Transactions Involving Australian Public Companies and Their Related Parties

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SUMMARY

The *Corporate Law Reform Act* 1992 (Cth) introduced a new regime for the regulation of transactions involving Australian public companies and their related parties. The new regime came into effect on 1 February 1994. It prohibits companies, and their child entities, from giving financial benefits to related parties, subject to certain exceptions. The new provisions are set out in Pt 3.2A of the Corporations Law (the Law).

This paper examines the scope of the new provisions and their

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application in practice to some common related party transactions. The existence of the statutory and common law duties that directors owe to their companies, when combined with the statutory exceptions to the related party transactions prohibition, means that the operation of the new regime has been limited in its practical application. However, this paper also concludes that the new prohibition provides a useful reminder to directors when public companies consider entering into such transactions.

INTRODUCTION

It is common for Australian public companies to be involved in transactions with related parties, such as their directors, controlling shareholders and related bodies corporate.[1] Since 1 February 1994 the Law has included a general prohibition against public companies, and their child entities, entering into related party transactions. Parliament's reason for introducing this statutory restriction is reflected in the object of the related party provisions as stated in the Law. That object is set out in the Law in the following terms:

The object of the related party provisions of the Law is to protect:

1. a public company's resources (in particular, those available to pay the company's creditors); and
2. the interests of its members as members;

by requiring that, in general, financial benefits to related parties that could diminish or endanger those resources, or that could adversely affect those interests, be disclosed, and approved by a general meeting, before they are given.[2]

While the object stated above indicates that the general prohibition is intended to prevent public companies from giving "financial benefits" to related parties, the terms of the legislation are not so restricted. Indeed, the related party transactions prohibition will apply to almost every transaction involving Australian public companies and their related parties.

Before turning to consider the application of this new statutory prohibition against related party transactions it is instructive to consider the background to the law reform initiative that resulted in the introduction of those provisions.

1. The most common examples of related party transactions are the payment of remuneration (including the provision of fringe benefits) by public companies to their directors and the payment of dividends and other distributions to controlling shareholders. Other examples include the supply of goods or services (including the making of loans, the provision of guarantees, etc) by controlling shareholders or directors to their companies. In this paper a transaction involving an Australian public company and any of its related parties is referred to as a related party transaction.
2. Section 243A of the Corporations Law (the Law).

BACKGROUND TO THE LAW REFORM

The genesis of Australia's statutory regulation of related party transactions is to be found in the law reform proposal published by the Companies and Securities Advisory Committee (CASAC) in December 1989.[3] CASAC considered the state of Australia's law regulating related party transactions in the aftermath of the failure of a number of high profile Australian public companies in the late 1980s. Not surprisingly, as a result of these failures, CASAC recommended reform of the law governing three aspects of corporate financial transactions. They were:

1. loans to directors;
2. loans to related and connected companies; and
3. executive and intra-group remuneration.

CASAC's recommendations resulted from its assessment that the then current law governing loans to directors,[4] being the only relevant statutory regulation, was defective in certain important respects.[5] The proposed reform of the "loans to directors" prohibition, and the proposed introduction of regulations governing loans between related or connected companies, were designed to deal with:

> "possible mischiefs and in addition they introduce further regulatory mechanisms to guard against abuse."[6]

Unfortunately, CASAC did not at that time clearly identify the "possible mischiefs" that the reform proposals were intended to deal with. Indeed, CASAC expressly acknowledged that the rules relating to directors' duties and conflicts of interest were not necessarily inadequate.[7] It seems that CASAC felt that a strong response was needed because of the serious impact that perceived abuses in this area were having on public confidence

3. "Discussion of and Proposals on Reform in Principle of Australian Law Relating to Loans to Directors, Loans to Related and Connected Companies and Executive and Intra-Group Remuneration", Companies and Securities Advisory Committee, December 1989 (CASAC Discussion Paper).
4. Section 230 of the *Companies (Victoria) Code* and of each other State.
5. The ambit of the legislation then in force was thought to be inadequate because it failed to apply to certain persons (such as those who were directors or other associated persons within six months prior to a loan being made, or who became directors or associated persons within six months after a loan was made) and that the procedures for permitted loans to directors were unsatisfactory: see para 4.15 of the CASAC Discussion Paper, op cit n 3.
6. Paragraph 4.15 of the CASAC Discussion Paper, op cit n 3.
7. Paragraph 1.2 of the CASAC Discussion Paper, op cit n 3. The impact of the statutory and common law duties of directors (such as those obliging directors to avoid a conflict of interest, to exercise their powers for proper purposes and to act in good faith in the best interests of the company) needs to be considered in respect of each related party transaction. See, for example, *Mills v Mills* (1938) 60 CLR 150; *Whitehorse v Carlton Hotel Pty Ltd* (1987) 5 ACLC 421; *Permanent Building Society (in liq) v Wheeler* (1994) 12 ACLC 674. The duties of directors may prevent companies from entering into related party transactions, even if those transactions are permitted by Pt 3.2A of the Law without shareholder approval being required (eg, a transaction falling within the "arm's length" exception could, if entered into for an improper purpose, be in breach of the directors' duties).

