company law

> In his final year of schooling at Sydney's St Ignatius College, 16-year-old Charles Curran was asked by one of the priests to name the first man to use economic theories.
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> Curran found that one easy, according to the school's 1954 yearbook.
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> "It was Noah, Father; he was the first man to use the double entry and to float a limited company," he reportedly replied.
>
> Australian Financial Review
> 4 January 1990, p 5

back to basics. When the Commonwealth Solicitor-General, Dr Gavan Griffith, said that it was 'back to basics' as he opened the Commonwealth's defence of the Corporations Act 1989 (*Cth*) in the High Court, Justice McHugh pointed out that this was the slogan used by the NSW Labor Party at the last State election which the Labor Party lost (*Australian Financial Review,* 5 October 1989). Justice McHugh's comment was prophetic. On 8 February 1990, the High Court held that the Commonwealth did not have the power to regulate the incorporation of companies. The challenge to the legislation was confined to this issue as a result of an agreement between the Commonwealth and the challenging States (New South Wales, South Australia, Western Australia and, until it withdrew from the court action, Queensland) (*Australian Financial Review* 9 October 1989).

referral of power. Before the High Court decision, the Commonwealth was succeeding in its moves to a national companies scheme. Last year, Victoria and Queensland agreed to remove constitutional doubts about the operation of the *Corporations Act* in those States by referring their law making power over companies to the Commonwealth and, in return, being guaranteed a share of the revenue from the national scheme.

victoria. The agreement between the Victorian Attorney-General, Mr McCutcheon, and the federal Attorney-General, Mr Bowen, included the following elements:

- Victoria would refer full power to the Commonwealth to regulate companies, securities, takeovers and futures law
- Victorians would be appointed as Deputy Chairman of the Australian Securities Commission (ASC) and Chairman of the Corporations and Securities Panel and the positions would be based in Melbourne
- the Commonwealth would pay 28% of the profits from the administration of companies and securities law to Victoria
- Victoria would hand over all Corporate Affairs Office data bases, computer software and required staff to the Commonwealth (*Australian Financial Review,* 13 September 1989).

queensland. Queensland late agreed to cooperate with the Commonwealth and withdrew from the High Court challenge (*Australian Financial Review,* 4 October 1989). The agreement was similar to that reached with Victoria. It involved Queensland transferring all powers to legislate for companies, securities, takeovers and futures to the Commonwealth in return for a share of the companies scheme revenue. The Queensland Minister for Justice at the time, Mr Ian Henderson, said that the decision was influenced by a commitment by the Commonwealth that the legislation would not be used to regulate the activities of companies in areas such as the environment, consumer credit and industrial relations.

high court's decision. The High Court by a majority of 6 to 1 (Justice Deane dissented) found that the Commonwealth did not have power over the incorporation of companies. It held that the power with respect to 'foreign corporations and trading or financial corporations formed within the limits of the Commonwealth' only extended, in the case of trading or financial corporations formed within the limits of the Commonwealth, to trading and financial corporations which had already been formed under State law. Commentators differed in their opinion of the judgment. In the *Sydney Morning Herald,* Mark Westfield said that the argument of the majority

> is made to look naive by the more sophisticated judgment of the lone voice of Deane, J. He says bluntly that the meaning they have drawn after much agonising over the word "formed" fails to distinguish between "the abstract subject matter of the legislative power" and reality (*Sydney Morning Herald* 9 February 1990).

By contrast, Padraic P McGuinness writing in the *Weekend Australian* said that the majority judgment

> simply looked at the apparent meaning of the corporations power of the Commonwealth as laid down in section 51 of the Constitution, read the convention debates of the 1890s and the drafts of the Constitution, and determined what the actual intention of the framers of the Constitution was. It did not twist any terminology, it did not cite numerous irrelevant precedents, and it did not pretend that words meant other than their clear meaning (*Weekend Australian,* 10–1 February 1990).

effect of the judgment. Professor Harold Ford, part-time Chairman of the Companies and Securities Law Review Committee, identified three options available to the Commonwealth in dealing with the High Court's decision.

