MLL221 CORPORATE LAW

Contents

Chapter 7: Fundraising

Corporate Finance

Debt and equity

Ways a company can raise capital

	Debt	**Equity**
Payments to investors	Interest at an agreed rate that the company is contractually bound to pay	No requirement to pay dividends
Repayment of principal	Parties usually expect repayment of the principal at the end of the term	Usually, no expectation that equity capital will be repaid to members while company is solvent
Priority	Lender has priority over members for payment of interest and repayment of principal	
Membership	Lender is not a member	Equity holder is a member, with membership rights
Rights to share in surplus assets on winding up	After repayment of principal, no right to share in surplus assets	May participate in surplus assets, depending on the terms of issue

Debt: Have to pay no matter what, standard interest rate, higher risk for a company

Equity: only have to pay if they company makes a certain amount – no legal requirement to make dividend payments, relatively low rate of return

Fundraising by Issuing Shares

Directors must consider

- Member approval
  - Is member approval of the proposed issue required?
- Restrictions
  - Are there any restrictions on the people to whom the shares can be offered?
- **Chapter 6D**
  - Do the disclosure requirements in Ch 6D of the Corporations Act apply?

When is member approval required?

- If creating a new class of shares requires amending the constitution
- If there is a variation of class rights
- If the related party transaction provisions apple
- If member approval is required under the constitution or shareholders' agreement
- If ASX Listing Rules require member approval
- The power to issue new shares is a power of the company exercisable by the board of directors
- Member approval for issue of new shares is generally not required
- However, member approval may for a new issue may be required

Restrictions on the people to whom the shares can be offered?

Pre-emptive rights	Proprietary Companies
• Some companies include pre-emptive rights in their constitution or in a shareholders' agreement • This means that new issues must be offered pro rata to existing members • Sometimes known as 'right of first refusal'.	• Only public companies may invite the public to subscribe for shares • A proprietary company cannot invite the public to subscribe for shares • s 113(3): A proprietary company must not engage in any activity that would require the disclosure to investors under Ch 6D, except for the offer of shares to existing members or employees

Why is disclosure needed?

- In the past, members of the public have suffered enormous losses through subscribing for shares. The offers were often fraudulent, misleading or seriously deficient in the kind of information necessary to guide the decisions of intending investors. It is vital to the proper operation of the share market and for the protection of investors that written disclosure occurs.
- The Corporations Act elaborately regulates the content of a disclosure document (ss 710 and 711 for prospectuses, s 714 for profile statements and s 715 for offer information statements), and enables ASIC to maintain some supervision by requiring that it first be lodged with ASIC: ss 718 and 727.
- Importantly, the disclosure document must not be misleading: s 728.

Ch 6D Disclosure Requirements

Ch 6D	General Rule
• Company proposing to offer new shares for subscription must comply with the extensive disclosure requirements contained in Ch 6D of the Corporations Act, except in certain limited circumstances	• Section 706: An offer of securities for issue needs disclosure to investors under this Part unless s 708 or 708AA says otherwise. • Section 761A: 'securities' includes shares, debentures, options and legal or equitable rights in relation to them • Non-compliance is a criminal offence

Disclosure documents

If a security is to be offered, a disclosure document must be prepared: s 709. No forms of application for securities may be issued unless they are attached to, or accompany, a disclosure document: ss 721 and 727. A disclosure document is a prospectus, a profile statement or an offer information statement: s 9.

Why is disclosure needed?

In the past, members of the public have suffered enormous losses through subscribing for shares, for debentures, and for interests in money-making schemes. The offers were often fraudulent, misleading or seriously deficient in the kind of information necessary to guide the decisions of intending investors. It is vital to the proper operation of the share market and for the protection of investors that written disclosure occurs.

The Act elaborately regulates the content of a disclosure document (ss 710 and 711 for prospectuses, s 714 for profile statements and s 715 for offer information statements), and enables ASIC to maintain some supervision by requiring that it first be lodged with ASIC: ss 718 and 727. Importantly, the disclosure document must not be misleading: s 728. It must contain all the information necessary to enable an investor to make a reasonably informed decision whether or not to buy the securities: ss 710–716.

