

Topic 3 Replaceable Rules and the Constitution

Internal governance rules

They are the rules or arrangements agreed between the participants to govern the internal workings of the company and relationships between participants in the company.

S134: A company's internal governance rules will consist of:

- The replaceable rules set out in the Corporations Act
- A constitution, or
- A combination of the replaceable rules and a constitution.

They will deal with the following:

- The appointment, removal and powers of the company's officers (directors and secretary)
- The procedure for convening and conducting directors' meetings
- The procedure for convening and conducting members' meetings (including voting rights)
- Any special rights attaching to classes of shares
- Rules relating to dividends
- Rules relating to the transfer and transmission of shares.

For listed companies, the ASX Listing Rules impose some restrictions on the form of internal governance rules, which are designed to protect public shareholders.

Replaceable rules

If the company was formed on or after 1 July 1998, it may adopt replaceable rules simply by not adopting a constitution. If the company was formed before 1 July 1998, it can invoke the replaceable rules by repealing its existing memorandum and articles of association: s135.

Replaceable rules do not apply to single director/shareholder companies (proprietary companies): s135(1).

Replaceable rule can be displaced or modified by the company's constitution: s135(2).

Some provisions may not be suitable. E.g. pre-emption provision: s254D; majority rule; partly paid shares, indemnification of directors and officers for liabilities incurred by them in performing their functions.

Constitution

Why adopt a constitution?

- To substitute different rules for some or all of the replaceable rules
- To supplement the replaceable rules; to address matters not covered by them
- To collect all of the internal governance rules into a single document, for the convenient reference of officers and members
- To ensure that, if parliament amends a replaceable rule, that amendment does not take effect unless it is specifically adopted by the company
- To avoid legal uncertainty about certain aspects of the replaceable rules, e.g. questions over whether decisions made under them are reviewable under principles of administrative law
- For listed companies, to meet the requirements of the ASX Listing Rule
- To incorporate restrictions on the company's objectives

How does a company adopt a constitution?

- on registration, if each person specified in the application for the company's registration as a person who consents to become a member agrees in writing to the terms of a constitution before the application is lodged: s136(1)(a)
- after registration by special resolution: s136(1)(b)
- this will override some / all of the replaceable rules

Where a company has passed a resolution to adopt a constitution, that resolution will take effect on the day it is passed or on a later date specified in the resolution (unless it also involves a change of name, type, or variation of

class rights): s137.

Members of public companies that have adopted a constitution can obtain a copy of that constitution from the company: s139.

How does a company amend or repeal a constitution?

The company may modify or repeal its constitution, or a provision of its constitution, by special resolution: s136(2)

The company's constitution may provide that the special resolution does not have any effect unless a further requirement specified in the constitution relating to that modification or repeal has been complied with: s136(3)

Unless the constitution provides otherwise, the company may modify or repeal a further requirement described in subsection (3) only if the further requirement is itself complied with: s136(4)

A public company must lodge with ASIC a copy of a special resolution adopting, modifying or repealing its constitution within 14 days after it is passed. The company must also lodge with ASIC within that period: (a) if the company adopts a constitution--a copy of that constitution; or (b) if the company modifies its constitution--a copy of that modification: s136(5)

Where a company has passed a resolution to amend or repeal a constitution, that resolution will take effect on the day it is passed or on a later date specified in the resolution (unless it also involves a change of name, type, or variation of class rights): s137.

Public companies that amend or repeal their constitution must give notice to ASIC: s136(5).

Legal Effect of the Internal Governance Rules

How do the internal governance rules work?

They operate as a contract. This contract is created by statute.

S140: "A company's constitution and any replaceable rules that apply to the company have effect as a contract:

- a) between the company and each member; and
- b) between the company and each director and company secretary; and
- c) between a member and each other member;

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

Case: Eley v Positive Government Security Life Assurance Co Ltd

The company's article of association stated that Mr Eley should be the company's solicitor. When the company ceased to employ him as its solicitor, he sued to enforce the relevant article under the predecessor to s140. However, he failed because the court held that the statutory contract is a deemed contract only as between the parties referred to in the section.