- It could negotiate with the States for a referral of powers to enable it to produce national companies law.
- It could accept that the States control incorporation and concentrate on external regulation, including takeovers, the securities industry and public offerings.
- It could remove the provisions relating to incorporation from the Act and enact the balance (*Australian Financial Review* 13 February 1990).

The federal Attorney-General, Mr Bowen, has indicated that the government will adopt the third option. He said

> The Government regards this action as essential to keep faith with the wishes of the business community and Parliament's intention that a national scheme be brought into force at the earliest possible time (*Weekend Australian,* 10–1 February 1990).

However, any action must await the federal election on 24 March. The formal policy of the Liberal Party is to return to the current co-operative companies scheme, but, the Shadow Minister for Business and Consumer Affairs, MrJohn Moore, said that the Liberal Party would probably not return to the co-operative scheme as it is now but would look for a referral from the States to achieve a national scheme ('Chanticleer' *Australian Financial Review* 13 February 1990).

director's duties. In May 1988, the Senate asked the Standing Committee on Legal and Constitutional Affairs to enquire into and report on the social and fiduciary obligations of company directors. The Committee, chaired by Senator Barney Cooney, tabled its report in the Senate on 22 November 1989.

care skill and diligence. Under the current law, the degree of care and skill expected of a director is that which would reasonably be expected of a person of the same knowledge and experience as the particular director. Thus, although there is an objective standard for members of professions or trades such as architects, solicitors, physicians or builders, there is no objective common law standard of the reasonably competent company director. The Committee recommended that the companies legislation provide for an objective duty of care for directors. It recommended that a 'business judgment rule' such as operates in the United States of America be introduced into Australian company law. The rule would protect directors when they make business decisions in relation to the company provided they have informed themselves of matters relevant to the administration of the company and have shown a reasonable degree of care in the circumstances. The Committee also said that directors have to attend board meetings unless there is a reasonable excuse for non-attendance. Under the current law, there is little obligation for directors to attend meetings or take responsibility for decisions made in their absence.

delegation. The current law permits directors to rely on other company officials unless there are grounds to suspect that those officials are not performing their duties honestly. However, there is no requirement that directors actively supervise these officials or positively believe that they are trustworthy. The Committee recommended that the companies legislation specifically limit the extent to which company officers may rely on others. It favoured a recommendation of the American Law Institute which would require that the director act in good faith and reasonably believe that reliance on the other person is warranted.

creditors' rights. The Committee's report examined the developments in case law which impose liabilities on directors where they permit a company to incur debts when it is insolvent or approaching insolvency. The Committee also referred to *Companies Act (Cth) 1981 and Companies Codes* s 556 which makes directors liable for debts incurred when there are no reasonable grounds to expect that they will be paid. It supported the recommendation of the ALRC's *General Insolvency Inquiry* report that s556 be replaced by a clear, rational and readily enforceable provision which permits all creditors to share equally in the sums recovered from the directors of a company.

duties to outside interests. The Committee considered whether directors should have to have regard to interests other than those of shareholders and, in certain circumstances, creditors, for example, the interests of employees, the environment or consumers. It recommended that the companies legislation should make it clear that directors are entitled to take into account the interests of the company's employees since there is a special relationship between employer and employee requiring goodwill between the two. However, it recommended that matters such as the interests of consumers or environmental protection should be dealt with in consumer and environmental legislation rather than the companies legislation. A duty to act fairly between various interests would be vague and, without a legislative set of priorities between the various groups, it would be difficult for a claim by any one group to be upheld. On the other hand, if directors were merely permitted to take other interests into account there would be no breach of duty if they failed to do so and therefore no remedy. Furthermore, the ability of shareholders to bring directors to account for failing to act in the interests of the company would be weakened if the directors could legitimately have regard to the interests of outsiders.

audit committees. The Committee recommended that audit committees, which could scrutinise the financial aspects of company affairs, be provided for in the companies legislation. This would improve accounting and financial control, enhance the credibility of financial reports and public confidence in the company and strengthen the role of non-executive directors by giving them greater access to information. The Committee recommended that the establishment of an audit committee be required for public listing of a company and that the chairperson and a majority, or all, of the members be non-executive directors. Audit committees would have the following functions:

