

## TUTORIAL EXERCISE NO 1

### Question 1

*Explain why the Commonwealth Parliament has the power to make laws relating to companies. Discuss the role that ASIC plays in relation to companies.*

Each state and territory legislature has, by virtue of the Constitution of that state or territory, a general legislative power “to make law for peace, order and good government” of their particular state/territory.

Some of the Commonwealth’s legislative powers are exclusive to the Commonwealth parliament while others are shared with the states/territories. These powers being known as Exclusive, Concurrent and Residual Powers.

S51 (xx) of the Constitution 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. But in the early years of 20<sup>th</sup> century, the High Court adopted a narrow interpretation of the power in s51(xx) and held that s51(xx) did not empower the Commonwealth to make laws with respect to the formation of trading and financial corporations and consequently, provisions that related to company formation were invalid. The judgment was based on the strict interpretation of the phrase “formed within the limits of the Commonwealth”

The Cth and the States negotiated a new arrangement that established the Corporations Law scheme. In 2000, the States and the Northern territory agreed in principle to refer to the Commonwealth the substance of the Corporations Law scheme, the power to amend the legislation and the powers of the Cth authorities to carry out the scheme. **Section 51 (xxxvii)** of the Constitution gives the Commonwealth this power in relation to any matter referred to it by the States. If federal legislation conflicts with state or territory legislation in a sphere where the power to pass legislation is shared, the federal legislation prevails over the state legislation, but only to the extent of the inconsistency.

Why? Due to inconsistencies of corporations’ laws in each state (which triggered delays in dealings with interstate companies) the Cth was given the power to make legislations about the company to create a uniform and standard set of laws relating companies in every state.

### **ASIC (Australian Securities and Investments Commission)**

ASIC is the main Commonwealth body or authority responsible for administering the Corporations Act.

Some of the roles that ASIC plays in relation to companies are:

- Registration of companies
- Regulation of financial markets and services
- Provides licenses on businesses providing consumer credit activities (eg. Banks, credit unions, finance companies etc.)
- Maintenance of a publicly accessible registers of information about companies- names of the company, board of directors etc, public funding.
- Investigation of suspected breach of the law- s50 of the ASIC act
- Regulation of company takeovers
- Advise Commonwealth Minister on Law Reform. S11(2) of the ASIC Act. (Corporations & Markets Advisory Committee)
- S50 of the ASIC act- Initiate civil proceedings or class actions for recovery of damage on behalf of the shareholders or other person.
- Administers and ensures compliance of the act.
- The commonwealth minister can give policy direction to ASIC but not specific directions.
- Federal director of public prosecution can also file civil proceedings or prosecution.
- S49 of the ASIC Act, where they can file a criminal proceeding against the company.

## Question 2

In the absence of specific legislation, courts have, as a general rule, been reluctant to depart from the principle established in Salomon v Salomon and lift the veil of incorporation.

Specify with reference to Australian legislation and general common law precedents the exceptional situations in which this veil of incorporation may be lifted.

The recognition that a company is a separate legal entity distinct from shareholders is often referred to as the “veil of incorporation”. This veil serves as a protection to the members and directors from the debts of the company. But the existence of this veil is subject to abuse and can be used for anomalous trading by the person(s) behind the veil. Therefore lifting the veil looks behind the company form to see the real story and impose liability on: (1) directors (2) controllers (members) (3) holding company. In *Salomon v Salomon*, Salomon had a genuine purpose to protect himself from liability. If the existence or purpose of building the company was not genuine (illegal or incompliant) then lifting the corporate veil comes into place.

### Statutory Exceptions.

- *Insolvent trading*- “trading when company cannot pay its debt on time”. The directors breach their duty under s588G by failing to prevent the company incurring debts when there are reasonable grounds for suspecting that it is insolvent. (Directors are then liable on the extra new debt when the company is already insolvent). Holding companies may also be liable under s588V if it allows its subsidiary to do insolvent trading.
- *Voidable transactions/uncommercial transactions* – the corporate veil may also be lifted if the insolvent company has disposed assets at “anything other than market value” prior to liquidation. Under s588 FE(3), the company’s liquidator may set aside uncommercial transactions entered into within 2 years of application for winding up or for a period of going back to 4 years before application for winding up if the recipient of uncommercial transaction is a related entity.
- *Company Officer Security Interest* (s588FP) - void if secured interest is enforced by officer within 6 months of the creation of the security interest. Officer can enforce the charge until 6 months unless leave is granted by the court.
- *Financial Assistance* (s260A) - person involved in contravention is guilty of offence (s260D) if a company provides financial assistance for the acquisition of its own shares in contravention of s260A.

