there have been mutual credits, mutual debts or other mutual dealings between an insolvent company that is being wound up and a person who wants to have a debt or claim admitted against the company, account is to be taken of what is due from one party to the other in respect of those mutual dealings: *Hamersley Iron Pty Ltd v Forge Group Power Pty Ltd* [2018] WASCA 163. The sum due by one party can be set-off against any sum due from the other party. Only the balance of the account is admissible to proof against the company or is payable to the company, as the case may be. Debts incurred after winding-up has commenced are capable of set-off if they existed as contingent liabilities prior to winding-up: *Grapecorp Management Pty Ltd v Grape Exchange Management Euston Pty Ltd* [2012] VSC 112.

### *Quantification of debts*

**[32.655]** Section 554 provides that the amount of a debt or claim of the company (including a debt for interest) is to be computed as at the relevant date. This is the date of the winding-up order in the case of a court-ordered winding-up. Sections 554A–554C set out rules for determining how specific types of debts and claims are to be calculated.

## Unliquidated damages claims.

Section 554A provides a mechanism for estimating debts or claims of uncertain value. This includes claims for unliquidated damages for breach of contract or tort. Under s 554A(2), a liquidator must make an estimate of the value of a debt or claim of uncertain value or refer the question to the court. A person who is aggrieved by the liquidator's estimate may appeal to the court against the estimation: s 554A(3). If the liquidator refers an estimation question to the court or a person appeals against the liquidator's estimation, the court must either make its own estimate or determine a method to be applied by the liquidator in working out the value of the debt or claim: s 554A(4). The estimated or worked out value of the debt or claim is admissible to proof against the company: s 554A(8).

Under s 554B, the amount of a debt that is admissible to proof is reduced if, as at the relevant date, the debt was not payable by the company until after the relevant date. The amount of the reduction is the discount calculated in accordance with the regulations. Section 554C deals with the conversion into Australian currency of foreign currency debts or claims in situations where the parties have agreed on the basis of conversion and where they have not come to an agreement.

### *Secured creditors*

**[32.660]** Sections 554D–554J deal with the rights of secured creditors in relation to proving debts and give a secured creditor several choices. The secured creditor may either retain the security or give it up and prove in the winding-up for the value of the debt. Alternatively, the secured creditor may retain the security and prove for the difference between the debt and the value of the security. This may occur where the debt exceeds the value of the secured property. In such a case, the secured creditor ranks equally with the unsecured creditors for the difference.

### *Procedure for proving debts*

**[32.665]** The procedure for proving debts is governed by the *Corporations Regulations*. A liquidator fixes the time within which creditors must prove their debts. Notice must be given to the creditors of the time and the fixing of the time advertised. A debt or claim must be proved formally in accordance with the *Corporations Regulations* if this is required by the liquidator: *Corporations Act*, s 553D(1). Section 553D(2)(b) also permits a liquidator to allow a creditor to prove for a debt or claim informally, subject to compliance with the requirements of the regulations relating to the informal proof of debts and claims. The liquidator can admit a debt without formal proof if satisfied that the debt is valid. If formal proof is required, the liquidator must notify the creditors and fix the final day for their receipt. The formal proof of debt contains particulars of the debt and is made on the prescribed form.

The liquidator must deal with a formal proof of debt within 28 days after receiving it or such further period as ASIC allows. If a proof of debt is rejected, the liquidator must notify the creditor within seven days, supplying the grounds for the rejection. Both a creditor and a contributory can appeal the liquidator's decision to the court: s 1321. A liquidator's decision to reduce or vary a creditor's proof of debt is not regarded as a

decision to reject it and therefore such a decision does not give the creditor a right to appeal the liquidator's decision under s 1321: *Perrin v Williams* [2014] QSC 21.

## Priorities on payments of unsecured debts

### *The pari passu rule*

**[32.670]** One of the most important principles of insolvency law is the general rule that unsecured creditors participate equally in the distribution of a company's assets on the winding-up of the company.

The *pari passu* rule, set out in s 555, provides that except for certain priority debts, all debts proved in a winding-up rank equally and, if the property of the company is insufficient to meet them in full, they shall be paid proportionately.

