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Business Associations Law Cram Notes

1st Edition

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1. INTRODUCTION

A. HOW TO USE CRAM NOTES

The Business Associations Law Cram Notes are formatted into a step-by-step guide, which you can use as a checklist in your exams to ensure that every element of the exam question is answered. You may find the Table of Contents to be a quick and useful overview of the law to be applied.

You should also answer the exam question using the ILAC method, which will ensure your answer is comprehensive.

Issue	State the legal issue relevant to the problem
Law	Identify the relevant case law and legislation
Analysis	Analyse and apply the law to the legal issue. This is the most important part, so ensure your legal analysis is very thorough.
Conclusion	Form a conclusion based on your analysis and application of the law, giving some practical advice to the hypothetical client.

It is very important to spend time perfecting your analysis section, as this is the part that examiners are most interested in. Do not worry if you reach the correct conclusion (there often isn't one clear answer) – examiners will give more weight to your legal analysis, and sometimes may even reward answers that propose an innovative and unconventional answer!

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2. Background

A. Types of companies and corporations

Under s 1378 of the Corporations Act, companies may no longer be registered as companies limited both by shares and by guarantee, although companies of this type formed under prior legislation continue to exist pursuant to this section.

At the very least, a company must at least have 1 member (s 114). Part 2B.7 of the Corporations Act provides that a company can change its type with shareholder approval and consent.

i. Proprietary companies (Pty Ltd)

Section 45A provides that for two different forms of proprietary companies:
- small proprietary company
  - consolidated revenue is $25 million or less
  - value of gross assets is $12.5 million or less
  - has fewer than 50 employees
- large proprietary company
  - consolidated revenue is $25 million or more
  - value of gross assets is $12.5 million or more
  - has more than 50 employees
  - large proprietary companies have more stringent financial reporting obligations (Part 2M.3)

A proprietary company cannot (s 113)
- have more than 50 non-employee shareholders
- offer shares to the public or anything that requires disclosure under Chapter 6D (i.e. equity-raising to the public)

If these provisions are contravened, and the ASIC is satisfied that there has been contravention of these prohibitions, ASIC may direct the proprietary company to change to a public company (s 165).

Proprietary companies can be limited by shares or unlimited with share capital (s 112). Where a company is limited by shares, the share confers to the shareholder an interest in the company to participate in the financial distributions made by the company and in group decisions. A limited proprietary company must display the words "Pty Ltd" at the end of its name (s 148(2)).

ii. Public companies (Ltd)

Under s 9, public companies are simply those that are not proprietary companies. As with proprietary companies, they can be limited by shares or unlimited with share capital (s 112). A limited public company must display the words "Ltd" at the end of its name (s 148(2)).

In addition, they can also be limited by guarantee, or simply be a no liability (NL) company. No liability companies are only allowed for mining purposes. The main difference between a no liability company and a public company is that a shareholder of a no liability company cannot be compelled to pay calls on partly-paid shares (s 254M).

Public companies may be listed on a stock exchange (such as the ASX), although this is not a

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ostensible authority in X's name.
- But if X only has ostensible authority, he cannot make a representation and hold out Y as having the same ostensible authority to act in the name of the principal (i.e. the company).
- In this case, because the managing director did not have the full powers of management (which was vested in the board), and only had ostensibly authority, the managing director could not have represented another person to have had actual authority.

The mere position of director does not suggest ostensible authority, unless the board has represented as such (*Northside*).

iii. Protected under Indoor management rule or other statutory assumption as to authority

The indoor management rule protects third parties from the effect of irregularities in internal management.

Turquand's case
- Persons dealing with a company in good faith may assume that acts within its constitution and powers have been properly and duly performed and are not bound to inquire whether acts of internal management are regular

Northside Developments v Registrar-General
- Facts: A mortgage was executed under the common seal of RS and GS. Art 56 provided that the seal shall never be used except by the authority of the directors. The directors had not by resolution at a meeting authorised the affixing of the seal to the instrument of mortgage or delegated power to RS. Also, GS was not in fact the company secretary.
- The indoor management rule does not apply where there are suspicious circumstances sufficient to put the person upon inquiry
- If the nature of the transaction is such as excite a reasonable apprehension that the transaction is entered into for purposes apparently unrelated to the company's business, it will put the person dealing the company upon inquiry.
- The indoor management rule only applies where it is something for which ostensible/apparent authority could be given – it does not create authority, it merely allows the third party to presume that the authority has been acted upon without irregularities.

