

Law of Business Organisations

Corporations Law

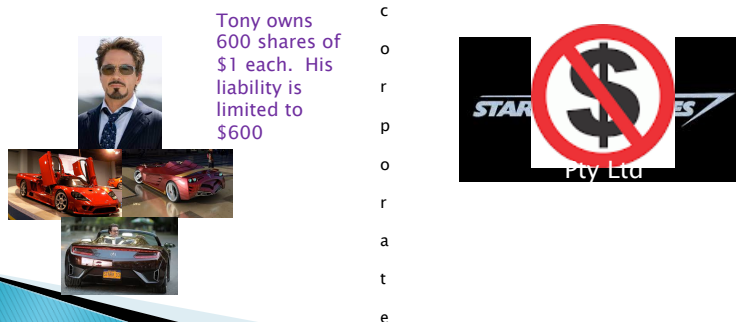
CACL Chapter 17

1. Introduction

- ▶ See Introduction @CACL p391 comparing other forms of business organisations.
- ▶ Corporations (companies) are an important form of business organisation. It is one of the most important advancements in capitalism.
- ▶ As at January 2017, there were 2,429,200 registered companies in Australia. They vary in size and type.
- ▶ There are significant benefits that flow from incorporating a company. The key features of corporations are that:
 - They are a **separate legal entity** from the people who own or manage the company; and
 - The owners (shareholders) of the company have **limited liability**.

2. Nature & Formation of a company

- ▶ The Australian Securities and Investments Commission (ASIC) is responsible for the administration and enforcement of the Corporations Act. (CACL 17.40)
- ▶ A company is formed when it is registered with ASIC: s119 of the *Corporations Act* (CACL 17.45)
- ▶ A company is a separate legal entity, distinct from its shareholders and directors: *Salomon v Salomon*. Shareholders are not liable for the company's debts – they have limited liability.



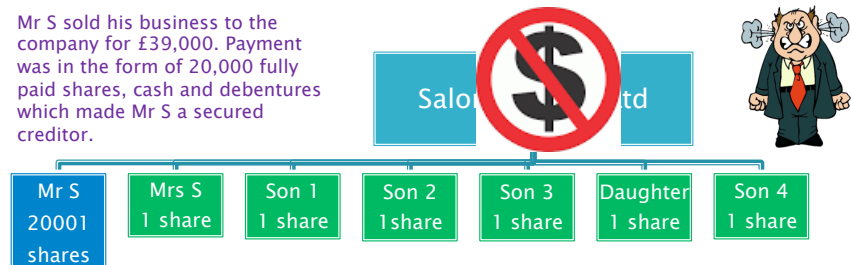
3. Features of a company

The **core features** of the company are:

- ▶ Full **legal personality**, distinct from its owners (shareholders) and managers: **s124** (CACL 17.50);
 - Can **sue or be sued** in its own name;
 - Can commit a **crime or tort or other wrongful conduct** – is a 'person'
- ▶ The **liability of its members/owners is limited** – ie not liable for debts of the company (see CACL 17.57 and 17.60).
- ▶ The ability to raise capital
 - shares are easily transferred
 - shareholders are not involved in the day to day management of the company, and only vote on major corporate decisions.
- ▶ Permanent existence
- ▶ Governed by many rules – compliance can be costly.

Salomon v Salomon & Co Ltd

Mr S sold his business to the company for £39,000. Payment was in the form of 20,000 fully paid shares, cash and debentures which made Mr S a secured creditor.