This rule recognises that insolvency proceedings are of a collective nature. They aim to benefit the general body of creditors. Each creditor has lost the individual right to pursue separate remedies and must rely on the outcome of collective proceedings. It is then only reasonable that each creditor should have a fair interest in the insolvency proceedings.

As discussed at [32.675], certain categories of unsecured debts (preferential debts) are paid in priority to all other unsecured debts and claims. While these statutory priorities detract from the *pari passu* rule, they are justified because they assist an orderly winding-up for the benefit of all creditors or there is a general public acceptance of the fairness in recognising special interests, such as that of employee creditors.

### *Preferential debts*

**[32.675]** Sections 556–564 rank the debts of particular classes of unsecured creditors in order of priority. The creditors with priority are known as “preferential creditors” and their debts referred to as “preferential debts”. The preferential creditors are themselves ranked in priority. The scheme of priorities is only relevant if the company is insolvent and there are insufficient funds to pay all unsecured creditors in full. Where this is the case, preferential creditors are paid in full before any amount is paid to the other unsecured creditors. If there are insufficient funds to meet the claims of all preferential creditors of a particular rank, they are paid proportionately.

Certain unsecured debts (preferential debts) are paid in priority to all other unsecured debts and claims.

The debts and claims that must be paid in priority to all other unsecured debts and claims are set out in order in s 556. These include:

- s 556(1)(a): the expenses of recovering, preserving and realising the property of the company or carrying on its business. Where a liquidator makes use of company property for the purposes of the liquidation, any liabilities incurred in respect of that property under a pre-liquidation contract are treated as liquidation expenses: *Grapecorp Management Pty Ltd v Grape Exchange Management Euston Pty Ltd*. These rank first because all creditors have an interest in maximising the fund for distribution;

- s 556(1)(b): the costs of the application for the winding-up order. This expense is also incurred in the interests of all creditors as it initiates the winding-up;
- s 556(1)(c): various expenses that are also necessary for an orderly winding-up. These include debts for which an administrator is entitled to be indemnified under s 443D(a), costs and expenses of the liquidator's report as to the company's affairs and the costs of an audit of the liquidator's accounts;
- s 556(1)(de): the remuneration or fees for service of the liquidator or, if applicable, the administrator. These are referred to as "deferred expenses", which are defined in s 556(2). They are deferred for payment after the above liquidation expenses; and
- s 556(1)(e): various employee entitlements rank next. These recognise that employees are a class of unsecured creditors who ought to receive special priority. Section 556(1)(e) limits the protection in the case of employees who are directors or relatives of directors. While employees receive priority for wages, superannuation contributions, amounts due in respect of injury compensation and other benefits under industrial awards, these are limited in the case of excluded employees who are defined in s 556(2) to include directors and their relatives. An employee who becomes a director is only excluded from the general employee priorities from the date of becoming a director. An excluded employee retains limited priority of \$2,000 for wages and \$1,500 for industrial award benefits, but no priority for retrenchment payments: s 556(1A), (1B) and (1C).

As a general rule, liquidators have a lien over the assets in their hands for the costs and expenses of obtaining the assets and also for their remuneration. The right of lien does not extend to placing the liquidator in the position of a secured creditor with respect to all costs and expenses of the winding-up where there are higher priority claims: *Re Biposo Pty Ltd (No 2)* (1995) 124 FLR 385.

The claims of employees have priority over the rights of a secured party seeking to enforce a circulating security interest granted by the company. Payment of employee debts can accordingly be made out of the proceeds of the secured property: s 561. Where both a liquidator and a receiver have been appointed to a company, the payment of employee debts under s 561 can be made directly by a receiver as well as a liquidator: *Kirman v RWE Robinson & Sons Pty Ltd* [2019] FCA 372.

Section 562 enables a person who is a creditor of a company in respect of a claim for which the company is insured, to be paid from the insurance money received by the liquidator in priority to other unsecured creditors. The money does not go into the general fund. Notwithstanding s 562, a liquidator's remuneration has priority ahead of a creditor in respect of the insurance proceeds: *Re Brighton Hall Securities Pty Ltd (in liq)* [2013] FCA 970.

## FEG scheme

**[32.680]** The FEG scheme is an assistance program that provides a government-funded safety net to cover employee entitlements or redundancy pay of employees who lose their jobs because of an employer's insolvency. The FEG scheme provides financial assistance (by way of an advance) to cover basic employee entitlements such as up to

13 weeks wages, annual and long service leave, payment in lieu of notice and redundancy pay up to four weeks per full year of employment.

