Are the objects stated in s. 243A *Corporations Law* achieved in Part 3.2A?

Annette Donselaar*

1. Introduction

The role and scope of directors has changed markedly over time. Gone is the view that:

> No effort of any kind is called for. You go to a meeting once a month in a car supplied by the company. You look both grave and sage and on two occasions say 'I agree', say 'I don't think so' once, and if all goes well, you get 500 pounds per year. If you have five of them, it is total heaven, like having a permanent hot bath.[1]

This paper seeks to examine one area where the accountability of directors has changed, namely the provision of financial benefits to related parties. This change, relating to public companies only, followed the introduction of Part 3.2A to the *Corporations Law* ('the Act') in 1992.[2] This paper will examine the background to the change and the way in which previous attitudes and actions were considered in developing the objects stated in s. 243A. In turn, the construction of Part 3.2A will be discussed to determine whether the objectives stated in s. 243A are met. In particular, the influence of other sections of the *Corporations Law* in helping to achieve the stated objectives will be explored.

2. Background

The aforementioned quote was a rather 'tongue in cheek' address given in 1962. However, it did reflect the general attitude that being a director on a board was not a particularly onerous task. That position may well have remained, had it not been for the actions of some directors who took advantage of the relatively few checks and balances concerning their actions, and the comparative ease with which funds could be moved from within the corporate structure.

---

* BA; BCom; ASA; Student of Law, Deakin University.

1 Bosch, H. 1995, *The Director at Risk: Accountability in the Boardroom*, Pitman Publishing, Sydney, 8.

2 All reference to legislation will be to this Act unless otherwise specified.

Such abuses would probably have gone unnoticed, without the downturn in the economy in the late 1980's which began to reveal how financially unsound many companies had become, due to the siphoning of funds to related entities or other business ventures. Bosch comments that 'the damage that was suffered was aggravated by the disillusionment of seeing former heroes revealed as little more than reckless gamblers with other people's money.'[3]

Indeed, in relation to the collapse of Rothwells, the Lavarch Committee pointed out that:

> After reconstructing the company's accounts, loans from the company to companies associated with Mr Connell [the Chairman] in 1987 totalled between $324 and 450m, which represented 53—82% of the total assets of Rothwells ... Depositors would surely have been alarmed had they known that they were, in reality, lending largely to Connell, on an unsecured basis, to finance personal acquisitions such as racehorse stables and art.[4]

Creditors and members of companies began to question the protection afforded to them at law. The general feeling was that this protection was insufficient.

Prior to 1992, s. 234 gave special consideration to loans made to directors. Section 234(1)(a)(i) stated its objective as prohibiting direct or indirect loans to directors, spouses of directors or relatives of directors or their spouses. Section 234(1)(a)(ii) applied a similar prohibition to the aforementioned parties, but in relation to related companies.

However, there were ongoing concerns as to the effectiveness of s. 234, and whether it gave sufficient protection to both creditors and members of the company. Almost from the time the *Corporations Law* was brought into effect in January 1991, it was under review. In particular, the section concerning loans and benefits to directors received constant scrutiny.

The now defunct Companies and Securities Law Reform Committee and the Advisory Committee both recommended that s. 234 should be given a wider operation.[5] Specifically, the Law Reform Committee stated that other forms of financing which had a similar effect to loans to directors should be included within the prohibition. The Advisory Committee recommended that the provisions be extended further to include asset transfers between

3 Id at 48.

4 Ibid.

5 Lipton, P. & Herzberg, A. 1992, *Understanding Company Law*, 4th edn, Law Book Company, Sydney, 625.

companies and suggested a precise procedure be set out regarding the obtaining of consent by the general meeting.[6]

The review was extensive, concentrating on corporate abuse and response. During the drafting of the Reform Bill legislation, concerns were raised that it was trying to cover too many ills and that the 'black letter law' approach could be self-defeating by creating as many loopholes which could be exploited as the ones they were trying to close.[7]

Upon the release of the draft Bill in July 1991, the report on Reform of the Law Governing Corporate Financial Transactions stated that the development of s. 243A and Part 3.2A was due to the following:

> Following the corporate collapses of the 1980's, 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 distinguishing 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 involved 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 markets, with detrimental consequences for the national economy.[8]

It was in this environment that Part 3.2A was developed. The object of the Bill was the promotion of higher standards in the management of companies. When the Bill was originally presented, this object was identified in s. 243A which stated that the Bill's purpose was to 'give investors in companies confidence that directors of companies will manage those companies, and the resources of those companies, honestly and diligently.'[9]

---

6 Ibid.

7 Ibid.

8 Tomasic, R., Jackson, J. & Woellner, R. 1992, *Corporations Law, Principles, Policy and Process,* 2nd edn, Butterworths, Sydney, 386.

9 Id at 387.

The Bill sought to achieve this object by employing three key regulatory mechanisms aimed at overcoming possible self-dealing by corporate controllers or the intrusion of other conflict of interest considerations:

- the prohibition of particular loan transactions;
- 'arms-length' consent rules; and
- mandatory disclosure of various permitted transactions.[10]

3. Objects of s. 243A

The Bill sought to reinforce investor and consumer confidence in the corporate structure by ensuring that abuse and other conflicts of interest by directors (or related parties) were prevented. This was embodied in the proposed s. 243A.