Legal limitations

- 1) s140 is limited in that it provides for the internal governance rules to have effect as a contract only:
 - between the company and each member
 - between the company and each director and secretary
 - between each member and each other member

Further, the contract cannot be enforced by outsiders.

- 2) To the extent that s140 confers rights or obligations on a member, it does so only if (and while) the person is a member and only in their capacity as a member.
- 3) A member cannot enforce compliance by the company with a procedural requirement in the internal governance rules where failure to comply with that requirement can validly be excused by a majority of members in general meeting.
- 4) A member's right to enforce the internal governance rules under s140 may be limited to those of the rules that confer rights that are personal to the member in its capacity as such.

Non-compliance with the internal governance rules

Replaceable rules do not operate as public law requirements, but instead as contractual terms binding on a company, its members and officers only by operation of s140 and not by force of law. Therefore it is not a contravention of the Corporations Act. So provisions in the corporations Act creating criminal or civil liability for breach of the Act, or allowing for statutory injunctions against breach of the Act, do not apply: s135(3).

If a provision of a company's internal governance rules has not been observed, then the following may result:

- Non-compliance by the company → a member (or a director or the company secretary) may be able to obtain a declaration or injunction requiring the company to comply, provided the rule is one that a member can enforce on the principles set out above.
- Non-compliance by a member → another member or the company may be able to obtain declaratory or injunctive relief, or damages
- Non-compliance by a director or secretary → the company may be able to obtain declaratory or injunctive relief, or damages.

Non-compliance with the internal governance rules may amount to a procedural irregularity. E.g. holding a meeting without a quorum

In this case, s1322 applies. The effect is that a proceeding under the Corporations Act is not invalidated because of any procedural irregularity unless the court is of the opinion that the irregularity has caused or may cause substantial injustice that cannot be remedied by any order of the court, and the court by order declares the proceeding to be invalid.

Single Director / Shareholder Companies

Because such companies have only one participant, the rules of company law that regulate the relationship between multiple participants have no application to them.

S135 provides that the replaceable rules do not apply to a proprietary company while the same person is both its sole director and sole shareholder.

Rules that govern these companies

- The director may appoint another director by recording the appointment and signing the record: s201F
- The director may exercise all of the powers of the company except any powers that the Corporations Act or the company's constitution requires the company to exercise in general meeting: s198E(1).
- The business of the company is to be managed by or under the direction of the director: s198E(1)
- The director may execute a negotiable instrument such as a cheque, and may determine that a negotiable instrument may be executed in a different way: s198E(2)
- The director is to be paid any remuneration for being a director that the company determines by resolution. The company may also pay the director's travelling and other expenses properly incurred by the director in connection with the company's business: s202C
- It can be done by the member recording a resolution in writing and signing it: s249B
- The resolution must be recorded in the company's minute book: s251A
- Where sole participant in a single director/shareholder company dies or otherwise incapacitated, it can provide for their personal representative to take over the company: s201F

Changing the company's name or type

Changing the company name requires a special resolution of members: s157

There are other conditions for a change of name that must also be met, which are set out in Div 2 of Pt 2B.6

Permitted changes of type are set out in a table contained in: s162(1)

A change of type requires a special resolution: s162(1)(a).

The company must also comply with the requirements of s163 and 164.

Restrictions

Why are restrictions needed?

It is to protect minority shareholders from exploitation.

E.g. the majority may favour the appointment of certain individuals as directors while the appointment of these individuals is opposed by the minority. These are not typically the concern of the law.

Actions that the majority of members may take which the law will endeavor to prevent:

- Amend the company's constitution in a way that disadvantages the minority
- Alter the share capital of the company in a way that disadvantages the minority
- Vote to approve the sale of assets of the company to themselves at a price which is below that of the market value of the assets
- Amend the company's constitution with the objective of forcing the minority to sell some or all of their shares at an unfair price
- Vote to approve certain benefits to themselves that are not available to the minority

Selling the shares is not always an option

Selling shares may be possible in a company that has its shares listed on the Australian Securities Exchange (ASX) and there is a liquid market for those shares, most companies do not have a liquid market for their shares.