in business activities.[8]

During the year following the release of its recommendations, CASAC circulated to the public an exposure draft Bill to amend the law in accordance with its law reform proposals.[9] This draft Bill provoked an outcry of resistance from the business community. Serious concerns were expressed about the likely costs of complying with the proposed complex regime that would regulate this area.

In consequence of its further deliberations, and after careful consideration of the submissions that it received, CASAC prepared another draft Bill,[10] which differed in material respects from its first Bill. CASAC stated that the new Bill was designed to perform an independent yet complimentary function to the existing common law and statutory obligations of directors.[11] It was thought necessary to extend the regulatory net to deal not only with inter-corporate loans, but also to regulate asset transfers. CASAC recognised that the proposed Bill would cover various transactions coming within Listing Rule 3J(3) of the Australian Stock Exchange,[12] but this was thought necessary in order to apply the new rules to a greater number of companies (not just listed companies), and to ensure that criminal and civil liabilities were attracted in the event of a breach.[13]

CASAC again justified its extensive law reform proposals by reference to the corporate collapses of the 1980s, and to the fact that:

> "it has become evident that some corporate controllers abused their positions of trust by arranging for the shifting of assets around and away from companies and corporate groups, and into their own hands. They achieved this by various means, including remuneration payments, asset transfers or loan arrangements, on terms highly advantageous to themselves but to the detriment of these companies. In other instances, substantial inter-corporate loans were entered into with the apparent purpose or effect of disguising the true financial position of individual companies within a group. This was made easier by the lack of any general statutory requirement that shareholders either consent to, or be informed of, these transactions. These abuses generally involve significant losses of corporate funds, with adverse effects on investor and creditor returns and confidence. They also brought into question the integrity of Australian financial

8. Paragraph 1.1 of the CASAC Discussion Paper, op cit n 3.
9. Corporations Amendment Bill 1991 (Cth), CASAC, September 1990.
10. "Report on Reform of the Law Governing Corporate Financial Transactions", CASAC, July 1991 (the Report on Reform).
11. Ibid, p 4.
12. At that time ASX Listing Rule 3J(3) essentially prohibited a listed company from acquiring assets from, or disposing of assets to, a substantial shareholder or a director or any of their associates, where the value of those assets exceeded 5% of the listed company's shareholders' funds. CASAC's proposed introduction of a statutory equivalent of Listing Rule 3J(3) did not proceed. As a result of the ASX's introduction of "simplified" listing rules on 1 July 1996, Listing Rule 3J(3) is now contained in Ch 10 of the listing rules.
13. Report on Reform, op cit n 10, p 4.

markets, with detrimental consequences for the national economy."[14]

The redrafted Bill released by CASAC once again provoked strong opposition from the business community. Notwithstanding this, Parliament decided that it was necessary to implement legislation to deal with the perceived problems. This resulted in the introduction of the Corporate Law Reform Bill 1992 (Cth). The relevant provisions of this Bill were radically redrafted following their consideration by Parliament. However, Parliament ultimately approved new laws regulating the giving of financial benefits to related parties of Australian public companies. That legislation, which is contained in Pt 3.2A of the Law, is far less onerous than the provisions recommended by CASAC.

PART 3.2A OF THE CORPORATIONS LAW

The new Pt 3.2A, regulating "Financial Benefits to Related Parties of Public Companies", was inserted into the Law on 1 February 1993. It replaced the former "loans to directors" prohibition in s 234 when it came into effect one year later.

The long lead time prior to the implementation of the provisions regulating related party transactions enabled public companies to review and consider the application of the new statutory regime to their operations. It also permitted them to obtain shareholder approval for any transactions which would otherwise have been prohibited by the new legislation.