However, the section which was eventually passed was modified from the proposed wording in the Bill to one of 'protecting' two key groups—being a public company's resources (particularly creditors) and members. The method by which these objectives are to be met requires that financial benefits to related parties that could diminish, endanger or adversely affect the interests of these key groups be disclosed and approved by a general meeting before they are given.

The Explanatory Memorandum for the Corporate Law Reform Bill 1992 which introduced Part 3.2A stated that: 'The basic principle of proposed Part 3.2A is that "uncommercial" transactions with related parties should be referred to disinterested shareholders before the transactions take place.'[11] Accordingly, the *Corporations Law* was modified to empower members of a company, with knowledge of how finances were proposed to be transferred between related companies, to approve such transactions in appropriate circumstances.

It is important to note that, while the intention of both the Bill and the *Corporations Law* was to protect investors and creditors, the latter group's protection still depended on the actions taken by members. The object of s. 243A makes no provision for creditors to be actively involved in the process to prevent the transfer of financial benefits between related companies. However, creditors are able to minimise their risk by lodging an objection with the Court where a transfer results in a reduction of capital in the debtor company

10 Ibid.

11 Ford, H.A.J. & Austin, R.P. 1995, *Principles of Corporations Law*, 7th edn, Butterworths, Sydney, 349.

pursuant to s. 195(3). Large creditors may also seek to protect their interests by contracting in terms which ensure their interests receive priority.

4. Part 3.2A

Part 3.2A details how the legislation meets the objectives stated in s. 243A. These are set out in Divisions within the Part, which are outlined in s. 243B. Essentially, Division 3 sets out the prohibitions which are central to the operation of the Part, while Divisions 4 and 5 contain the exceptions. Division 6 sets out the enforcement provisions.

Prohibitions

The central prohibition to the Part is set out in s. 243H, which, subject to the applicable exemptions at Divisions 5 and 6, prevents a public company from giving a financial benefit to a related party, and provides that a child entity of a public company must not give a financial benefit to a related party of the public company.

The relationship between s. 234H and s. 243A provides the basis as to whether Part 3.2A achieves its stated objectives. The key elements are the definitions of the concepts 'financial benefit', 'related party' and 'child entity'. These are defined in Division 2 of the Part.

To be effective and meet the objectives of s. 243A, it is submitted that these definitions should be very broad. This is also in keeping with the ultimate purpose of the Bill, to ensure that 'the legitimate interests of companies, their shareholders and creditors are preserved, and that the proper standards of the market are maintained.'[12]

Sections 243C and 243D define 'entity' and 'child entity' for the purposes of Part 3.2A. The fundamental concept is that of control. Control is further defined at s. 243E which adopts the definition of control in 'an accounting standard'. The accounting standard applicable to this section is AASB 1017 Related Party Disclosures, which states that 'control' means 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.

It is submitted that the definition of 'entity' and the concept of 'control' are not broad enough to fully satisfy the object of s. 243A.

12 Tomasic, Jackson & Woellner, fn. 8 at 387.

The current definition confines an entity to one that is either subject to the control of another company, as defined above, or where another entity is the holding company. The original draft of Part 3.2A proposed that the definition be wider, relating to one entity having 'significant influence', but not necessarily control, over another entity.[13] However, this wider concept was not used in the definition of 'parent entity' ultimately adopted.[14] The broader definition of an entity would ensure that moneys are not transferred to other entities, which, due to the fact that the parent company does not exercise 'control', within the narrow definition stated, would escape inspection. The broader definition better satisfies the objective of protecting the resources of the company.

While s. 243H concentrates on the nature of a commercial relationship between two related companies, it fails to recognise the direct link between a parent and child entity. A public company may be a parent company of a subsidiary, but never exercise any control over that child entity so as to attract the prohibition contained in s. 243H. Accordingly, a parent entity can legitimately provide a financial benefit to a child entity if it is not the holding company or if it does not exercise any control over that company. The omission of this fundamental relationship from the ambit of Part 3.2A does not support the overall object of protection promised by s. 243A.

While the child entity is omitted from the prohibition, other corporate entities in close relation to the public company, such as a parent entity or sibling entity are not. The definition of 'related party' covers a wide range of persons and entities for the purposes of the Part. The list of whom is a related party is set out in s. 243F, and includes, *inter alia*, 'a parent entity or sibling entity of the public company.'[15] This inclusion goes part of the way to widening the net of applicable entities, and is broader in scope than the provisions under the previous s. 234 concerning companies.