Private companies may have a provision in their constitutions limiting the right of members to sell their shares. It is because the members of those companies want control over who may become members. E.g. obtain permission of directors before the member sells their shares.

Basis of restrictions on majority voting power

Restrictions are imposed:

- Under a legal principle known as the equitable limitation on majority voting power
- Through procedural requirements that apply to particular decisions made by company members
- Through provisions of the Corporations Act 2001 and, for listed companies, the ASX Listing Rules, which prevent interested members from voting on certain resolutions
- Under statutory provisions protecting the minority
- Through legal rules that protect the personal rights of members
- Through limits on the power of the majority to ratify breaches of directors' duties

Statute

A member must agree in writing to be bound to change in constitution to:

- Take up additional shares: s140(2)(a)
- Increase contribution liability: s140(2)(b)
- Restriction on right to transfer shares: s140(2)(c)

Common Law

Equitable limitation on majority voting power

What are the restrictions?

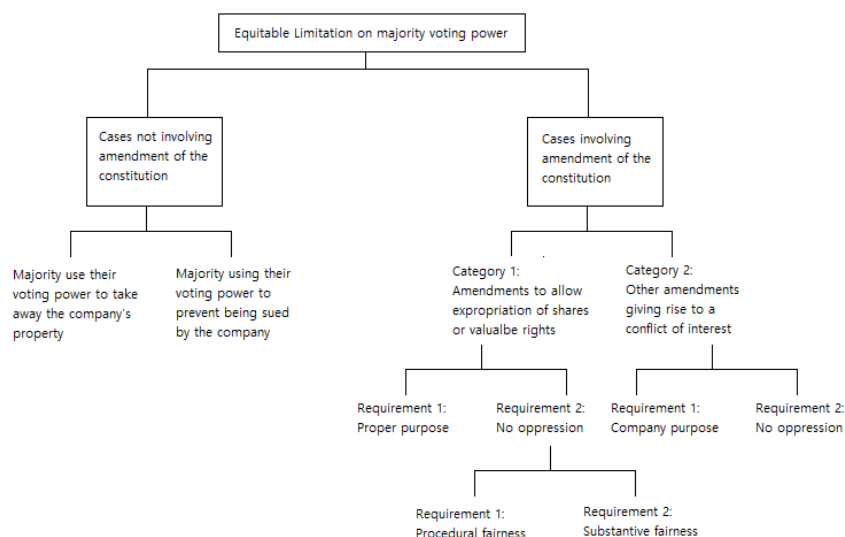
It restricts the action that is beyond the authorized or legal powers given to the majority. Where the court finds that the majority has breached the equitable limitation, the action of the majority is invalid.

What is the equitable limitation?

"A member, unlike a director, does not have to be concerned about conflict of interest and duty and may vote to

advance his or her own interest; the member has no duty. However, while a member has no positive duty to consider others when voting there is an overall control in that, if the majority passes a resolution which no body of reasonable persons could have supposed to be within the scope of the majority's power, having regard to the contemplated purposes of the company, the resolution is liable to be declared void by a court."

Overview of the equitable limitation



Restrictions to cases involving an amendment of the company's constitution

Significance of the Gambotto case

Gambotto is important because it raises the issue of the appropriate balance between the interest of majority and minority members in the context of the majority wanting to have the minority sell their shares because this would be in the best interests of the company.