1) Statutory assumptions as to authority

The indoor management rule is supplemented by s 128 to s 129.

Under s 128, the assumptions in s 129 can be made in relation to dealings with the company which cannot be disputed by the company, even if the agent or officer acts fraudulently, or forges a document. However, such assumptions cannot be relied upon if at the time of the dealings, the third party knew or suspected that the assumption was incorrect (s 128(4)).

Section 129 provides the assumptions that can be made under s 128.
- That the Constitution and replaceable rules complied with
- From the ASIC records, all directors have been duly appointed and have authority
- Anyone held out as officer/agent has been duly appointed and has authority
- The officers and agents of the company are properly perform their duties to the company
- May assume that a document has been duly executed by the company if it complies with s 127(1)

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  - Section 127(1) provides that a company may execute a document without using a common seal if the document is signed by
    - 2 directors of the company, or
    - a director and a company secretary, or
    - sole director who is also the sole company secretary (for a Pty Ltd company).
- That a document has been duly executed with the company's common seal

2) Section 128(4) exclusion

The s 128(4) exclusion provides that the assumptions in s 128 and s 129 cannot be relied upon if at the time of the dealings, the third party knew or suspected that the assumption was incorrect. Generally, the s 128(4) exclusion will be made out where the person being held out had no authority of any kind which should have been known to the third party.

Actual knowledge
If a company holds out a person to be the company secretary after an ASIC search revealed that he was in fact not the secretary, this will amount to a holding out by the company that the person could speak on behalf of the company in that transaction (*Brick and Pipe Industries Ltd v Occidental Life Nominees*). A refusal at first not to proceed because of the results of a company search does not constitute 'actual knowledge' of lack of authority in these circumstances (*Brick and Pipe Industries Ltd v Occidental Life Nominees*).

Connection or relationship
The third party's relationship with the company prevents them from relying on the assumptions, because from their connection/relationship they ought to have known there was no authority or that it was a forgery (*Story v Advance Bank*). However in *Story*, because there was some benefit to the company in entering the loan, it was different to *Northside* and the bank would not be put on inquiry.

Ought to know
In considering whether s 128(4) applies, the Court must look at the person's connection or relationship with the company in regard to the particular matter and then decide whether in those circumstances that person acting reasonably would know the true position about the matter assumed (*Fiberi* case). That is, whether a reasonable person in the position of the third party would have known or suspected the true position.

As such, whether a benefit accrues to the company will be important in establishing the s 128(4) exclusion.

7. Did Director's breach their duty to the company?

A. Duty of Care and Diligence

i. What was the standard of care required?

The level of care that a reasonable person under similar circumstances (i.e. doing the director's job in the director's company) would exercise (*Daniels v Anderson, Gamble v Hoffman)*.

Section 180(1) provides that a director/officer must exercise their powers 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

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- occupied the office held by, and had the same responsibilities as, that director/officer.

This is an objective test.
- Non-executive directors may rely on management except where it would be unreasonable to do so
- Poor education or skills are no excuse (*Gamble v Hoffman*)
- As the chairperson decides which issues the board addresses, a higher standard of care is required (*ASIC v Rich*).

Directors should thus be familiar with the company's business, remain informed as to the company's activities, and attend board meetings.

Marquis of Bute's case
- The directors of a company are only bound to use fair and reasonable diligence in the management of their company's affairs
- neglect or omission to attend the meetings is not the same thing as neglect or omission of a duty which ought to be performed at those meetings
- To hold that the Marquis was guilty of neglect or omission in respect of this duty, in the absence of any knowledge or notice that it was not duly performed, would be to fix him with liability for the neglect and omission of others rather than his own.