### Common Law (Precedents)

- *Avoidance of a legal obligation* - or avoidance of obligations.
  - Case: *Gildford Motor Co Ltd v Horne*. Horne created a company to carry on business as a way around the clause (Restraint of Trade Clause). (Here, the company is trading not Horne the individual). Court granted an injunction against Horne and his Company.
- *Fraud*
  - Case: *Re Darby*. The profit 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. The liquidator of Welsh, the English company claimed in Darby’s bankruptcy the “secret profit” made by him as a promoter of Welsh. Court lifted the veil of the Channel Island Company and treated D&G as promoters of the English company.
- *Agency/partnership*
  - Case: *Smith Stone & Knight Ltd v Birmingham Corp*. In some cases, the court looks behind the corporate veil when the subsidiary has acted as an agent on behalf of its holding company. Initially, the holding company will not be liable for the subsidiaries’ liabilities (*Salomon*). The subsidiary is regarded as an agent for the parent company after the court has looked behind the corporate veil. If these nature of relationship is proven (or if independency was not proven), then the parent company will be held liable for the subsidiaries acts.
- *Benefit of group as a whole*
  - Case: *Equiticorp Finance Ltd (in liq) v Bank of New Zealand*. Every company in the group is only allowed to look after its own interests. It is almost impossible for the creditor of the subsidiary to claim liability from the holding company. This instance will lead to lifting the veil to see if the

directors have breached their fiduciary duties where they act on the basis that the corporate group is a single entity.

- *Company knowingly participates in breach of Director's fiduciary duties*
  - Case: *Green v Bestobell Industries Ltd.* **Fiduciary duty:** includes a duty of looking after the employer. Here there was a clear breach of fiduciary duty by Green (manager of Bestobell) and this placed 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 order to account to Bestobell Industries for the profit it derived.

## TUTORIAL EXERCISE NO 2

### Question 1

Bill, a property developer, bought a large block of land in Perth for \$200,000 in January. Bill then approached Jack, a real estate agent, to help sell some "off the plan" home units. The units were to be developed and sold in two stages by a company called Propco Pty Ltd, which had not then been formed.

The plans for the units were prepared and on 20th March Jack sold one of the stage two units to Amy for \$65,000 under a contract which he signed as "agent of Propco Pty Ltd".

Propco Pty Ltd was not incorporated until 7th April. The directors are two business colleagues of Bill. There are four shares issued, one held by Bill and three held by Ben.

In May Bill sells the land to Propco for \$350,000 and building of the first stage units then commences.

In early June Propco discovers the local council will not give planning permission for stage two and that part of the development does not proceed.

Amy is furious. She is demanding from Jack the return of a \$65,000 deposit paid by her to him and damages. Ben is also concerned about the propriety of the sale of the land by Bill to the company. Recently, the company held an extra-ordinary general meeting where the original directors were removed and new directors appointed. Ben wants the new directors to take action against Bill.

#### **Advise Bill and Jack of any liability arising from their actions.**

The main issue is whether Bill, the promoter has breach his fiduciary duties to the company. There is also an issue with regards to Jack's extent of liability to Amy.

#### Bill

A promoter is one 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*). Bill is a promoter of Propco Pty Ltd and a question arises as to whether he breached any of his fiduciary duties to the company (duty of disclosure, undisclosed profits). If he didn't breach any of these, Propco would not be able to sue Bill.

Duties owed by the promoter are similar to the duties owed by the directors. These are:

1. No conflicts of interests
  - There was clearly an incentive for him to sell the land to Propco at a higher price, which he actually did.
2. Undisclosed Profits – duty is owed by the promoter to the company, the board and the shareholders of the company, to disclose any secret profits that was made by them (*Gluckstein v Barnes*).
3. Duty of Disclosure- full disclosure of promoter's interests in contract has to be disclosed to an independent board of directors and shareholders (prospective). Although there is an issue as to whether he his business colleague is an independent board.

There was no disclosure made by Bill therefore will be liable for damages.

#### Remedies

- a. Rescission: *Erlanger, Tracy*. – it would be hard to claim these remedy as there was changes to land and third parties involved
- b. Account of profits: *Gluckstein* (damages).
- c. Tort of deceit

Jack - Jack signed the contract for the sale of the stage two unit to Amy on 20<sup>th</sup> of March and Propco (the selling company) was not incorporate until 7<sup>th</sup> of April.

Part 2B.3 covers contracts before registration. Under section 131(1), if a person enters into contract:

- (1) On behalf of (before it is registered), or
- (2) For the benefit of

Proposed Company, company becomes bound by the contract if the company is later registered and ratifies contract, within agreed and reasonable time. A pre-registration contract is formed on the date it is ratified not on the date when it is signed.

Ratification means that a company adopts or confirms the pre-registration contract. Ratification is also deemed to happen if: A) Directors pass a resolution, B) company signs a document, C) Company uses item and D) there was a part payment of the purchase price.