Accordingly, since 1 February 1994 specific legislation has applied in Australia to a range of transactions commonly entered into by public companies with their related parties. Despite the introduction of this new legislation, the approach adopted in practice by most public companies to related party transactions has not altered significantly. The reason for this is considered later in this paper.

It is worth noting that the general prohibition against related party transactions, which is outlined below, applies not only to listed companies, but also to every other public company (except for charitable and other companies that have been granted a licence to exclude the word "limited" from their names).[15]

General prohibition

Part 3.2A of the Corporations Law provides that:

1. a public company must not give a "financial benefit" to a "related party"; and
2. a "child entity" of a public company must not give a financial benefit to a related party of the public company,

except for certain permitted transactions or unless shareholder approval is

14. Report on Reform, op cit n 10, p 1.
15. See the definition of "public company" in s 9.

obtained.[16]

When this general prohibition was first introduced there was considerable concern by public companies as to how their operations would be affected by the new restrictions. The initial widespread concern was, however, misplaced. Despite the broad application of the general prohibition, public companies have not been prevented from entering into ordinary commercial transactions. This has been due to the practical operation of the statutory exceptions. These are discussed below.

Before turning to the statutory exceptions, it is first necessary to appreciate the very wide application of the general prohibition.

Financial benefits, related parties and child entities

As noted above, the general prohibition applies where a "financial benefit" is given by a public company or its "child entity" to a "related party". Each of these expressions is defined in Pt 3.2A of the Law.

Financial benefit

The term "financial benefit" has a very broad meaning.[17] It catches any situation where a company's resources are transferred, even if the other party to the transaction gives full consideration.[18]

The legislation provides that in order to decide whether an entity has given a financial benefit:

> "(a) the economic and commercial substance and effect of what the entity has done is to prevail over its legal form; and
>
> (b) any consideration that has been or may be given for the benefit is to be disregarded, even if it is full or adequate."[19]

The legislation also provides that a benefit which does not involve the payment of money can still be a financial benefit. Indeed, the granting of a benefit by a public company will be caught by the prohibition so long as it confers some financial advantage.[20]

Examples of financial benefits

A few examples of an entity giving a financial benefit to another entity are:

1. lending money, guaranteeing a loan or providing security for a loan to the other;
2. forgiving a debt owed by the other, otherwise releasing or neglecting

16. Section 243H of the Law.
17. Section 243G(1) of the Law. A reference to a company giving a financial benefit includes a reference to giving a financial benefit indirectly (for example, through one or more interposed entities) or by making or giving effect to a relevant agreement as defined in s 9.
18. Section 243G(2) of the Law.
19. Ibid. Accordingly, even transactions that are entered into between parties negotiating at arm's length are caught by the prohibition. But in such a case the statutory exception for "arm's length transactions" (see below) will apply.
20. Section 243G(3) of the Law.

to enforce an obligation of the other or assuming an obligation of the other;
3. buying or leasing an asset from, or selling or leasing an asset to, the other;
4. acquiring services from, or supplying services to, the other;
5. issuing securities, or granting an option, to the other; and
6. giving money or property to the other.[21]

It can be seen from this list of examples that most transactions are caught by this legislation. In fact it is difficult to think of transactions that are not caught. It is clear that transactions commonly entered into by public companies with directors will fall within the prohibition. For instance, the allotment of shares or the granting of options to directors (or to their immediate relatives or to companies controlled by them) are subject to the legislation. In addition, ordinary commercial dealings (such as purchases and sales of goods in arm's length transactions) between public companies and their directors will be caught.

The wide range of transactions caught by this legislation can be contrasted with the previous prohibition, as s 234 of the Law only applied to loans to directors. There was, however, one important relaxation of the statutory position as a result of the introduction of Pt 3.2A. For the first time in 30 years, the statute permitted companies to make loans to their directors on arm's length terms without requiring them to obtain shareholder approval.