Re City Eq Fire Insurance
- Courts will take account of the background, skills and experience of the director. A director with little knowledge of the company's business and little skill was judged against the standard of someone with the same (poor) knowledge and skill
- Directors not bound to give continuous attention to the affairs of the company - directors not bound to attend all Board meetings
- Directors entitled to assume that management will perform their duties properly

Daniels v Anderson
- Directors should be familiar with the fundamentals of the business and have at least a general understanding of that business and the effect that a changing economy may have on that business
- Ignorance is no longer necessarily a defence to proceedings brought against a director. The director must inform himself or herself about the affairs of the company
- Directors are under a continuing obligation to keep informed about the activities of the corporation. Otherwise, they may not be able to participate in the overall management of corporate affairs
- The board collectively must be in a position to assess whether the company is being properly run – individual directors must take steps to place themselves in a position to guide and monitor the management of the company
- This is not a subjective test (limited by director's knowledge and experience), but rather, an objective test. The duty is to display the degree of diligence, care and skill that an ordinarily prudent person would exercise under similar circumstances in the same positions.

Gamble v Hoffman
- Facts: The respondents (Hoffmans) were directors and shareholders of T, a company. Director said to have no business expertise and cannot expect to have been liable for the company's failures. Due to a bad loan made by T to S (another company), T was placed into voluntary administration. The liquidator of T sought to recover from the respondents

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amounts advanced to S by T, on the grounds that the respondents action in doing so amounted to a breach of the common law duty to exercise due care and diligence in the performance of their duties as directors.
- Lack of education and expertise do not justify a lower standard of care. Directors must take reasonable steps to make good their lack of qualifications and experience. It is clear that the lack of experience and expertise is not a defence.
- Objective test: "Did the officer exercise the degree of care and diligence that a reasonable person in a like position in a corporation would exercise in the corporation's circumstances?"

ASIC v Adler
- In determining whether a director has exercised reasonable care and diligence, one must ask what an ordinary person, with the knowledge and experience of the director might be expected to have done in the circumstances if he or she was acting on their own behalf
- Under the implied term in a contract of employment of an executive director, the director will be taken to have promised the company that he or she has the skills of a reasonably competent person in his or her category of appointment and that he or she will act with reasonable care, diligence and skill.
- In determining whether a director has breached the statutory standard of care and diligence (s 180(1)), the court will have regard to the company's circumstances and the director's position and responsibilities within the company"

ASIC v Rich
- The role of the chairperson is to take greater responsibility than other non-executive directors.
- The chairperson is not simply a figurehead, but the most senior director on the board of the company who conducts the decision-making of the board.
- The chairperson is subject to a higher standard of care than other non-executive directors due to the following factors:
  - Chairperson settles the agenda of Board meetings
  - Chairperson has the primary responsibility for deciding what matters and documents are brought to the attention of the board
  - Chairperson is responsible for formulating the general policy of the Board and promoting the interests of the company in conjunction with the Managing Director
  - Chairperson is responsible for the overall performance of the Board – has primary responsibility for ensuring appropriate membership of the Board, initiating policies and monitoring the implementation of those policies

ii. BUSINESS JUDGMENT RULE

The business judgment rule in s 180(2) provides that a director/officer who makes a business judgment is deemed to have met the required standard of care in s 180(1).

Firstly, a director must have made a "business judgment" in order to fall within s 180(2). A business judgment is a decision to act or refrain from acting in respect of a matter relevant to the company's business (s 180(3)).

Secondly, the business judgement must must satisfy the following requirements (s 180(2), *ASIC v Adler*)
- made in good faith for a proper purpose
- director does not have a material personal interest in the subject matter of the decision

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- director has taken reasonable steps to inform him/herself about the subject matter of the decision
- director rationally believes that the decision is in the best interests of the company
  - The director's belief that a 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 (s 180(2)).

B. DUTY TO ACT IN GOOD FAITH IN BEST INTERESTS OF THE COMPANY

Directors have a duty to act honestly having regard to the best interests of the company (s 181(1)(a). The objective test is whether a reasonable person, in the director or officer's position, acting in good faith would believe the act to be in the best interests of the company (*ASIC v Adler*).