Under s 560, FEG advances paid by the government to a liquidator have the same priority of payment under s 556 (discussed at [32.675]) as the employee would have been entitled to. The government proposed strengthening Pt 5.8A dealing with protection of employee entitlements which is discussed at [32.636].

As discussed at [32.625], Pt 5.8A of the *Corporations Act* contains provisions to protect employee entitlements from agreements and transactions that are entered into with the intention of defeating the recovery of those entitlements.

### *Priority of the Commissioner of Taxation*

**[32.685]** A company's debts to the Commonwealth Government do not receive any special priority. This means that amounts in respect of unpaid income tax rank as unsecured debts and are payable only if there are sufficient funds left over after all preferential debts have been paid.

A company that is liable to remit amounts such as employers' pay as you go (PAYG) tax to the Commissioner of Taxation must either pay the required amounts or go into voluntary administration or liquidation. If these options are not taken up before the due date for payment, all directors become *prima facie* personally liable to a penalty equal to the outstanding amount of unremitted deductions. Directors who are made personally liable have a right of indemnity from the company and rights of contribution from other directors.

This personal liability of directors is subject to certain defences, such as failing to take part in management because of illness or other good reason and where all reasonable steps were taken to ensure that the company would pay the amount or go into liquidation.

### *Deferred debts*

**[32.690]** There are three types of unsecured debts that are deferred until all other unsecured debts are paid in full:

- Payment of a debt to a member in the capacity of a member is postponed until all other debts are paid: s 563A.
- A creditor who is paid an amount in respect of an admitted debt or claim is also entitled to interest at a prescribed rate for the period between the commencement of winding-up and the date of payment: s 563B(1).
- Where creditors agree among themselves that certain of them will be paid in priority to others if the debtor becomes insolvent, s 563C(1) recognises that such a debt subordination agreement is binding and prevails over the *pari passu* rule stated in s 555.

### *Debts owed to shareholders*

**[32.695]** Section 563A (discussed at [32.690]) implements the underlying insolvency law principle that shareholders rank after creditors where a debt owing to a shareholder is



owed in the capacity of a shareholder. The case may arise where a shareholder is owed a debt in a non-shareholder capacity.

Debts owed to shareholders in a non-member capacity.

This arises where a shareholder was misled by the company into acquiring their shares. It was unclear in these circumstances whether a misled shareholder could prove for their damages claim together with other unsecured creditors when the company went into liquidation. The High Court considered this issue in *Sons of Gwalia Ltd v Margaretic* [2007] HCA 1 (*Sons of Gwalia*) where a shareholder bought shares in a listed company just before it was placed in administration. He claimed to have been misled into buying the shares because the company failed to comply with its continuous disclosure obligations in not disclosing its financial difficulties, and this constituted misleading and deceptive conduct. The shareholder had a provable debt in relation to his claim for damages against the company being the difference between the purchase price of the shares and their actual value, which was nil. The court held that shareholder claims for debts owed to shareholders in an outside capacity were not postponed until all other creditor claims were paid as the predecessor of s 563A applied only to defer member debts that were incurred in the capacity of a member.

[32.705] The decision in *Sons of Gwalia* aroused considerable debate as it arguably overturned an underlying principle of insolvency law that shareholders rank after creditors. It was also claimed that the decision would result in some external administrations becoming more complex and costly as shareholder claims were often difficult to quantify. These matters were referred to CAMAC which issued its report, *Shareholder Claims Against Insolvent Companies: Implications of the Sons of Gwalia decision* (2008). The report acknowledged the difficulties that could arise from allowing shareholders to rank equally with non-shareholder creditors but recommended that the law in this regard, as stated by the High Court, should not be changed. This report is on the CAMAC website and is linked to the Understanding Company Law website at <http://www.uclaw.com.au/resources>.

Despite this CAMAC recommendation, s 563A was amended (see [32.690]) to effectively reverse the *Sons of Gwalia* decision by providing that all claims of shareholders relating to the buying, selling, holding or otherwise dealing with shares are to be ranked equally and *after* all other creditors' claims.