Related parties

The definition of a "related party"[22] is intended to include all persons in a position to exercise control over the company. This includes holding companies and other "parent entities"[23] as well as directors, most of their immediate relatives, and entities controlled by the directors.[24]

In contrast to the former restriction in s 234 of the Law, the current provisions catch persons who were related parties within the previous six months, or are likely to become related parties at some future time.[25]

Child entity

An entity is a "child entity" of another entity if the other entity is its "parent entity". An entity is a "parent entity" of another entity if:

"(a) both are bodies corporate and the first entity is a holding

21. These examples are set out in s 243G(4) of the Law.
22. See Section 243F of the Law.
23. A "parent entity" is defined in s 243D(1) of the Law and discussed below.
24. Section 243F(1) of the Law. The Corporations Law Simplification Task Force (the Task Force) has proposed that the definition of a "related party" be expanded by the addition of grandparents, grandchildren, and brothers and sisters of directors and their spouses or de facto spouses, and any entity controlled by any of them: see of "Officers and Related Party Transactions", Proposal for Simplification, Simplification Task Force, October 1995, para 12.
25. Section 243F(2) and (3) of the Law.

company of the other; or

(b) the first entity has control over the other."[26]

The most difficult aspect of this definition is whether one entity has "control" over the other. This issue is analysed in detail later in this paper. For present purposes it is sufficient to note that the legislation incorporates the definition of "control" from accounting standard AASB 1017, which deals with related party transactions.

As a result of these definitions that an entity will be regarded as a child entity if it is controlled by another entity (that is, the parent entity) and will thus be prohibited by s 243H(2) of the Law from giving financial benefits to related parties of its parent entity.

The legislation contains a very wide definition of an "entity". That term is defined to include not only companies, but also partnerships, individuals, trusts and unincorporated bodies.[27] The aim of this wide definition is to ensure that a benefit that is given to any person or organisation falls within the prohibition.

Exceptions to the general prohibition

There are a number of specific exceptions to the general statutory prohibition.[28] If a proposed transaction does not fall within a specific exception it will be necessary for the relevant public company to obtain shareholder approval before the transaction is implemented.

The specific exceptions are:

1. Benefits given under contracts existing prior to the commencement of the legislation on 1 February 1994.[29]
2. Remuneration paid to an officer of a company in that person's capacity as an officer:

   "if it is reasonable for a body corporate in the body's circumstances to pay or provide that remuneration to an officer in the person's circumstances."[30]

   Remuneration is defined to include salary, wages, bonuses, allowances (to meet expenses), fringe benefits and superannuation contributions made by the company.[31]
3. Advances of up to $2,000 to a director or a director's spouse.[32]
4. Benefits passing between a wholly-owned subsidiary and its holding company.[33]

26. Section 243D(1) of the Law.
27. Section 243C of the Law.
28. These exceptions are set out in Div 4 of Pt 3.2A of the Law.
29. Section 243J(1) of the Law. This exception does not apply if s 234 of the Law, as it then existed, prohibited the public company or child entity from giving the benefit to the related party.
30. Section 243K of the Law.
31. This exemption is analysed below under the heading "Directors' remuneration and retirement benefits".
32. Section 243L of the Law.
33. Section 243M of the Law.

5. Benefits given on arm's length terms. Those terms must be:

   "no more favourable to the related party than those on which it is reasonable to expect that the company or entity, as the case may be, would give the benefit directly if dealing with the related party at arm's length in the same circumstances."[34]

   The legislation contains specific guidance as to the factors that should be considered when determining whether a loan to a related party would be at arm's length.[35] The matters to be examined include the following (the list is not exhaustive):

   (a) the amount of the loan or the extent of the accommodation;
   (b) the credit risk;
   (c) the security provided; and
   (d) the timetable for repayment of principal and for payment of interest or charges.

6. A benefit may be provided to any member of a public company if it is provided to the member in its capacity as a member and does not discriminate unfairly, either directly or indirectly, in favour of one or more related parties of the relevant company.[36]
7. A benefit can be given pursuant to an order of a court.[37]

Shareholder approval

There is also a general exception to the statutory prohibition against related party transactions. A financial benefit can be given to a related party if the benefit has been specifically approved by the shareholders of the public company in general meeting.[38]

Detailed rules are set out in the legislation in order to regulate the disclosure of information that is to be made to shareholders, the way in which interested parties are disqualified from voting, how the relevant meeting to approve the transaction is to be conducted and related matters.

For the purposes of this paper, it is sufficient to note that shareholders must be provided with an explanatory statement that satisfies the disclosure requirements specified in s 243V of the Law. That section requires the explanatory statement to set out the nature of the financial benefit to be provided, together with all other information known to the company and its directors that is reasonably required by shareholders in order to decide whether it is in the company's interest to pass the proposed resolution.