Exceptions – Do Not Need Disclosure

Small scale, personal offers (s 708(1) – (7))

- Exception for private offers resulting in no more than 20 new members or raising more than $2m in 12 month period

Sophisticated investors (s 708(8) & (10)

- Large offers (minimum of $500,000 per offer accepted)
- Offers to wealthy investors
    - Certified gross income of $250 000 in previous 2 financial years or net assets of at least $2,5 million (including their controlled companies/trusts)
- Offers to experienced investors, if made through a financial services licensee who judges client to be sufficiently experienced
- Offers to professional investors

Senior managers (s 708(12))

- Senior manager means person (not director) who makes or participates in making decisions that affect the whole or substantial part of the business [people who are already employed by the company]
- Includes senior manager's family

Existing security holders (s 708(13))

- Certain offers, e.g. dividend reinvestment scheme
- Certain rights issues
    - Offer of securities to existing shareholders in proportion to their current shareholding
    - No disclosure required if certain ASIC conditions are met (including issuing a "cleaning notice" stating specific information)

Types of Disclosure Documents

- Prospectus (most common)
- Short-form prospectus – refers to ASIC information rather than including it in the document
- Profile statement (fairly rare) – where approved by ASIC, it may be sent to investors so long as they are informed that the full prospectus is available on request
- Offer information sheet – Limited disclosure document for relatively small fundraisings ($10mil or less)
- Extent of disclosure depends on type of disclosure document.

Disclosure Requirement

- It must contain all the information necessary to enable an investor to make a reasonably informed decision whether or not to buy the securities: ss 710–716.
- Should contain information reasonably required and expected (objective test).
- Clear, concise: s 715A

Consequences of breach of disclosure requirements

- The consequences of offering securities under a disclosure document which contains false or misleading statements, or with a material omission, are serious
- Section 728 makes it a criminal offence to make such an offer

- Persons suffering loss or damage through misleading statements or material omissions have a civil right of recovery from those whose conduct gave rise to such contraventions of the law

Who is liable?

- Personal liability extends to:
    - Person making the offer
    - Each director of the body making the offer
    - Any person named as proposed director of body whose securities are offered
    - Named underwriter to the offer [underwriter – make up the shortfall that the company needs]
- Also any person (e.g. expert) named with their consent and who provided information grounding a statement – in relation to that statement

Defences

Due diligence in relation to a prospectus: s 731

- Made reasonable inquiries and believed on reasonable grounds that statement was not misleading

General reliance: s 733(1)

- Reasonably relied on information provided by another who is not a director, employee or agent (e.g. professional service)

Withdraw consent: s 733(3)

- Public withdrawal of consent to being named in disclosure document

Shares

What is a share?

Pilmer v The Duke Group [2001]

"Once issued, a share comprises a collection of rights and obligations relating to an interest in a company of an economic and proprietary character, but not constituting a debt"

- Defined in terms of rights and liabilities that stem from ownership of the share
- Property of shareholder
    - Item of intangible property known as a 'chose in action'
    - Can be dealt with in the same way as other property (e.g. sold, mortgaged, will)
    - s 1070A Corporations Act
- A claim against the company for the rights set out in the Corporations Act and constitution, being:
    - Distribution rights
        - Dividends
        - Surplus assets on winding up
    - Control rights
        - Voting

1070A Corporations Act:

(1) "A share ...:
    (a) is personal property; and

(b) is transferable or transmissible as provided by:
    (i) the company's ... Constitution; or
    (ii) the operating rules of a [Clearing & Settlement Facility]; and
    (iii) is capable of devolution by will or by operation of law.

- Distribution rights
  - receive dividends
  - repayment of principal and surplus assets of co on winding up
- Control rights
  - voting rights

Choses in action

Chose in action	Other forms of property
• Consists of the rights it confers • You can only enjoy the benefit of choses in action by exercising the rights which make up that property.	• Separate from the rights recognised by law. • Rights can change; property stays the same.

What rights do shares confer?

- The right to receive dividends
- Voting rights
- The right to receive information
- The right to share in the assets of the company on a dissolution.