## Division of surplus assets

[32.710] One of the final tasks in a winding-up is the distribution of the surplus assets among the members. In a compulsory winding-up, a liquidator is not entitled to distribute surplus assets without special leave of the court: s 488(2). There is no such requirement in a voluntary winding-up. In granting special leave under s 488(2), the court is particularly concerned that the liquidator has taken all steps necessary to verify that a surplus truly exists and that members' entitlements have been ascertained: *Re RH Trevan Pty Ltd (in liq)* [2013] NSWSC 1445.



Members are entitled to share in the distribution of company assets only after all the creditors have been paid in full.

Members are entitled to share in the distribution only after all the creditors have been paid in full. The unsecured debts of members are referred to as “deferred debts”. After these deferred debts are paid, the surplus assets remaining are distributed among the members. Debts owed by a company to its members in their capacity as members are not admissible to proof against the company unless the members have paid to the company or the liquidator all contributions they are liable to pay as members: s 553A. Unpaid dividends are an example of debts owed to members in their capacity as members. Unpaid calls on partly paid shares are an example of a member’s liability to pay as a member.

The company’s constitution usually sets out how the surplus is to be divided.

## Simplified liquidation process

**[32.712]** A liquidator of a small company in a creditors’ voluntary wind-up may adopt the simplified liquidation process if a number of eligibility criteria are met. This process was introduced in 2020 to provide a simpler, quicker and cheaper process for the benefit of creditors, including employees, of small companies. The simplified liquidation process is based on the existing framework for creditors’ voluntary liquidations however it introduces some modifications that recognise the less complex nature of most small company liquidations and the need for a simpler, more efficient process.

### Eligibility criteria.

The liquidator of a company may adopt the simplified liquidation process in a creditors’ voluntary winding-up if the liquidator reasonably believes that the eligibility requirements set out in s 500AA are met: s 500A(1). The liquidator must give each member and creditor of the company notice in writing of the intention to adopt the simplified liquidation process and a statement that the liquidator will not adopt the simplified liquidation process if at least 25 per cent in value of the creditors direct the liquidator not to do so. The liquidator’s decision to adopt the simplified liquidation process must be made within 20 business days of the occurrence of a triggering event, as defined in s 489F, usually the passing of a special resolution under s 491 that the company be wound up or an administrator becoming a liquidator under ss 446A or 446AA as discussed at [31.370]: s 500A(2) and (3).

The eligibility criteria set out in s 500AA include:

- the directors have given the liquidator a report on the company’s business and financial affairs as required under s 497(4) and a declaration under s 498 that the directors reasonably believe that the eligibility criteria for the simplified liquidation process will be met;

- the company will be insolvent within 12 months;
- the company has liabilities of less than the amount specified in the Regulations, currently \$1 million;
- the company and no directors or previous directors in the past 12 months have been a director of a company that has undergone restructuring (as discussed at [31.390] and following) or been subject to a simplified liquidation process; and
- the company has complied with its taxation obligations.

|                                                   |
|---------------------------------------------------|
| General liquidation provisions that do not apply. |
|---------------------------------------------------|

The provisions set out in s 500AE(2), which apply to liquidations generally, do not apply to the simplified liquidation process. These include the liquidator's report under s 533 discussed at [32.375] and meetings of creditors can be conducted electronically. Under the Regulations, the rules dealing with unfair preferences only apply where the transaction occurred within three months of the relation-back day rather than the usual period of six months.

## Winding-up trustee companies

[32.715] We discussed at [3.190] the growth in the use of \$2 companies, which act as trustees of discretionary family trusts. The liquidation of trustee companies causes special problems for their creditors. Despite the fact that discretionary trusts have been popular since the early 1960s, the courts have only recently developed techniques for dealing with some of the problems that arise.

### Trustee's right of indemnity

[32.720] Trustee companies are liable to trust creditors for debts incurred in operating the business of the trust. Trustee companies, however, rarely have significant amounts as issued capital from which to pay creditors. Further, they rarely derive income in their own right. Such income as they do earn is derived on behalf of the beneficiaries of the trust. As a general rule, the only significant asset of trustee companies is their right to be indemnified from the trust's assets for debts and other liabilities properly incurred.