34. Section 243N(1) of the Law. The operation of this exception is analysed in detail below under the heading "Arm's length transactions".
35. Section 243N(2) of the Law.
36. Section 243PA of the Law.
37. Section 243PB of the Law.
38. The requirements that need to be satisfied in order for shareholder approval of the financial benefit to be effective are set out in Div 5 of Pt 3.2A of the Law. A public company, or child entity of a public company, may give a financial benefit to a related party of the public company if a resolution approving the benefit was passed at a general meeting of the public company held within 15 months before the benefit is given: see ss 243Q and 243R of the Law.

This broad disclosure requirement is supplemented by an example, which is set out in s 243V(2), of the kind of information that the legislation requires to be disclosed. The example given is that disclosure is required of:

> "information about what, from an economic and commercial point of view, are the true potential costs and detriments of, or resulting from, giving financial benefits as permitted by the proposed resolution, including (without limitation):
> (a) opportunity costs;
> (b) taxation consequences (such as liability to fringe benefits tax); and
> (c) benefits foregone by whoever would give the benefits."

As a result of this onerous disclosure obligation, most public companies prefer to avoid having to seek shareholder approval to related party transactions. Of course, this can only be done if one of the specific exceptions referred to above applies.

It is also worth noting that where shareholder approval is required, the Australian Securities Commission (ASC) must be given the opportunity to comment on the information to be put before shareholders, and any comments made by the ASC must be provided to shareholders.[39]

Liabilities for contravention

Neither the public company nor its child entity will be guilty of an offence if it contravenes the statutory prohibition against related party transactions.[40] However, the related party and all persons involved in the contravention will be liable.[41] The directors of the public company or of the child entity giving the financial benefit, in particular, will be at risk. But it should be appreciated that liability for a contravention of the statutory prohibition extends beyond the company's directors to those who are "involved"[42] in the contravention and to those who are, by act or omission,

39. Sections 243U, 243W and 243X of the Law. The ASC must be given 14 days within which to consider the documents, but this time period can be abridged by the ASC under s 243U(2). The ASC has exercised this discretion to shorten the document lodgment period on a number of occasions, and has even reduced the time period to a matter of hours where it has been provided with advance drafts of the documents: see ASC Policy Statement 76, where the ASC indicates when it will grant relief in this respect and how it will exercise its discretion in relation to allowing related parties and their associates to vote.

40. Section 243ZE(1) of the Law.

41. Section 243ZE(2) and (3) of the Law. Some guidance as to the application of these provisions can be gained from a recent case where, in another context, a bank was found liable for damages where it had been involved in a breach of s 205: *Hunters Products Group Ltd v Kindly Products Pty Ltd* (1996) 14 ACLC 826.

42. Persons involved in a contravention are defined in s 79. There are conflicting authorities in relation to the question of whether, to be "knowingly concerned in" a contravention, actual knowledge of each of the essential elements that constituted the contravention is required, or whether it is merely necessary to establish knowledge of the facts involved. *Yorke v Lucas* (1985) 61 ALR 307 is the seminal case, which has been affirmed in *Edwards v* R (1992) 173 CLR 653. The cases, such as *Wheeler Grace & Pierucci Pty Ltd v Wright* [1989] ATPR 40-940, which adopt the view that it is merely necessary to prove that there was knowledge of the acts in question appear to involve a misapplication of the High Court's decision in *Yorke v Lucas.*

directly or indirectly, recklessly concerned in, or party to, the contravention.[43]

A person who contravenes the statutory prohibition will be exposed to a civil penalty of up to $200,000 and, in the case of officers, disqualification from being able to act as an officer.[44]

CONTROL

As noted earlier in this paper, the definition of "control"[45] is central to the question of whether one entity is the parent entity of the other and is therefore related to it.

Accounting standard AASB 1017 defines "control" to mean:

> "the capacity of an entity to dominate decision making, directly or indirectly, in relation to the financial and operating policies of another entity so as to enable that other entity to operate with it in pursuing the objectives of the controlling entity."

AASB 1017 commentary

The commentary to AASB 1017 expands on the meaning of control. While the commentary does not form part of the accounting standard, it may be used in the interpretation of the standard, subject to s 109J of the Law[46].