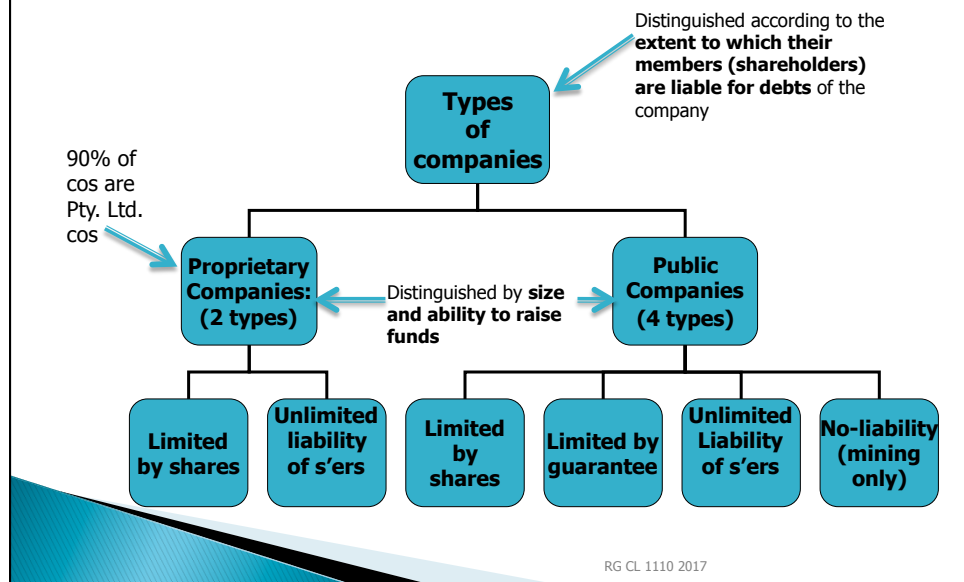


Salomon ran a successful leather shoe and boot manufacturing business as a sole proprietor. His sons worked with him. Salomon incorporated a company, and called it Salomon & Co Ltd. The company had 7 shareholders who held 1 share of £1 each, except for Mr Salomon who held 20,001 shares as a result of his sale of the business to the company.

Salomon v Salomon & Co Ltd (CA 17.55)

- ▶ The company became insolvent and a liquidator was appointed. When the company was liquidated (assets sold), there wasn't enough money to pay creditors.
- ▶ The liquidator argued that the company was a sham. In reality, Mr Salomon and the company were the same person, and Salomon should be personally liable for the debts of the company.
- ▶ The trial judge and the Court of Appeal agreed that the company was a sham and Salomon should be personally liable for the company's debts.
- ▶ However, the House of Lords reversed the decisions and held that **the company was a separate legal entity, distinct from its shareholders and directors**. The fact that Salomon & Co Ltd was a one-man company made no difference.

4. Types of companies



5. Management and Control

- ▶ **Members** collectively own the company. In a public co. members do not manage the business of the co.
- ▶ The company, as an artificial legal person, must act through the agency of others. **Directors** carry out day-to-day management of a company and s198A provides that the business of a company is managed “by or under the direction of the directors”.
 - If more than one director – referred to as ‘the Board’ which will then appoint a CEO.
 - Executive directors run the company; non-executive directors are on the Board but do not take part in management – but still liable for Board decisions!!
 - All corporations must have **directors** who are over 18, not disqualified and who may be appointed by ordinary resolution at a general meeting
- ▶ Companies must also have a **secretary** – responsible for “book-keeping”, drawing up agendas and organising meetings, ensuring compliance.

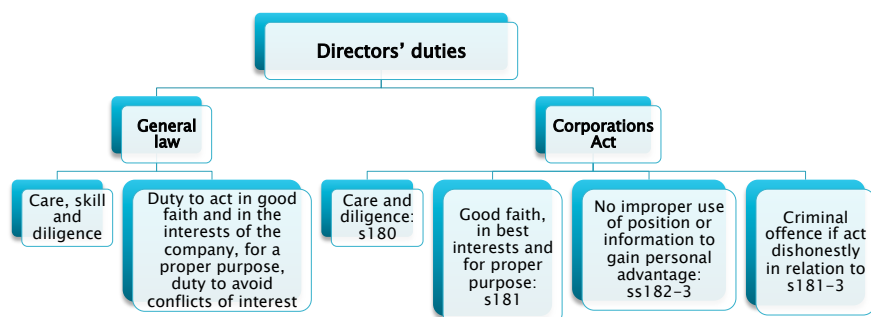
6. Directors' duties: introduction

3 categories of directors' duties: (CACL17.890)

- A. Duty of care and diligence: s180
- B. Duties of loyalty: ss181–184
 - i. Duty to act in good faith and for a proper purpose
 - ii. Duty not to misuse position
 - iii. Duty not to misuse information
- C. Duty to avoid insolvent trading: s588G

(See pp576–578 CACL for ss 180–184 and p584 CACL for s588G)