- reviewing financial information to ensure its accuracy and timeliness and the inclusion of all appropriate disclosures
- ensuring the existence and effective operation of accounting and financial controls
- overseeing the audit of the company, including nominating the auditors, approving the scope of the audit and examining the results

- providing a link between the auditors and the board
- any other functions allocated by the company which do not compromise the ability of the committee to perform its main functions.

corporate senates. In a submission to the Committee, Mr Shann Turnbull criticised audit committees on the grounds that an audit committee is a sub-committee of the board, appointed by the board of directors and not by the shareholders. He recommended that a corporate senate be established as a committee of company shareholders elected on the basis of one vote per shareholder rather than one vote per share. Its function would be to resolve all issues where there was a conflict of interest between the directors and the shareholders. While acknowledging the criticism of audit committees, the Committee said that evidence it had received showed they worked effectively both in Australia and overseas and that the concept of a corporate senate did not readily fit with existing company law.

personal liability. The current law makes a director liable for being knowingly concerned in an offence where he or she intentionally gives assistance or encouragement to the commission of that offence. The Committee recommended that a director should also be personally liable where he or she recklessly assists in or encourages an offence by a company. The Committee also considered the relative merits of corporate liability and individual liability for offences. Where corporations rather than individuals are prosecuted as a matter of convenience, regardless of the circumstances, there is a risk that people within the company who ought to be held liable will never be called to account for their actions. The Committee said that the way corporations are prosecuted and punished provides little incentive for them to use their internal disciplinary systems to ensure individual accountability. It recommended that a body such as the ALRC should investigate the appropriate mix of individual and corporate liability.

support for committee. The Chairman of the Trade Practices Commission, Professor Robert Baxt, proposed making directors more accountable and publicly supported the recommendation of the Senate Committee for compulsory audit committees for publicly listed companies and for making directors personally liable for complicity where they intentionally or recklessly assist in, or encourage, an act which constitutes an offence by the company (Sydney Morning Herald, 6 February 1990).

insider trading. On 8 February 1989, the Attorney-General, Lionel Bowen, asked the House of Representatives Standing Committee on Legal and Constitutional Affairs (headed by Mr Alan Griffiths MHR) to conduct an inquiry into insider trading and other forms of market manipulation. The report, entitled *Fair Shares for All: Insider Trading in Australia,* was tabled in federal Parliament on 28 November 1989. The Committee recognised that there were many more insider trading cases before the courts than ever before and acknowledged the argument that, given the lack of case law on insider trading, it should await the outcome of these cases before recommending major amendments to the law. However, it said that, where a significant deficiency or uncertainty in the law is apparent, as was the case with insider trading, Parliament should attend to the matter.

who's in, who's out? The current provisions of the *Securities Industry Act 1980 (Cth) and the State Securities Industry Codes* prohibit dealing in securities by persons who are, or have at any time in the preceding six months been, connected with a body corporate. The Committee recommended that the prohibition on insider trading should extend to any person (including a corporation) who is in possession of insider information and who knows or ought reasonably to know that it is inside information. This definition would include 'tippees' (that is, persons not connected with the corporation but who have been given inside information about the corporation).

inside information. The current legislation refers to information which is not generally available but, if it were, would be likely materially to affect the price of securities. The concept of materiality is not defined in the legislation. In its submission to the Committee, the National Companies and Securities Commission (NCSC) indicated that proving materiality almost certainly requires the calling of expert witnesses. The Committee recommended that, to simplify the legislation, the term 'inside information' should be used and that it should be defined as information which is not generally available, but, if it were, a reasonable person could expect it to have a material effect on the price or value of the securities issued by the company which is the subject of the information.

availability of information. The Committee considered that, consistently with its view that fundamental concepts should be clearly expressed in the legislation, the term 'generally available' should be defined. The Law Council of Australia noted in its submission to the Committee that proposals in America have moved towards specifying the period after the release of information when the information can be regarded as sufficiently absorbed by the market so that insiders are free to trade in securities affected by it. For example, it would be unsatisfactory for an insider to leave a press conference held to reveal information and commence trading before the market had sufficient time to absorb the information. On the other hand, the AMP Society argued that market efficiency would be reduced if it was necessary to wait until every investor had an opportunity to assess information and suggested that the interests of the private investor are best served by allowing market professionals to have instant access to information so as to produce a properly priced security. The Committee recommended that information be defined as generally available where it is disclosed in a manner which would, or would be likely to, bring it to the attention of a reasonable investor and where a reasonable period of time for the dissemination of the information has elapsed. The Committee also recommended that the NCSC or the ASC issue guidelines to assist the commercial community to determine appropriate methods for disclosure of information.