Paragraph (xiii) of the commentary to AASB 1017 provides that:

> "any of the following factors would normally indicate the existence of control by one entity of another entity:
> (a) the capacity to dominate the composition of the board of directors or governing board of another entity;
> (b) the capacity to appoint or remove all or a majority of the directors or governing members of another entity;
> (c) the capacity to control the casting of a majority of the votes cast at a meeting of the board of directors or governing board of another entity;
> (d) the capacity to cast, or regulate the casting of, a majority of the votes that are likely to be cast at a general meeting of another entity, irrespective of whether the capacity is held through shares or options; and

43. Section 243ZE(3) of the Law.

44. Section 243ZE(5) and Pt 9.4B of the Law. It should be noted that Pt 9.4B of the Law may restrict the operation of s 1324 so that it cannot be used in respect of a contravention of Pt 3.2A of the Law (*Mesenberg v Cord Industrial Recruiters* (1996) 14 ACLC 519), but this does not appear to be the better view.

45. Section 243E of the Law. The term "control" is defined in para 9 of AASB 1017.

46. Section 109J allows extrinsic material to be used to determine the meaning of a provision when the provision is ambiguous or obscure: see AASB 1017, para 3 and *Solomon Pacific Resources NL v Acacia Resources Ltd No 2* (1996) 14 ACLC 637.

(e) the existence of a statute, agreement, or trust deed, or any other scheme, arrangement or device which, in substance, gives an entity the capacity to enjoy the majority of the benefits and to be exposed to the majority of the risks of that entity, notwithstanding that control may appear to be vested in another party."

The factors set out above in subparagraphs (a)-(d) of paragraph (xiii) are similar to those taken into account in determining whether a body corporate is a subsidiary of another body corporate within the meaning of s 46 of the Law.[47] However, the definition of control in AASB 1017 and the commentary relating to it deal with a "capacity" to control, rather than control itself. It should also be noted that, in considering the "capacity" to control the casting of votes at a general meeting, reference is made in subparagraph (d) above to the majority of the votes likely to be cast, rather than to the number of votes that might be cast, which is the test under s 46(a)(ii). The test of control under AASB 1017 is on the whole considerably wider than the subsidiary test set out in s 46.

Capacity

The concept of "control" for the purposes of the related party transactions provisions is concerned with the capacity of a party to dominate decision-making in relation to certain policies of an entity. Capacity is defined in AASB 1017 to mean the:

> "ability or power, whether direct or indirect, and includes ability or power that is presently exercisable as a result of, by means of, in breach of, or by revocation of, any of or any combination of the following:
> (a) trusts;
> (b) relevant agreements; and
> (c) practices;
> whether or not enforceable."[48]

The fact that "control" is defined by reference to the "capacity" to dominate decision-making means that it is not necessary that such domination actually occur. Rather, it is enough if there is a potential for domination. Similarly, the concept of "capacity" to dominate is concerned with the ability or power to exercise dominance. It is unnecessary to show the actual exercise of that power, or the fact of dominance.

Accordingly, it can be seen that the definition of control is very wide indeed. Careful consideration therefore needs to be given to any case where it is necessary to determine whether one entity is the parent entity, and

47. See *Mount Edon Gold Mines (Aust) Ltd v Burmine Ltd* (1994) 12 ACLC 185 and *Bluebird Investments Pty Ltd v Graf* (1994) 12 ACLC 724.

48. Paragraph 9 of AASB 1017. Some guidance on the way in which the court will interpret this provision is provided by the decision in *Equiticorp Industries Ltd v ACI International Ltd* (1987) 5 ACLC 237, where the court had to consider whether a person was in a "position" to control voting power.

therefore a related party, of the other.

PARTICULAR TRANSACTIONS

It is obvious that public companies need to monitor their operations to ensure compliance with Pt 3.2A of the Law. The following areas require careful scrutiny.

Directors' remuneration and retirement benefits

In order to fall within the specific "reasonable remuneration" exception, the remuneration of each director must be "reasonable" having regard to the particular circumstances of the company and the relevant director. This means that public companies must obtain sufficient information and carefully consider all relevant factors in determining whether the remuneration of their directors is reasonable. Most public companies have remuneration committees, comprised predominantly of non-executive directors, which perform this task (often with assistance from external consultants).

In considering whether a director's "remuneration" is reasonable, the whole salary package must be looked at. In the case of executive directors, remuneration obviously includes salaries and bonuses.[49] But remuneration for this purpose also includes allowances paid for the sole purpose of meeting expenses incurred in the performance of a director's duties.[50] In addition, the legislation specifies that fringe benefits,[51] superannuation contributions,[52] D&O insurance premiums[53] and the indemnification of a director against liabilities incurred as an officer of the company[54] constitute remuneration.