The duties of a director



A. Duty of care, skill and diligence— common law and s180(1) (CACL 17.890–5)

- ▶ Directors 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 in the **corporation's circumstances**; and
 - occupied the **office** held by that director: s180 of the *Corporations Act*
- ▶ The duty of care and diligence requires directors to:
 - Regularly attending board meetings: *Gold Ribbon (Accountants) Pty Ltd v Sheers*
 - Be familiar with the company's financial position, regularly reviewing its financial statements: *Daniels v Anderson*
 - Be able to read and understand financial statements: *ASIC v Healey*

RG CL 1110 2017

Daniels v Anderson (CACL 17.940)

Facts: AWA suffered a \$49m loss because of unauthorised foreign exchange dealings by an employee. Co's auditors (D) failed to notice the dealings and had not reported them to the Board. Nor had it pointed out problems with the co's controls and record keeping.

Held: Directors owe a **common law duty to their company** to take **reasonable care** in performance of their duties. A breach of this duty of care renders the directors liable. Directors should:

- Make enquiries and keep themselves informed of all aspects of the company's business operations;
- Be familiar with the company's financial position, regularly review financial statements. They cannot avoid liability by claiming that they don't know how to read financial statements.

RG CL 1110 2017

ASIC v Healey (CACL 17.900)



Centro – mistake in accounts – failed to disclose several billion dollars of short term liabilities, classifying some of them as ‘non-current liabilities’.

- ▶ Directors must bring an independent and inquiring mind to the exercise of their duties.
- ▶ Although they are allowed to delegate the task of preparing financial reports, there is a core, irreducible, requirement of all directors to be involved in the management of the company, and to take all reasonable steps to guide and monitor the company.
- ▶ **The directors had a responsibility to read and understand the financial statements & make further inquiries if necessary.** The errors in the financial statements should have been obvious to any reader who had the requisite financial literacy and knowledge of the affairs of the company.

ASIC v Hellicar (CACL 17.910)

ASIC brought proceedings against the directors.

The statement that the MRCF was ‘fully funded’ was misleading.

The directors knew or ought to have known that the announcement was misleading. The directors, including non-executive directors, breached their duty under s180(1).

A reasonable person in those circumstances would not have authorised the misleading announcement.

The Business Judgment Rule: s 180(2) (CACL 17.930)

- ▶ Directors have a **defence** for what otherwise may be a breach of s180(1). Directors will have acted with due care and diligence if *all* factors are satisfied:
 - a) Decision made in **good faith** for a **proper purpose**;
 - b) Director does not have a **material personal interest** in the subject matter
 - c) They **inform themselves** about the subject matter and
 - d) They **rationally believe** that the decision is in the best interests of the corporation
- **ASIC v Adler** (CACL 17.950 and 17.975)
 - **BJR** – not available to A – he had “material personal interest” in spending \$10 m – to prop up HHH share price so A would not lose money

RG CL 1110 2017

There are a number of points to be made about the Business Judgment Rule (s180(2))

- ▶ Like s 180(1), it applies to officers, not just directors.
- ▶ It applies to the **duty of care and diligence** under the Corporations Act and the general law – not to any other breach.
- ▶ **All conditions** (a) to (d) in s 180(2) **have to be fulfilled**.
- ▶ **There has to be a *business judgment***. This is defined in s 180(3) to mean “any decision to take or not to take action in respect of a matter relevant to the business operations of the corporation”. This seems to predicate an actual decision, not mere inactivity.
- ▶ **The need for rationality in (d) excludes decisions that cannot be coherently explained or are reckless**

RG CL 1110 2017

B. Duties of loyalty: ss181–184

- i. Duty to act in good faith and for a proper purpose: s181
- ii. Duty not to misuse position: s182
- iii. Duty not to misuse information: s183
- iv. Criminal liability if intentionally dishonest or reckless: s184

i. Duty to act honestly – common law and ss181-183

Directors have **duties to act in good faith** (fiduciary duty) and to exercise their powers for **proper purposes** — common law and s181 (CACL 17.960)

- Good faith: act honestly in the best interests of the corporation as a whole
- Proper purpose: for the benefit of the corporation as a whole and not for any extraneous purpose
 - Eg. Directors must not use the company's assets or their powers as directors for their own personal profit.