Rights conferred by a Constitution

- A Constitution typically deals with:
  - The appointment and powers of directors.
  - The procedure for voting at meetings of directors and shareholders.
  - The procedure for declaring dividends.
  - Terms of issue for certain classes of shares.
  - How shares can be transferred.

Rights conferred by the Corporations Act

- Replaceable rules.
- Part 2M – financial reporting.
- Part 2J – buy backs and dealings with class rights.
- Part 2F.1A – derivative action.
- Part 2F.1 – oppression remedy

Issue of shares

- How are shares created?
- Contract between company and shareholder.
- Investor pays issue price.
- Directors decide to issue shares.
- May be special requirements.

Classes of shares

What are classes of shares?	How do classes differ?
• Companies can issue shares of different types that have different rights attached to each type of share • s 124(1)(a) - power to issue shares • s 254B(1) - power to issue different 'classes' of shares ○ "A company may determine: (a) the terms on which its shares are issued; and (b) the rights and restrictions attaching to the shares."	• Entitlement to dividends • Priority in payment of dividend • Voting rights • Priority in payment of capital on winding up • Right to participate in distribution of surplus assets on winding up
Where are class rights set out?	**Why issue different classes?**

• Constitution
• Share issue contract
• Application for registration of company details classes of shares of initial members
• ASIC must be notified of any division of shares into classes: s 246F(1)
	• To concentrate control of the company in the hands of certain shareholders
	  ○ Particularly founding shareholders of small family companies
	• To issue shares that have the characteristics of debt
	  ○ Achieved by issuing shares with a stated rate of dividend but with limited voting rights (preference shares)
	• Tax minimisation schemes

Share classes

- Ordinary shares
- Preference shares
  - Cumulative
  - Non-cumulative

  Typically have right to receive fixed dividend provided dividend declared
- Redeemable preference shares
- Deferred shares
- Governor's shares
- Employee shares

Ordinary shares

- Most common
- Dividend before deferred shareholder but after preferred shareholders
- Full voting rights

Preference shares

- Preference to dividend ahead of ordinary shareholder
- Rights must be specified in accordance with s 254A(2) which provides that the company's constitution or special resolution must specify rights attached to the preference shares with respect to:
  i) Repayment of capital
  ii) Participation in surplus assets and profits
  iii) Cumulative and non-cumulative dividends

iv) Voting; and
v) Priority of payment of capital and dividends

- Non-cumulative preference shareholders:
  - Only entitled to share of declared dividend for that particular year
- Cumulative preference shareholders:
  - Entitlement to dividend accumulates from year to year whether or not dividend has been declared. Undeclared dividend are effectively carried forward and added to future year entitlement
- Voting rights generally confined to specific situations, e.g.:
  - Reduction in capital
  - Winding up of Co
  - Variation of class rights

Redeemable preference shares

- s 254A(3) shares that are liable to be redeemed:
  - Fixed time or event
  - Company's option; or
  - Shareholder's option
- Why use?
  - Co can react to change in market by buying back shares entitled to a high percentage of dividend
- Redemption must be paid out of profits otherwise available for dividend or proceeds of a fresh issue made for purpose of the redemption (s 254K)

Governor's Shares

- Small proprietary companies will often issue governor's shares to the company founder/governing director.
- These shares will usually enjoy special voting rights, enabling that shareholder to control the company.

Employee Shares

- Some companies' constitutions provide for the issuing of shares to employees - Employee Share Option Plans (ESOPS)
- Generally confer limited rights so too much control not conceded to employees

<u>Preference Shares</u>

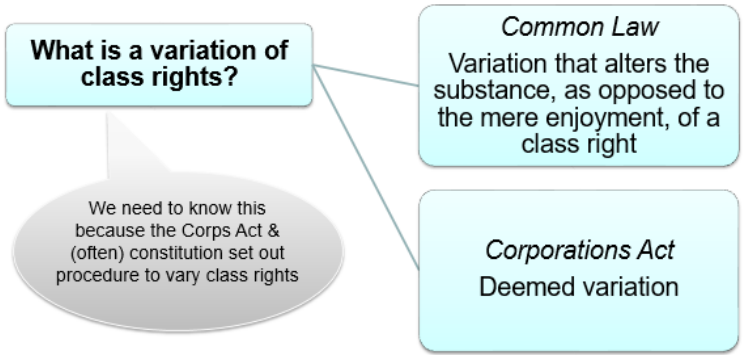
- Right to receive dividends ahead of ordinary shareholders.
- Usually fixed % of the issue price.
- Limited voting rights.
- Akin to debt.