This deeming of indemnification to be a category of remuneration gives rise to difficulties. First, it is not possible to value an indemnity granted to a director in order to determine whether the director's remuneration during the year in which the indemnity is granted is reasonable. Secondly, if a payment is made to a director under an indemnity it will again be difficult to say whether the director's remuneration in the year of payment is reasonable, particularly if the payment is a large one.

It is not clear why the granting of indemnities, and any payment subsequently made under them, should be deemed to be remuneration at all. It would be more logical if indemnities constituted a separate exception

49. Section 243K(4) of the Law.
50. Ibid. It is noteworthy that para (d) of this section only refers to "allowances" and does not extend to the "reimbursement" of expenses.
51. Section 243K(5) of the Law.
52. Section 243K(6) of the Law.
53. Section 243K(7B) of the Law. This provision, like that specified in footnote 54, was inserted in the legislation on 15 April 1994.
54. Section 243K(7A) of the Law.

to the general related party transactions prohibition.[55]

Retirement benefits are also deemed by the legislation to constitute remuneration, so it will be necessary to ensure that they are reasonable. Retirement benefits will not be reasonable merely because they fall within the limits permitted by s 237 of the Law (that is, emoluments for the last three years in the case of non-executive directors and seven times final average emoluments for executive directors). Once again a difficulty arises in relation to retirement benefits. It seems that it is necessary to determine not only whether the retirement benefit itself is reasonable, but also whether the other remuneration paid or provided to the director during the year in which the retirement benefit is received is reasonable.[56]

Group companies must pay particular attention to the directors' remuneration exception. The exception will only apply where remuneration is paid or provided directly to a director.[57] The exception does not appear to apply when, for example, an executive director is employed by a service company in a group and the service company is reimbursed by another group company for the cost of providing the director's services to that company.

Directors' business expenses

There is no clear exception permitting public companies to pay or reimburse business expenses incurred by directors.

As noted above, the remuneration exception permits a company to pay or provide benefits to directors in the nature of "fringe benefits" and allowances "for the sole purpose of meeting expenses incurred in connection with performing services" as an officer. This exception may not, however, cover all business expenses that are commonly paid or reimbursed by public companies. There seems to be no logical reason for this.

Most business expenses incurred by public company directors (including costs incurred in attending directors' meetings, business lunches, subscriptions to professional bodies, acquisitions of magazines, et cetera) are paid or reimbursed by their companies. Perhaps the only explanation for the exclusion of such expenses (to the extent that they do not constitute fringe benefits) is that they are not regarded as financial benefits at all.

55. The Task Force has in fact suggested the repeal of ss 243K(7A) and (7B) of the Law, and their replacement with what would appear to be a separate exception: see "Officers and Related Party Transactions", Proposal for Simplification, Simplification Task Force, October 1995, para 17.

56. The reason why this difficulty arises is that the "reasonable remuneration" exception appears to require an aggregation of all remuneration (including deemed remuneration) paid or provided to a director to be considered in order to determine whether any element of that remuneration may infringe the statutory prohibition.

57. This is because s 243K(1) of the Law states that a body corporate may pay or provide remuneration to a person in a capacity as an officer of the body if it is reasonable to do so. It seems clear that the person must receive the remuneration in their capacity as an officer of the body paying or providing the remuneration, rather than in their capacity as an officer of some other (related) body.

Arm's length transactions

The exception to the prohibition that is most commonly relied upon in practice in respect of related party transactions is that permitting a public company, or a child entity of a public company, to give a financial benefit to a related party of the public company on arm's length terms.

The meaning of "arm's length" in this context has not yet been tested in the courts. However, the same expression has often been interpreted for the purposes of taxation law. It is likely to be given a similar meaning when interpreted by a court for the purposes of Pt 3.2A of the Law. In relation to taxation law, the courts have held that parties will be regarded as dealing with each other in respect of a particular matter at arm's length if "the outcome of their dealing is a matter of real bargaining".[58]

It should be noted, however, that the taxation cases have often been concerned with a distinction that is not relevant for the purposes of the related party transactions provisions. For taxation purposes, the question is not whether the parties were at arm's length, but rather whether they were dealing with each other at arm's length. This distinction was considered by Hill J in *The Trustee for the Estate of the Late A W Furse No 5 Will Trust v Federal Commissioner of Taxation*[59] where his Honour said:

> "The fact that the parties are themselves not at arm's length does not mean that they may not, in respect of a particular dealing, deal with each other at arm's length. This is not to say that the relationship between the parties is irrelevant to the issue to be determined.
>
> ...
>
> What is required in determining whether parties dealt with each other in respect of a particular dealing at arm's length is an assessment whether in respect of that dealing they dealt with each other as arm's length parties would normally do, so that the outcome of their dealing is a matter of real bargaining."