For this reason, the debts due to trust creditors can only be satisfied to the extent of the assets of the trust.

|                                                       |
|-------------------------------------------------------|
| Personal liability of directors of trustee companies. |
|-------------------------------------------------------|

Under s 197, directors are personally liable to trust creditors where a trustee company incurs a liability and their company's right of indemnity is not available to satisfy those debts because they were incurred in breach of trust. In *Hanel v O'Neill* [2003] SASC 409, the court held that directors were personally liable under s 197 even if the trust has insufficient assets to indemnify the trustee. After this case was decided, s 197(1) was amended in 2005 by clarifying that it does not impose liability on a director merely because there are insufficient trust assets out of which the corporation can be indemnified.

Creditors of a corporate trustee also have the right to apply to wind up the company in insolvency: s 459A. If the court grants the application and appoints a liquidator, the liquidator can take control of the assets of the trust to satisfy the trustee company's right of indemnity. The liquidator has this power even where the trust deed provides for the appointment of another person as trustee in the event the company is wound up: *Re Indopal Pty Ltd* (1987) 5 ACLC 278.

## Trustees' unsecured priority creditors

**[32.725]** One problem that arises is whether unsecured creditors who have priority under the legislation retain their priority in cases where the debtor company acts as a trustee. As discussed at [32.675], s 556 ranks the debts of certain preferential creditors such as liquidators and employees in order of priority. The costs and expenses of winding-up are given first priority and employees a later priority. That section, however, does not directly address the position of trust creditors.

Only trust creditors can be paid out of the assets of a trust.

According to trust law, only trust creditors can be paid out of the assets of a trust. Trust assets cannot be used to pay the debts and liabilities of a trustee's personal creditors. The question arises whether distributions to creditors of an insolvent corporate trustee are subject to the s 556 priorities accorded to liquidators, employees and the Commonwealth under the FEG scheme. This question was largely unresolved until the High Court decision in the *Amerind* case.

*Carter Holt Harvey Woodproducts Australia Pty Ltd v Commonwealth of Australia* [2019] HCA 20  
(*Amerind* decision)

**[32.730]** *Amerind Pty Ltd* was the trustee of a trading trust that carried on business solely in that capacity. It borrowed money and granted security over all its assets. The company defaulted under its loan agreements and was put into voluntary administration. The lender appointed a receiver who sold the company's non-circulating assets, the proceeds of which were sufficient to pay out the secured debts in full. The circulating assets were then sold to provide a surplus for distribution. The question arose whether the Commonwealth could gain priority over other creditors as a result of payments it made under the FEG scheme. Under this scheme, the Commonwealth stands in the same position as an employee priority creditor. The FEG scheme is discussed at [32.680]. The High Court held that employees of a company that is in receivership or liquidation are entitled to statutory priority in cases where the insolvent company was acting as a corporate trustee and so the Commonwealth also stood as a priority creditor.

**[32.760]** Trustee companies, like all other companies, can be wound up for reasons other than insolvency. However, where a solvent trustee company is wound up, there is considerable doubt whether the liquidator's costs and expenses can be met out of the assets of the trust.

## Deregistration

**[32.770]** A company may be deregistered voluntarily by ASIC upon the application of eligible persons. Deregistration may also be initiated by ASIC.

### Voluntary deregistration

**[32.775]** Under s 601AA(1), the persons who can apply to ASIC for voluntary deregistration of a company include the company, a director, member or liquidator.

An application for voluntary deregistration can only be made if:

- all the members of the company agree;
- the company is not carrying on business;
- the company's assets are worth less than \$1,000;
- the company has no outstanding liabilities and has paid all outstanding fees and penalties; and
- the company is not party to any legal proceedings.

If ASIC is not aware of any failure to comply with the above requirements, it must give notice of the proposed deregistration on the ASIC database and in the *Gazette*: s 601AA(4). ASIC may deregister the company when two months have passed since the *Gazette* notice. ASIC must give notice of the deregistration to the applicant: s 601AA(5).

### ASIC-initiated deregistration

**[32.780]** ASIC may decide to deregister a company if the requirements of either s 601AB(1) or (2) are met.

Under s 601AB(1), ASIC may deregister a company if:

- its response to the return as to particulars is at least six months late;
- the company has not lodged any other documents in the last 18 months; or
- ASIC has no reason to believe that the company is carrying on business.