<u>Cumulative and non-cumulative preference Shares</u>

Non-Cumulative PS	**Cumulative PS**
• Non-Cumulative Preference Shareholders are only entitled to dividend declared in any year	• Cumulative Preference Shareholders entitlement to dividend accumulates from year to year, whether or not dividend has been declared.

• That is, they lose the entitlement to any dividend that is not declared in the relevant year	• That is, undeclared dividend are effectively carried forward and added to future year entitlement

Variation of class rights



Common Law: Alteration must affect substance

- Only variations that affect the substance of the class right, as opposed to the mere enjoyment or value of the right, need to comply with the class right variation procedure

***White v Bristol Aeroplane Co* [1953]**

- Bonus issue of shares to ordinary shareholders had the effect of diluting the voting rights of preference shareholders
- Held not to effect the substance of the preference shareholders rights
- They still had their voting rights (substance the same)
- Only their enjoyment of their voting power that was affected by the share issue

Greenhalgh v Arderne Cinemas Ltd

- Sufficient shares were issued to Mr. G to enable him to block a special resolution
- Members by ordinary resolution voted to sub-divide their shares, thereby increasing the number of votes they had
    - Effect was to diminish the proportion of shares Mr. G had and meant he could not block a special resolution
- So even though Mr. G's overall voting power has suffered, the shares he held still held the same rights and the issue was held not to be a variation of class rights

Corporations Act: Deemed Variation s 246(C) (Textbook 8.170)

- When a class of shares is divided into further classes
- When rights attaching to some shares are varied
- When new shares are issued and rights of existing shares are different
- When new preference shares are issued

Procedure to vary and cancel class rights

If constitution sets out procedure

- Procedure in the constitution must be followed to vary or cancel class rights (s 246B(1))

No constitution or constitution doesn't set out procedure

- May only vary or cancel class rights:
  - By special resolution of the company; and
  - By special resolution passed at a meeting of the holders of the affected class; or
  - With the written consent of members with at least 75% of the votes of the affected class (s 246B(2))

<u>Q: What can a disgruntled shareholder do? A: Challenging a variation of class rights</u>

Section 246D(1)

- Members with at least 10% of votes in affected class
- Apply to court (within one month) to have variation set aside
- **Test**: Does the variation unfairly prejudice the members of the affected class?

246D Variation, cancellation or modification without unanimous support of class

(1) If members in a class do not all agree (whether by resolution or written consent) to:
  (a) a variation or cancellation of their rights; or
  (b) a modification of the company's constitution (if any) to allow their rights to be varied or cancelled;

members with at least 10% of the votes in the class may apply to the Court to have the variation, cancellation or modification set aside.

(2) An application may only be made within 1 month after the variation, cancellation or modification is made.
(3) The variation, cancellation or modification takes effect:
  (a) if no application is made to the Court to have it set aside—1 month after the variation, cancellation or modification is made; or
  (b) if an application is made to the Court to have it set aside—when the application is withdrawn or finally determined.
(4) The members of the class who want to have the variation, cancellation or modification set aside may appoint 1 or more of themselves to make the application on their behalf. The appointment must be in writing.
(5) The Court may set aside the variation, cancellation or modification if it is satisfied that it would unfairly prejudice the applicants. However, the Court must confirm the variation, cancellation or modification if the Court is not satisfied of unfair prejudice.
(6) Within 14 days after the Court makes an order, the company must lodge a copy of it with ASIC.
(7) An offence based on subsection (6) is an offence of strict liability.

<u>Other Remedies</u>

- If company fails to follow variation procedure in constitution
  - Breach of the s 140(1)(a) statutory contract
- If company fails to follow s 246B procedure
  - Affected members can apply for an injunction (s 1324)
- If variation is oppressive or unfair
  - Remedy under s 232