The company's interests include those of:

a. Shareholders
   i. Shareholders as a whole (*Parke v Daily News Ltd*)
   ii. Directors must act fairly as between the different classes or groups of shareholders (*Mills v Mills*), including:
      1. variation of class rights
      2. selective capital reduction
      3. selective buy-back
      4. issue of shares
b. Employees and the community
   i. This was ruled out in *Parke v Daily News*.
   ii. However, in the Canadian case of *Teck v Millar*, a 'decent respect for interests' beyond shareholders won't lead to a breach of duty.
c. Creditors
   i. Interests of the creditors can only be considered where the company is insolvent – (*Walker v Wimborne, Kinsela*)
   ii. Consider creditors where company is insolvent or where a transaction may cause insolvency (*Nicholson v Permakraft*)

ASIC v Adler

- The standard of behaviour required by s 181(1) is not complied with by subjective good faith or by a mere subjective belief by a director that his purpose was proper, especially if no reasonable director could have reached that conclusion.
- Thus the duty of good faith is a positive duty to act in a manner consistent with the best interests of the company.

Parke v Daily News

- Facts: Directors of company decided to cease trading and distribute proceeds from sale of business to employees. Majority of shareholders approved the proposal. Minority sued on the basis that the interests of the company did not include those of the employees of the company
- The directors, in considering the interests of the employees, were prompted by motives which, however laudable, were the law does not recognise as a sufficient justification.
- As such, the interests of the company did not include those of the employees.

Teck Corp v Millar

- While it would be a breach of their duty for directors to disregard entirely the interests of a company's shareholders in order to confer a benefit on its employees, to observe a

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fundamental attribute of membership and are rights which the member should be able to protect by legal action against improper diminution.
- If such allotment infringes the personal rights of shareholders, a potential ratification cannot deprive the wronged shareholder of standing whilst the infringement continues.

v. STATUTORY OPPRESSION REMEDY

A statutory oppression remedy exists for minority shareholders in company who are unhappy with a particular policy the directors are following, especially about decisions regarding the declaring of dividends and retaining of profits. The oppression remedy is similar to the fraud on the minority action.

The court may grant a remedy (discussed below) where the conduct of the company's affairs, an act of omission of the company, or a resolution would be oppressive to, unfairly prejudicial to, or unfairly discriminatory against a shareholder whether in that capacity or in any other capacity (s 232(e)). An application for such an order may only be made by a shareholder of the company or a former shareholder (s 234).

Re Tivoli Freeholds
- Oppression is a conduct which is unfair or 'burdensome, harsh and wrongful' to the other members of the company or some of them, and lacks that degree of probity which they entitled to expect in the conduct of the company's affairs.
- Oppression may occur even although all the members of a company are treated equally
- So far as the alleged oppressors are concerned, it must also be established that oppression results from "some overbearing act or attitude on the part of the oppressor"

1) Unfairly prejudicial or discriminatory

Wayde v NSW Rugby League
- Facts: The constitution allowed the board to decide which teams could participate in a competition. The board excluded one team for the purpose of efficiency.
- A decision made in good faith may be one that is unfairly prejudicial, being one that reasonable directors would think unfair.
- Unfairness is objective – a reasonable director, balancing the benefits for members as a whole against the disadvantage to one member, would think it was unfair.
- Mere prejudice or discrimination does not suffice to place conduct within unfairly prejudicial or unfairly discriminatory under s 232(e). There must also be proof of unfairness.

Re Jeffrey Mens Store
- Oppression involves conduct which is unfair, or burdensome, harsh or wrongful or which lacks probity or is persistently illegal and dictated by self interest. There was no discrimination in the case for each shareholder had been treated the same.
- The mere refusal by the other shareholders to accommodate the applicant in getting his money out of the companies by purchasing his shares does not amount to conduct of affairs of the companies in a manner prejudicial to or discriminatory against the applicant.