Under s 601AB(2), ASIC may deregister a company if it is being wound up and ASIC has reasonable grounds for believing that:

- the liquidator is no longer acting;
- the company's affairs have been fully wound up and a return that the liquidator should have lodged is at least six months late; or
- the company's affairs have been fully wound up and it does not have enough property to pay the costs of obtaining a court order for deregistration.

If ASIC decides to deregister a company, it must give notice of the proposed deregistration to the company, its directors and liquidator (if any): s 601AB(3). Notice of the proposed deregistration must also be given on the ASIC database and in the *Gazette*. This ensures that ASIC will not be able to deregister a company only because the company has forgotten to lodge necessary returns with ASIC.

ASIC may deregister the company when two months have passed since the publication of the *Gazette* notice. Once the company is deregistered, ASIC must give notice of the deregistration to the persons listed in s 601AB(3).

## Deregistration following amalgamation or winding-up

**[32.785]** Section 601AC requires ASIC to deregister a company if the court orders the deregistration under:

- s 413(1)(d) (reconstruction and amalgamation); or
- s 481(5)(b) (release of liquidator); or
- s 509(2) (deregistration after end of administration return is lodged).

## Effect of deregistration

**[32.790]** A company ceases to exist on deregistration and all its property vests in ASIC, which has all the powers of an owner: s 601AD. ASIC may dispose of or deal with the property as it sees fit and may apply any money it receives to defray expenses incurred by it: s 601AE(2). Section 601AF gives ASIC the power to fulfil any outstanding obligations of the company. This will bind the company as if it still existed.

Deregistration does not affect a person's pre-deregistration rights over the company's property, which remain subject to all liabilities imposed on the property: s 601AE(3). These liabilities include a liability that is a security interest or claim on the property or an obligation for rates, taxes or other charges imposed by a law. If the property was subject to a security, other interest or claim, ASIC takes the property subject to that security interest or claim: s 601AD(3). If the ASIC vested property was held by the company on trust, ASIC may continue to act as trustee or apply to the court for the appointment of a new trustee: s 601AE(1).

Under s 601AD(5), the directors of the company immediately before deregistration must keep the company's books for three years after the deregistration.

## Reinstatement

**[32.795]** A deregistered company may be reinstated by ASIC if it is satisfied that the company should not have been deregistered: s 601AH(1). Under s 601AH(2), the court also has the power to order ASIC to reinstate a deregistered company if it is satisfied that it is just to do so. Factors that could be taken into account in determining whether it is just to reinstate a company include whether it is of practical significance and there has been any inordinate delay by the applicant in seeking reinstatement: *Re Brockweir Pty Ltd* [2012] VSC 225.

The reinstatement application can be made by a person aggrieved by the deregistration or a former liquidator of the company. The aggrieved applicant must show that the deregistration deprived the applicant of something or injured or damaged the applicant in a legal sense: *Bell Group Ltd v ASIC* [2018] FCA 884. There must be a causal link between the grievance and the deregistration and the grievance may arise after the

deregistration: *Pilarinos v ASIC* [2006] VSC 301. A person's status as a shareholder or director is not enough to establish standing as a person aggrieved: *Re Piccoli Tesori Pty Ltd* [2006] FCA 462. However a person aggrieved by deregistration need only show that their claim is not hopeless and bound to fail: *Re Brockweir Pty Ltd*. Persons aggrieved by a company's deregistration include persons with a proprietary or pecuniary interest in the reinstatement, such as the company's creditors and other claimants. In determining whether a person is aggrieved by a company's deregistration, the grievance must be genuine and real at the date of the application.

*Krstevska v ACN 010 505 012* [2001] NSWSC 1093

**[32.800]** A company was reinstated on the application of a former employee who had suffered injuries in the course of her employment. A workers' compensation claim was brought against the company and it was later discovered that the company had been deregistered. The reinstatement enabled the employee to continue with her legal proceedings against the company, which was insured for such claims.