Note: the duty to act in good faith (s181) often overlaps with the duties in ss182 and 183.

ii. Directors' duty not to misuse their position: common law and s182

- ▶ Directors must not **improperly use their position** for personal gain, gain by a third party or cause detriment to the company: s182 (CACL 17.970).
 - Reflects the fiduciary duty not to make undisclosed personal profits: *Regal (Hastings) Ltd v Gulliver*.
- ▶ **Cummings v Claremont** (CACL 17.980)
 - Facts: directors provided themselves luxury cars and generous severance packages.
 - Excellent extract from Fed Court – Directors have a duty to avoid advancing their personal interests. Cummings and Fuller put themselves in a position where their personal interests conflicted with the interest of the company they served.
 - The directors breached their **fiduciary duties, misused their position and failed to act honestly**.

RG CL 1110 2017

Disclosure of interests by directors: s191 (CACL 17.1020)

- ▶ Where directors have conflicts of interest, they have a duty to disclose the conflicts.
- ▶ Director with 'material personal interest in a matter that relates to the corp must give other directors notice of that interest': s191(1).
- ▶ Director of a public corporation who has a material personal interest in a matter that is being considered at a director's meeting must not vote and must not be present while the matter is being discussed: s195(1). (Cf Pty co: s194)

RG CL 1110 2017

iii. Duty not to use inside information improperly: common law and s183

- ▶ Directors have a **duty not to misuse** inside/corporate **information** for personal gain, or gain to third parties or causing detriment to the corporation (CACL 17.985).
 - Corporate information refers to information directors find out in the course of carrying out the company's business.
- ▶ **ASIC v Vizard** (CACL 17.990)

Vizard was a non-executive director of Telstra. He misused confidential information, obtained as a director of Telstra, for personal gain, breaching s183. ASIC commenced civil proceedings against Vizard. He was fined and disqualified from acting as a director for 10 years.



RG CL 1110 2017

ASIC v Adler (CACL 17.975)

- ▶ Adler breached ss180–183
 - He did not exercised the required degree of **care and diligence**: **s180**
 - Breached obligation to act in **good faith for a proper purpose**: **s181**
 - Breached obligation **not to improperly use his position** as a director to gain an advantage for himself or cause detriment to HIH: **s182**
 - Breached obligation **not to improperly use information** obtained by him as a director to gain an advantage: **s183**

RG CL 1110 2017

iv. Criminal offences: s184(1) (2) (3) (CACL 17.1000)

- ▶ **Recklessly or intentionally dishonestly:**
 - Fail to exercise powers in good faith – s184(1)
 - Misuse position – s184(2)
 - Misuse information – s184(3)
- ▶ **ASIC v Adler (CACL 17.975)**
 - Four criminal charges inc s184(1) and Crimes Act (obtaining \$ by deception)
 - 'offences are serious and display an appalling lack of morality. Directors are not appointed to advance their own interests but to manage for the benefit of shareholders to whom they owe fiduciary duties...these were not stupid errors but deliberate lies.'
 - Penalties:
 - Imprisoned for 2.5 years
 - Disqualified for 20 years
 - Compensation to \$7M
 - Pecuniary penalty

RG CL 1110 2017

Statutory remedies (CACL 17.1010)

- ▶ **Civil consequences for ss180–183**
 - Civil penalty order up to \$200,000: s1317G;
 - Prohibition from managing companies in future: s206C;
 - Orders to compensate the company: s1317H
 - including profits made by the director in breach of ss181–183.
- ▶ **Criminal consequences: s184 (CACL 17.100)**
 - Involves recklessness or intentional dishonesty in breaching ss181–183;
 - fine up to \$220,000 and/or five years' imprisonment.

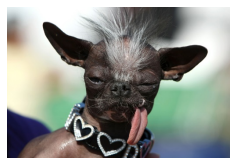
RG CL 1110 2017

Common law and equitable remedies

- Damages to compensate the company for loss;
- Orders to account for profits made in breach of duty: *Regal Hastings v Gulliver*,
 - eg. recovery of secret profit obtained in breach of directors' duties
- Injunction if necessary;
- Rescission of contract created with the company in conflict of interest
 - but note that the right of rescission may be lost eg. if not possible to restore parties to their original positions.

RG CL 1110 2017

Question: directors' duties



Tony, the director of Stark Industries Pty Ltd, uses the company's money to buy his pet dog a diamond-studded collar for \$10,000.