### S131(1)

A question arises as to whether there was a ratification by the proposed company, (Propco Pty Ltd). On the given facts, two sides of argument can be made:

- a. There was ratification- In May, the building of the first stage unit has commenced. This is considered a "positive act", therefore it seems that Propco had adopted the pre-registration contract. The ratification also occurred within a reasonable time (2 months) since its incorporation. Jack, the real estate agent approached by Bill, acted as an "agent on behalf of" Propco Pty Ltd before the company was incorporated. Therefore, Propco is bound by the contract to Amy entered into on behalf of Jack under s131(1) and will therefore be liable to Amy.
- b. There was no ratification: There was really no document signed by the board of directors (prospective board) in signing the contract. In this case, due to the absence of ratification, Jack will be personally liable for damages to Amy under s131(2).
  - Section 131(2) states that the person who signs the pre-registration contract is liable to pay the 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.
  - Jack will not be able to ask for some compensation from the company. S132(2) states that the company may not indemnify the person who signed the pre-registration contract. Propco Pty Ltd, cannot compensate Jack for the damages he is liable to pay.
  - Under s131(3), a person if sued for damages under s131(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:
    - o Pay all or part of the s131(2) damages
    - o Transfer to the other contracting party property that the company received because of the contract, or
    - o Pay an amount to a part to the contract.

### **Question 2**

Amanda built a development of four units. She set up a proprietary limited company (called "Melrose Pty Ltd") which owned the entire property and issued shares to herself and three others, Billy, Allison and Jane, who were also tenants of the property. All four were appointed directors of the company.

The constitution contains the following two provisions:

- (i) "Each director of the company shall be entitled to rent a unit while a director for personal use, but no director other than Amanda, is permitted to sublet to an outsider without the unanimous approval of the directors"

- (ii) "No internal walls are to be knocked down or altered without the unanimous approval of the directors".

The following events have happened:

- (a) Amanda proposes to sublet the flat to Alan. However, Billy, Allison and Jane do not wish her to do this and recently passed the following special resolution at a general meeting:

"That provision (i) be amended by deleting the words 'other than Amanda'".

**Advise Amanda.**

The issue is whether the alteration of part (i) of the company's constitution is valid and whether Amanda has breached one of the provisions of the Co. constitution.

Under s136(2), general meeting must pass a special resolution (s9) which requires 75% majority in order to alter or amend provisions in the company's constitution. The effectivity of the resolution will take place on the date it was passed s137(1). It is stated in the facts that the special resolution passed on the general meeting was effected with 75% majority (composed of Billy, Allison and Jane who each own 25% of the shares of Melrose Pty Ltd.). The required special majority is met therefore the alteration is valid under s136(2). Amanda wouldn't be able to sublet her flat to Alan despite her right stated on the constitution due to s136(2) taking effect.

Restrictions on right to alter the constitution is available under s136(3)- Entrenched provision, s140(2)- Minority, s246B-Variation of class rights and s232- Oppression remedy. There is no entrenched provisions contained in provision (i) or (ii) of the company's constitution. The alteration then is still valid under s136(2). As Amanda proposed the sublet to Alan without unilateral approval from the Board, Amanda would then breach provision (i) of the company's constitution if she proceeds.

- (b) Jane now wishes to renovate the inside of the unit by knocking down the kitchen wall. Allison objects to this.

**Advise Jane.**

The issue is whether Jane has the right to renovate the inside of the unit by knocking down the kitchen wall given the provision (ii) in the company's constitution.

S140(1)(a)- constitution has contractual effect between Company and Member.

Provision (ii) of Melrose's Constitution states that "No internal walls are to be knocked down or altered without the unanimous approval of the directors". Similar to Amanda's case, there has to be a unilateral and unanimous approval amongst the Board to vary a clause in a provision of the Constitution. Jane doesn't have a unanimous approval from all the directors since there was no clear and absolute agreement amongst the members of the board. If Jane proceeds with her plan, she will be breaching provision (ii) of Melrose's Constitution and must therefore refrain from performing any renovation on her unit.

**Question 3**

Howard Ltd has a constitution which provides that John, who is a shareholder, shall be managing director for life. Beazley Ltd, which has acquired 90% of the shares of Howard Ltd, intends to delete this provision and remove John from the Board of Directors altogether.

Discuss whether:

- (a) John can prevent this alteration of the constitution.

John can prevent the alteration by stating in the provision that John is has been appointed as managing director for life under s140(1)(b) but this is subject to s136(2). He can also prevent the alteration under s136(2) but it is unlikely possible here. S203D(1)(a) ordinary resolution to remove John.

- (b) If the constitution is changed and John is dismissed from his post as managing director does he have any form of legal redress?

The Constitution previously provided that John was to be managing director for life under section 140(1)(b) contract, which is a statutory contract. The Constitution was amended to allow removal of John as a managing director. The dismissal is valid and no damages are payable as there was no independent contract between John and the new Board of director (*Shuttleworth v Cox Bros (Maidenhead) Ltd*). However, if the contract between Howard Ltd and John is independent, John can recover damages for wrongful dismissal. (*Allen v Gold Reefs of West Africa Ltd*).