## Tutorial questions

1. Barry is the managing director of Home Entertainment Ltd, which carries on business as a retailer of home entertainment electrical goods. The company owns 15 stores which are located throughout Australia. Franz is also a director but for the past 18 months has lived in Monaco where he conducts a large family-owned business. During this period Franz has taken no part in the business of Home Entertainment Ltd, apart from signing documents when requested by Barry. The company fell into increasing financial difficulties from early last year and by March this year a large number of creditors were owed debts outside their negotiated trading terms. Several of the company's major suppliers refused to extend credit and only supplied further goods if cash was paid on delivery. Other creditors had taken legal action and were paid their debts only after obtaining court judgments. Home Entertainment Ltd's bank indicated that it was no longer extending the company's overdraft facility and was looking to reduce the overdraft limit. As a result, a number of cheques made out to suppliers were dishonoured during April.

Barry decided that the best way to improve the financial position of the company was to conduct a widely publicised sale at discounted prices. In May Barry purchased, on behalf of Home Entertainment Ltd, 100 LCD televisions valued at \$325,000 from Screen Imports Pty Ltd, a business owned by Hal, an old school friend of Barry's who was a major supplier of goods to Home Entertainment Ltd. Hal's usual terms were payment within 30 days of delivery, however he agreed to Barry's request to do him a favour and extended credit for the full purchase price for 60 days. Barry then sold several televisions owned by Home Entertainment Ltd to Surround Sound Pty Ltd for \$105,000 and paid the proceeds of these sales into his own personal bank account. This money was mainly used to part-purchase an apartment for Barry's daughter.

After the sale was completed in June, Barry realised that the financial position of Home Entertainment Ltd had deteriorated further. In July Barry sold several televisions and sound equipment to his sons Harvey and Wilfred for \$80,000, which was half their purchase price. They were able to sell these goods through their contacts in the trade for \$180,000 and retained the proceeds for their personal use.

In August, Hal asked Barry for payment of the debt owing to Screen Imports Pty Ltd. Barry indicated that Home Entertainment Ltd was in severe financial difficulties and was unable to pay its creditors in full and was likely to go into liquidation soon. He then paid Hal \$120,000 which he said was the best he could do, given that he had known Hal for so many years.

Home Entertainment Ltd went into court-ordered liquidation in October this year and it was apparent to the liquidator that there were insufficient assets to meet the claims of unsecured creditors. Advise the liquidator of any actions which she can bring and possible defences which may be available in relation to:

- (a) the debt to Screen Imports Pty Ltd;
  - (b) the payment to Hal;
  - (c) the sale of equipment to Surround Sounds Pty Ltd; and
  - (d) the sale of equipment to Harvey and Wilfred.
2. Eagle Soft Rock Ltd is a medium-sized company that operated several hotels, the largest of which was called Hotel California. It had the following four directors: Frey, the managing director and significant shareholder, Henley, Walsh and Schmit, the independent non-executive directors. Dylan, the company's chief operating officer and finance manager, was in charge of Eagle Soft Rock Ltd's finances and was responsible for providing the directors with monthly budgets and profit forecasts. Dylan's remuneration included a large annual bonus payable if the company's expenses were less than an agreed amount.

About a year ago, Frey went on an extended overseas holiday. While he was away the company's business began to decline. Occupancy levels at its hotels fell, resulting in a fall in its gross income, and its expenses increased alarmingly. This began to have an impact on the company's cash flow and in January last year its liquidity ratio was well below 1. During the early months of this year, it was constantly late in remitting goods and services tax collected from hotel guests to the ATO. Amounts due to the Eagle Soft Rock Ltd's many suppliers were not paid until they sent solicitors' letters of demand for unpaid debts. Some major suppliers refused to supply goods or services to the company unless they were paid for on delivery. Even then, Dylan arranged for those suppliers to be paid with company cheques that its bank later dishonoured.

For a long time, the Eagle Soft Rock Ltd directors were unaware of the company's financial difficulties. In order to protect his bonus, Dylan began to supply them with obviously false financial information that indicated the company was doing well. Matters came to a head in June when employees of Eagle Soft Rock Ltd went on strike for non-payment of their wages. The directors then discovered the company's true financial position and sacked Dylan. At that time, Eagle Soft Rock Ltd owed over \$10 million to over 100 different unsecured creditors.

In July, when Frey returned from his overseas holiday, he began intensive negotiations to borrow a large amount from the company's bank which was already owed \$5 million on an unsecured basis. During the negotiations, the bank insisted that Eagle Soft Rock Ltd reduce its debt by repaying \$500,000 fortnightly. Frey arranged for the company to use its diminishing cash reserves and reduced the debt to the bank to \$4 million. The bank negotiations dragged on for a whole month but in the end the bank decided not to lend any more money. At the end of July, the amount Eagle Soft Rock Ltd owed its unsecured creditors increased to \$12 million.