Has Tony breached any directors' duties?

Directors' duties: Hogan



Hogan, Pepper and Tony are now all directors of Stark Industries Pty Ltd. Hogan, a professional boxer, is too busy training for boxing competitions to pay attention to the company's affairs. Hogan doesn't attend directors' meetings or read the company's financial statements.

Is Hogan fulfilling his duties as a director?

Directors' duties: Hogan's defence

In his defence, Hogan says that it is pointless for him to read the company's financial statement as he has no knowledge of financial matters.



a) Is it a valid excuse for Hogan not to keep track of the company's financial situation on grounds that he doesn't understand financial statements?

Directors' duties: Pepper

Stark Industries Pty Ltd develops highly advanced transport and defence technologies. Soon after it developed the prototype of a high-tech plane known as Quinjet, a rival company secretly contacted Pepper and asked for a copy of the plans for Quinjet. Pepper replied that the plans were highly confidential and she would never betray Stark Industries Pty Ltd.

However, after they offer her diamond ring worth \$100,000 and an all-expenses paid luxury cruise to Antarctica in exchange for a copy of the plans, Pepper secretly gives the rival company the plans for Quinjet.

Has Pepper breached her duties as a director?

What are the consequences?

Quinjet: Highly
Confidential Information



Financial difficulties

Stark Industries Pty Ltd has financial difficulties. Their sales are poor and debt has been increasing. Creditors have been demanding payment for overdue unpaid debts.

Feeling depressed over the company's inability to pay its creditors, Tony enters into a contract to buy a new sports car for the directors' use. He signs the contract on behalf of Stark Industries Pty Ltd. Under the contract, Stark Industries Pty Ltd will have to pay \$100,000 for the car in 2 months' time.

What duty do the directors have when companies are unable to pay their debts (i.e insolvent)?



C. Directors' duty to prevent insolvent trading: s588G

- ▶ Section 588G imposes a duty on directors to prevent insolvent trading by the company (CACL 17.1030).
- ▶ A company is 'insolvent' when it cannot pay its debts as and when they become due and payable: s95A
- ▶ A director contravenes the section if, **when the co. incurs a debt (eg buys something, borrows money) there are reasonable grounds for suspecting that the co. is, or would become, insolvent** (unable to pay its debts when they fall due).

RG CL 1110 2017

Defences to insolvent trading: s588H

- ▶ Directors have a defence if at the time the debt was incurred the director had:
 - **588H(1)**—reasonable grounds to expect (and the director did expect) that the company was solvent and would remain solvent even with the new debt(s);
 - **588H(2)**—reasonable grounds to rely on info provided by a competent and reliable person that the co. was solvent
 - **588H(3)**—s/he did not take part in management owing to illness or other good reason (NB mere ignorance of the co's operations is not a defence)
 - **588H(4)**—s/he took all reasonable steps to prevent the co. from incurring the debt

RG CL 1110 2017

Insolvent trading: remedies

- ▶ **Civil penalty: 588J**
 - Directors can be made **personally liable** for cos. debts if they were incurred at a time the co was insolvent
 - Director may have to compensate the co or liquidator may seek compensation for creditors
- ▶ **Criminal offence: 588G(3)**
 - Director can be charged if dishonesty involved
- ▶ **Recovery by liquidator: 588M**
 - Liquidator can recover from the director personally
- ▶ **Recovery by creditor: 588M**
 - Creditor can recover from director personally

RG CL 1110 2017

ASIC v Plymin

- ▶ **Facts:**
 - ▶ Elliot, a non-executive director knew of the circumstances – he had reasonable grounds for suspecting insolvency. Elliot argued that he had relied on Plymin, the managing director, and the management whom he believed were competent and reliable.
- ▶ **Held:**
 - ▶ The court found that a reasonable person would not have regarded Plymin and the management as competent and reliable. Further, Elliot had not acted reasonably but had turned a blind eye to the company's financial problems.
 - ▶ Elliot breached his duty to prevent insolvent trading. Penalties included:
 - ▶ disqualification from managing corporations for 4 years
 - ▶ orders to pay compensation of about \$1.4 million and
 - ▶ payment of a pecuniary penalty of \$15,000 to ASIC