penalties. The Committee said that a truly effective deterrent to insider trading must strike at the profit realised or the loss avoided by that trading so that insider traders risk losing everything which could be gained from the transaction. It recommended that the penalties for insider trading should be twice the amount of profit realised or loss avoided or (in the case of a natural person) $100 000 and (in the case of a body corporate) $500 000 whichever is the greater. The Committee also recommended 5 years imprisonment for natural persons. This could be imposed as well as or instead of the monetary penalty, and the courts should be able to make orders in relation to insider trading matters similar to those available where a person is found guilty of unacceptable conduct during a takeover. The orders could include

- restraining the exercise of voting or other rights attached to shares
- directing the disposal of shares
- vesting shares in the NCSC or ASC
- cancelling a contract or arrangement for the acquisition or sale of shares and
- removing the licence of a professional involved in insider trading.

financial rorts. The Australian Companies and Securities Advisory Committee recently released a paper proposing changes to the companies legislation to overcome some of the abuses which have been revealed by recent company crashes. The paper was prepared by Mr John Kluver, the executive director of the Committee, and Ms Jillian Segal. The proposals focus on three aspects of corporate financial transactions.

loans to directors. Loans to directors of more than $5000 would be prohibited except for those related to housing and share schemes. Loans of up to $5000 could be approved by disinterested directors. The approval of disinterested shareholders would be required for the other categories of permitted loans. The ASC would have the opportunity to object to a court about a loan up to 21 days after the meeting of shareholders. Shareholders would not be permitted to approve loans exceeding 5% of shareholders' funds as at the date of the loan unless the prior consent of the ASC to a meeting of shareholders for that purpose had been obtained. Directors who approve the loan have to provide shareholders with financial impact and solvency statements and to state that the loan was fair and reasonable. They would be personally liable for amounts outstanding on the loan if the statements were inaccurate or if the proper procedure for disclosure and consent had not been followed. The restriction on loans to directors would extend to those who were directors in the six months before, or became directors in the six months after, being lent the money. The Committee suggested that the legislation could require persons who become directors after being lent the money to repay the money, obtain consent within a certain period or obtain an extension of time or waiver from the ASC.

loans to related companies. All loans to related companies would require the approval of directors. As in the case of loans to directors, the directors would be required to make solvency and financial impact statements and would be liable for incorrect statements and failure to follow the correct procedures. The Committee proposed that loans to related and connected companies should not exceed 10% of the shareholders' funds without the prior consent of the ASC and of disinterested shareholders. Related companies are defined in the existing companies legislation s7(5) and the *Corporations Act 1989* (*Cth*) s50. A connected company would be defined as one in the shares of which the lending company or any substantial shareholder of the lending company had a relevant interest of 20% or more. Less stringent procedures would apply to wholly owned subsidiaries.

remuneration. Details of remuneration and other payments to directors, senior executives and consultants and any legal entity (such as a company or partnership) in which these persons individually or in aggregate have a relevant interest of 10% or more should be disclosed promptly to the ASC and in the company's next annual return and report to shareholders.

new zealand. The New Zealand Government proposes to introduce securities legislation and companies legislation this year. The securities legislation would change the constitution of the Securities Commission from a law reform body to a supervisory body focussing on public securities markets and self regulatory organisations. The companies legislation would implement recommendations of the New Zealand Law Commission (see [1989] *Reform* 139). Amendments would include

- abandoning the notion of par value and nominal capital in relation to shares
- enabling companies to buy their own shares and finance acquisition of their shares
- recognising the circumstances in which the interests of shareholders need special protection
- requiring experience and independence in those conducting liquidations and receiverships.

While New Zealand may be ready to embark on its reforms of company law, reform of Australian company law in relation to directors' duties, insider trading and loans to directors must await the determination of how Australian company law as a whole should be regulated.

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