Similarly, it is not necessary for the parties to be at arm's length for the purposes of Pt 3.2A of the Law. The question here will be whether the parties have dealt with each other in a way that has resulted in the terms of the transaction being no more favourable to the related party than they would have been if the parties had dealt with each other at arm's length.

In order to rely upon the arm's length exception, it should therefore not be necessary for companies to show that their related party transactions were the result of real bargaining. But it is important to ensure that where a public company, or a child entity of the public company, provides, for example, services to a related party (such as a parent entity), those services

58. See, for example, *The Trustee for the Estate of the Late A W Furse No 5 Will Trust v Federal Commissioner of Taxation* (1990) 91 ATC 4,007; *Granby Pty Ltd v Federal Commissioner of Taxation* (1995) 95 ATC 4,240. The Commissioner of Taxation has adopted a similar test for international transfer pricing purposes (namely, that an "arm's length consideration should be consistent with the consideration that would arise as a result of real bargaining between independent parties").

59. (1990) 91 ATC 4,007.

are provided on a basis that can be justified (where possible, by reference to similar transactions with third parties and, in some cases, by reference to the views of an independent expert).[60]

Intra-group transactions

Any transaction between a partly-owned public company and its "parent" will need to fall within the "arm's length" exception mentioned above. If this exception is not available in respect of the particular transaction, and arrangements did not exist prior to 1 February 1994 (so as to fall within the "existing contract" exception), then shareholder approval will need to be obtained.

In particular, transactions between parent entities and public companies that are parties to joint ventures need to be considered carefully. While a parent entity can provide a benefit to such a joint venture company, any transaction passing resources from the joint venture company to the parent entity needs to fall within one of the exceptions to the statutory prohibition against related party transactions.

CONCLUSION

A consideration of the application of Pt 3.2A of the Corporations Law to particular transactions indicates that the scope of the new statutory regime is limited in practice. Despite the width of the general prohibition against public companies being involved in transactions with their related parties, the statutory exceptions provide considerable scope for avoiding the application of the new regime.

Indeed, it could well be argued that the existing statutory and common law duties of directors provide adequate regulation in respect of related party transactions. Those duties provide an effective prohibition against directors permitting their companies to enter into transactions that are not in their best interests. Accordingly, the scope of separate operation of the new legislation is limited to transactions that, although in the best interests of the company concerned, are caught by the general prohibition and do not fall within one of the statutory exceptions. The number of transactions of this kind is limited because of the breadth of the exceptions (particularly the "arm's length" transactions exception).

It seems that the only transactions that are prohibited by the new regime, but are not prohibited by the laws relating directors' duties, are those that are in the best interests of the company, despite the fact that the terms of the transaction are not as favourable to the company as they would have

60. For example, if a public company were to provide the services of its in-house legal counsel to, say, a joint venture entity in which the company is involved on a particular time charging basis, then a similar basis of charging should be adopted in relation to the provision of legal services to its parent entity in comparable circumstances.

been if the transaction was entered into on an arm's length basis.

An example of such a transaction may be found in the allotment of securities (shares or options) to executive directors at less than market value. The non-executive directors of the company concerned may believe it is in the company's best interests to allot securities to executives at a discount to their real value, in order to provide an incentive to management to improve the performance of the company. In such a case, the allotment would not put the directors in breach of their duties despite the transfer of value from the company to the directors concerned. Assuming that such an allotment of securities did not form part of the executive director's remuneration package, the transaction would be prohibited by the new regime unless shareholder approval was obtained.

The scope of the application of the new regime is therefore limited in practice. But this is not to say that it does not serve a useful purpose. It can be strongly argued that the statutory prohibition against related party transactions constitutes a salutary reminder for directors that such transactions should only be entered into after careful consideration of their terms. Like the statutory prohibition against public company directors taking part in transactions in which they have a material personal interest,[61]reflecting as it does the common law obligation to avoid conflicts of interest. Part 3.2A of the Law provides a useful signpost for public company directors when considering transactions with their related parties.

61. Section 232A of the Law.