Thomas v H W Thomas
- Facts: The company was a family run business. The financial management of the company had long been conservative. The company had significant property holdings and accumulated revenue reserves. A shareholder M sought an order for the purchase of his shares and regulating the conduct of company affairs. M complained he was locked into the company and that the conduct of its affairs was "oppressive, unfairly discriminatory

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and unfairly prejudicial" to him.
- A company is to be carried on for the financial benefit of shareholders, but there are many different ways of obtaining commercial return on the shareholding
- Not pursuing revenue profits does not amount to unfair, discriminatory or oppressive conduct if attention is diverted to build up the assets of the company, increasing the underlying value of the shareholding.

10. REMEDIES

A. COMMON LAW REMEDIES

i. RESCISSION OF CONTRACT

Where a director in breach of fiduciary duty causes the company to be bound to the director or a third person by a transaction, usually a contract or disposition of property to which the company is a party, the transaction is voidable at the election of the company which can seek an order rescinding the transaction ab initio.

The right to rescind is lost once the company affirms the transaction with knowledge of the right to rescind.
- Needs to be by vote of company in general meeting not acting in fraud or minority: or by the informal unanimous assent of the members
- The right to rescind will be lost if the rights of innocent third persons would be prejudiced by the company avoiding the transaction (*Transvaal*)
- No rescission can take place affecting the rights of an innocent third party.
- No rescission where the scheme, having been effected, is no longer practically just to rescind (*Coleman v Myers)*

ii. ACCOUNT OF PROFITS

A director being in a fiduciary relationship to the company must account to the company any benefit obtained either:
- Where there was a conflict or real sensible possibility of conflict between the fiduciary duty owed to the company and either the personal interest of the director or a duty owed to a third person
- Where the director's fiduciary position or by reason of the director taking advantage of an opportunity or knowledge derived from the fiduciary position

The director must give up the benefit regardless of whether the director was acting in good faith in the interests of the company when the benefit was obtained. A director must yield a benefit irrespective of whether the company had been unwilling, unlikely or unable to obtain the benefit and regardless of whether the company suffered any loss (*Furs v Tomkies*).

A company can claim the proceeds of realisation of its property if the director improperly deals with an asset, in which the company already has a propriety interest and in doing so, makes an authorised personal profit (*Furs v Tomkies*, *Cook v Deeks*)

The court has a discretion to award a director who is accountable for property or profits, or a third person similarly accountable, a fair allowance in respect of the defendant's contribution by way of diligence, exercise of skill, provision of finance, assumption of risk and other expenditure to the value of the property or profits claimed by the plaintiff (*Warman International v Dwyer*)

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B. ASIC DECLARATION OF CONTRAVENTION

The ASIC has a power to make a declaration of contravention in relation to breaches of civil penalty provisions. ASIC's remedies in s 1317E to s 1317H are very potent.

Where ASIC makes a s 1317E declaration of contravention, a disqualification order (from serving as director) under s 206C may be made, or pecuniary penalties order may be granted, with a maximum penalty of $200,000 for an individual and $1 million for a company (s 1317G). ASIC may apply for a declaration of contravention, a pecuniary penalty order or a compensation order (s 1317J).

Alternatively, a compensation order under s 1317H may be ordered. This does not require a declaration of contravention to be issued by ASIC, as long as the person has contravened a civil penalty provision and damage has resulted from the contravention. Such damage includes profits made by any person resulting from the contravention (s 1317H(2)). The company itself may apply for a compensation order (s 1317J).

C. STATUTORY OPPRESSION

The remedies for oppression are prescribed in s 233. The court may make an order to
- wind up the company (s 233(1)(a))
- alter the constitution (s 233(1)(b))
- regulate the conduct of the company's affairs in the future (s 233(1)(c))
- for the purchase of any shares (s 233(1)(d) and s 233(1)(e))
- for the company to engage in legal action (s 233(1)(f))
- authorise a member to bring proceedings in the name of the company (s 233(1)(g))
- appointing a receiver or administrator (s 233(1)(h))
- restraining a person from engaging in specified conduct or from doing a specified act (s 233(1)(i))
- requiring a person to do a specified act (s 233(1)(j))

The circumstances of the company will have a bearing on the courts discretion to grant certain remedies, such as
- the size of the company
- how the problem arose
- the nature of the company
- possibility of the company's financial recovery

Re Spargos Mining
- In this case, the appointment of receivers would cause a loan default, so the court order the appointment of new directors instead, and ordered them to investigate past breaches by old directors.