Several significant events occurred in August. First, despite the company's financial position, its directors paid a dividend to its shareholders, including Frey. Second, the directors sold Hotel California to Frey's family company. While the contract price was the market value of the hotel, it was to be paid in 50 equal annual instalments over the next 50 years. A general meeting of Eagle Soft Rock Ltd's shareholders approved the sale. Third, one of Eagle Soft Rock Ltd's many unsecured creditors successfully obtained a court order winding-up the company on grounds of its insolvency and appointed McCartney as liquidator.

Advise McCartney what legal action can be taken against:

- (a) the directors of the Eagle Soft Rock Ltd; and
  - (b) Eagle Soft Rock Ltd's bank.
3. Not long ago, Johnson Manufacturers Pty Ltd was wound up in insolvency on the application of one of its major unpaid suppliers. While the company's liquidator was examining the company's inadequate financial records, he noticed that seven months before its liquidation the managing director of Johnson Manufacturers Pty Ltd deposited company funds into his sister's bank account. She then used the money to buy herself a penthouse apartment in the city.

Explain whether the *Corporations Act* enables the liquidator of Johnson Manufacturers Pty Ltd to recover any money from the managing director or his sister in the above circumstances.

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## Revision questions on the material in this chapter

- Please see the Corporations Law **mentor** module at <http://www.thomsonreuters.com.au/mentor> for multiple choice questions and answers.
- For further corporations law links and material please refer to the Understanding Company Law website at <http://www.uclaw.com.au>.

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*[Entries in grey italics denote cases that are summarised in the text.]*

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| Forge Group Power Pty Ltd v General Electric International Inc [2016] NSWSC 52 .....                | [11.70]                                                                           |
| <i>Forkserve Pty Ltd v Jack &amp; Aussie Forklift Repairs Pty Ltd</i> [2000] NSWSC 1064 .....       | [16.310]                                                                          |
| <i>Forrest v ASIC</i> [2012] HCA 39 .....                                                           | [7.195], [26.190], [26.216]                                                       |
| <i>Forsyth v Blundell</i> [1973] HCA 20 .....                                                       | [30.140]                                                                          |
| Fortress Credit Corporation (Australia) II Pty Ltd v Fletcher [2015] HCA 10 .....                   | [32.590]                                                                          |
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| 400 Lonsdale Nominees Pty Ltd v Southern Cross Airlines Holdings Ltd<br>(1993) 11 ACLC 744 .....    | [11.160]                                                                          |
| <i>Fowlers Vacola Manufacturing Co Ltd, Re</i> [1966] VR 97 .....                                   | [8.215], [8.245]                                                                  |
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| Grimaldi v Chameleon Mining NL (No 2) [2012] FCAFC 6 .....                                   | [12.15], [19.150]                             |
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*Understanding Company Law* has for many years been a leading text for both law and business students undertaking the study of company law. In this 22nd edition, Phillip Lipton and Abe Herzberg have been joined by Catherine Robinson and Benjamin Saunders as co-authors. This edition has been updated to include the following recent legislative changes:

- The *Corporate Collective Investment Vehicle Framework and Other Measures Act 2022* (Cth) introduced a corporate collective investment vehicle (CCIV) as a new type of company limited by shares that is used for fund management. A key objective of the legislation is to increase the competitiveness of Australia's managed funds industry internationally to attract offshore investment. The features of a CCIV are discussed in Chapter 27.
- The *Corporations Amendment (Meetings and Documents) Act 2022* (Cth) makes permanent changes to the *Corporations Act* to permit virtual and hybrid meetings. The legislation also inserted Pt 1.2A into the *Corporations Act* to permit company documents to be executed electronically. The changes relating to execution of documents are discussed in Chapter 5 and the changes relating to meetings are discussed in Chapter 21.
- The *Treasury Laws Amendment (Modernising Business Communications and Other Measures) Act 2023* (Cth) now enables all documents under the *Corporations Act* to be signed electronically, and certain additional categories of documents can be sent electronically or in hard copy.



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