Gambotto case

Industrial Equity Ltd held 99.7% of the shares of WCP Ltd. The plaintiff, Mr Gambotto, was a minority shareholder in WCP. Industrial Equity wanted to make WCP a wholly owned subsidiary. This would result in both administrative savings and also taxation savings. The administrative savings arose from the fact that, if WCP was a wholly owned subsidiary of Industrial Equity, there would be savings in relation to maintaining the share registry as well as savings on accounting fees. More significantly, there would be taxation savings because there could be the transfer of tax losses within the Industrial Equity group. Under taxation law, only companies that are wholly owned subsidiaries can transfer tax losses. The financial benefits were estimated to be more than \$4 million in tax savings, \$3000 per year in accountancy fees because group financial statements would not have to be prepared, and \$1300 per year as a result of not needing to maintain a share registry service.

A meeting of WCP was held at which shareholders passed a resolution amending the constitution of WCP. A new provision was inserted in the constitution allowing any member of WCP who was entitled to at least 90% of the issued shares of WCP to acquire compulsorily the shares of other members at a price of \$1.80 per share. An independent expert had valued the shares at \$1.36. At the meeting of shareholders held to amend the constitution, the resolution was passed unanimously. Mr Gambotto did not attend this meeting and the majority shareholder did not vote. Three minority shareholders representing 8300 shares attended the meeting and all supported the amendment to the constitution.

Mr Gambotto commenced litigation in the Supreme Court of New South Wales and won on the basis that the amendment amounted to unjust oppression of Mr Gambotto. WCP appealed to the NSW Court of Appeal and won on the basis that considerable financial benefits would flow to WCP if the minority shareholders were forced to sell their shares. Mr Gambotto appealed to the High Court and won. The court found the amendment to the constitution to be invalid. As noted above, the High Court laid down new tests that apply in determining the validity of amendments to the constitution of a company where those amendments give rise to conflicts between members.

Legal tests established by Gambotto

- Category 1 – where amendments to a constitution are proposed that, if passed, allow expropriation by the majority of the shares of the minority or of valuable proprietary rights attached to the shares
- Category 2 – where amendments to the constitution are proposed that involve conflicts of interest but do not involve expropriation

The test applied in Category 1 situations

The test applied by the High Court for these types of amendments to constitutions was that an amendment can only be made if:

- It is done for a proper purpose
- The effect of the amendment is not to oppress minority shareholders

Proper purpose

Where the purpose of the amendment is to prevent significant detriment or harm being done to the company because of the minority shareholder.

E.g.

- The minority shareholder is competing with the company, or
- The expropriation of the shares of the minority shareholder is necessary to ensure that the company continues to comply with the law governing the company's principal business activities.

Not a proper purpose is an amendment designed to advance the commercial interests of the company. E.g. taxation and other benefits

Not oppressive

It means that the amendment must be “fair in the circumstances”.

Fairness has both procedural and substantive aspect.

- Procedural fairness requires the majority shareholders to:
 - Fully disclose all relevant information relating to the amendment e.g. purpose of the transaction and why alternatives were not adopted
 - Obtain and disclose an independent expert's valuation of the shares to be expropriated
- Substantive fairness means that the price for the shares to be expropriated must be fair. Whether the price offered is fair depends on a variety of factors, including assets, market value, dividends and the nature of the corporation and its likely future.

The test applied in Category 2 situation

It refers to the situation where amendments to a constitution are proposed that, if passed, involve a conflict of interest but do not involve expropriation.

The court stated that these amendments will be valid if the amendment is:

- Done for a company purpose
- Not oppressive of the minority

More ‘purposes’ are valid. E.g. commercial purposes are valid

Key policy aspects of Gambotto?

- To what extent should the law protect the rights of minority shareholders when a corporate restructuring will offer significant commercial advantages?
- Should a share be treated like any other property or should it be viewed simply as a dividend stream which can be compulsorily acquired provided the price offered is fair?
- Does the decision in Gambotto facilitate “greenmail”? (Minority shareholders preventing a corporate restructuring that has commercial benefits for the company unless they are paid a price well above the

fair value of their shares)

Limits on Gambotto

Principles in Gambotto do not apply to situations where the shares of minority shareholders are expropriated in accordance with statutory procedures in the Corporations Act.