D. STATUTORY WINDING UP

Under s 461(1), the court may order the winding up of a company if:
- directors have acted in affairs of the company in their own (or others) interests (s 461(1)(e))
- the affairs of the company are being conducted in an oppressive or unfairly prejudicial manner (s 461(1)(f))
- the court is of opinion that it is <u>just and equitable</u> that the company be wound up (s 461(1)(k)).

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The following persons have standing to apply for the company to be wound up (s 462(2)):
- the company
- a creditor (including a contingent or prospective creditor) of the company
- a contributory (fully paid or partly paid shareholder)
- the liquidator of the company
- ASIC

i. JUST AND EQUITABLE

It will be just and equitable (s 461(1)(k)) to wind up the company where the company has abandoned its main objects or has entered upon activities beyond the general intention of the corporators (failure of substratum). That is, the basis upon which they entered the enterprise has been defeated.

Re Tivoli Freeholds
- Facts: Tivoli had been incorporated with the main object of public entertainment (2 theatres). After one theatre was damaged in a fire, the company ceased its theatrical activities. The company then resolved to lend surplus to its principal shareholder. These funds were applied for the purpose of assisting the parent's corporate raiding activities. Widely dispersed minority shareholders (49% holding) opposed the current direction of the company and petitioned for a s 461(1)(k) order.
- It may be just and equitable to wind a company up if the company engages in acts which are entirely outside what can fairly be regarded as having been within the general intention and common understanding (constitution and objects) of the company when they became members.
- Consider whether the shareholders are being asked to leave money in a venture altogether different from that to which that have subscribed.

Ebrahimi v Westbourne Galleries
- Facts: The company been originally conducted as a partnership between E & N. Soon after the incorporation, N's son was appointed as a third director. The company was profitable and all proceeds were distributed as directors' remuneration. After a dispute with E, N and his son combined their majority voting power to remove E from his office as director. E petitioned for relief under s 461.
- While the removal was pursuant to the constitution, E had a legitimate expectation that these powers would not be so exercised in this manner and that the shared management of the business would continue (i.e. consider personal relationship between the parties).
- The reasonable expectations of parties in becoming members of company were that the pre-existing partnership obligations continue to underlie the new company.
- Where a member can pointing to special underlying obligation of mutual good faith, trust or confidence, the failure of such a relationship will justify the winding up of the company.

ii. DIRECTORS HAVE ACTED IN AFFAIRS OF COMPANY IN OWN OR OTHERS INTERESTS (S 461(1)(E))

Re Cumberland Holdings
- Directors may be held to have acted in their "own interests" when they have acted in the interests of another company of which they are also directors and shareholders.
- It is sufficient if it is shown that the conduct is unfair or unjust at least to any significant body of other members, and perhaps to any other member.

Re Weedman case
- Facts: Weedmans had an apparel business. Sportscraft purchased a sufficient

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shareholding in the company to appoint their own board members to Weedmans. Once the directors were on the board, the decisions of Weedmans were made in Sportscraft's interests (e.g. allotting shares to Sportscraft's subsidiaries, basically favouring the interests of Sportscraft and their subsidiaries to the detriment of Weedman's share value).
- This was sufficient to justify an order under s 461(1)(e) due to breach of commercial morality.

E. STATUTORY INSOLVENT TRADING

On application for a civil penalty order, a court may order compensation against a director for insolvent trading (s 588J). Likewise, s 588K provides that a criminal court may order compensation (in relation to breach of s 588(3)).

Liquidators may apply for compensation for debts due to the company from directors (s 588M). In certain circumstances, creditors may also apply for compensation from the directors for debts due to them as creditors (s 588R, s 588S and s 588T). However, the creditor must have the written consent of the liquidators, and wait 6 months before giving liquidators notice of intention to obtain permission to pursue directors under s 588M.

The holding or parent company may also be liable for the subsidiary's insolvent trading, if the corporation or one or more of its directors was aware of the insolvent trading (s 588V).

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