In addition, specific relations such as spouse, de facto spouse, parent, son or daughter are also recognised as related parties for the Part.[16] However, this exclusive list of relatives is not as extensive as the original s. 234 which also included relatives of directors or their spouses.[17]

This deficiency is made up in part by the extension given at ss. 243F(2) and (3) which deem parties to be related if there are

13 Ford, fn. 11 at 351.
14 Ibid.
15 Section 243F(1)(g).
16 Sections 243F(1)(c) &(d).
17 Tomasic, Jackson & Woellner, fn. 8 at 385.

reasonable grounds to believe that they will become a related party in the future or have been a related party in the preceding six months. Moreover, s. 243F(5) extends the definition of a related party to an associate. A party becomes an associate where the public company or child entity gives a benefit to an unrelated party, and the related party receives a financial benefit in consideration for that act. The unrelated party, in turn, is deemed an associate, and thereby becomes a related party in relation to Part 3.2A.[18]

It could be argued therefore, that the definition of a related party and entity are not wide enough to achieve the object of protection provided under s. 243A. This is submitted on the basis that the concept of 'entity' does not involve a child entity for the purposes of the prohibition, and that the notion of related parties does not extend far enough into the family structure of directors. Further, the previous s. 234 extended the notion of a related party to include a company in which a director had only a 10% relevant interest (former s. 234(1)(a)(v)).[19] While the definitions have been extended in some areas, as discussed above, a number of limitations continue to narrow the scope of the prohibition set out in s. 243H, thereby reducing the value of its protection.

The definition of 'related parties' potentially enables directors to move financial benefits within a group of companies (which are not recognised as being related for the purposes of this Part), in order to benefit the whole group. In so doing, however, the financial position of the individual company and its shareholders and creditors may be seriously compromised. As a result, such actions by directors are regarded as a breach of their duty to act in that company's best interests.[20]

The third definition which affects the prohibition is the 'giving of a financial benefit'. Section 243G emphasises that this phrase is intended to operate broadly, and includes benefits given indirectly or through an agreement, arrangement or understanding. The Explanatory Memorandum to the Corporate Law Reform Bill stated that the term 'indirectly' was not intended to be interpreted narrowly.[21]

18 Ford, fn. 11 at 350.

19 Ibid.

20 *Equiticorp Financial Services Ltd v. Bank of New Zealand* (1993) 11 ACLC 952.

21 *Australian Corporations & Securities Law Reporter*, 1996, CCH, Sydney, para. 63-382.

This was particularly in reference to the decision by Lockhart J in *Trade Practices Commission v. Australian Iron & Steel Pty Ltd,*[22] where his Honour held that (in the context of s. 50 of the *Trade Practices Act 1974* (Cwlth)) 'an "indirect" acquisition is an acquisition by someone on behalf of the corporation acting as agent, trustee or nominee'.[23] The Explanatory Memorandum to the Reform Bill emphasised that the meaning of 'indirect' in relation to the Act was to be contrasted with the narrow interpretation given by the Court in that case.[24]

The term 'financial benefit' is not given a conclusive or exhaustive definition by the Act. Section 243G(4) provides examples of what would constitute a financial benefit, however s. 243G(3) states that such a benefit need not involve a monetary payment, but may merely convey some financial advantage.[25] Ford argues that if the transfer of an asset or the issue of securities or options necessarily constitutes a 'financial' benefit, the word 'financial' adds little to the word 'benefit'.[26]

Accordingly, the general prohibition seeks to satisfy the objects set out in s. 243A by to a wide group of related parties who may obtain a benefit from their interaction with the public company.

Exceptions

Section 243H states that the prohibition is subject to exemptions at Divisions 4 and 5. Division 4 lists general exceptions, while Division 5 covers financial benefits approved by a general meeting of the public company. The exceptions include contracts made before s. 243H applies (s. 243J), advances up to $2,000 to the director or director's spouse (s. 243L), and financial benefits given to another entity under a court order (s. 243PB). Ford identifies the three most important exemptions in practice as benefits on arm's length terms, remuneration of officers, and shareholder approval.[27] These will be discussed in turn.

---

22 (1990) 22 FCR 305.

23 Id at 316.

24 Ibid. See also Hurley, A. 1995, *Restrictive Trade Practices: Commentary and Materials*, 2nd edn, Law Book Company, Sydney, 521.

25 CCH, fn. 21 at para. 63-385.

26 Ford, fn. 11 at 350.

27 Id at 352-354.

(i) Section 243N—Benefits on arm's length terms

Section 243N(1) provides that public companies and their child entities may give financial benefits to a related party where such benefits are provided on terms and conditions no more favourable than those on which it is reasonable to expect that the company or entity would give if dealing with the related party at arm's length in the same circumstances. It is submitted that this exemption is consistent with the object of s. 243A. The company's resources are not compromised as such a transaction does not favour the related party.[28]

This exception is extremely important in proceeding with the company's affairs, as it permits the office bearers to authorise transactions without having to call a meeting of shareholders to approve the benefit. However, this exception should be cautiously dealt with.

Section 243N(2) provides examples of matters which may be taken into account in assessing whether the transaction was at arm's length. The flaw in this exception is that it relies on self assessment to ensure that the transaction meets the stated requirements. While such self assessment may ultimately be tested in court, the existence of this exemption and ability to comply with the Part without disclosure to the board or general meeting results in a lesser standard being imposed on directors in public companies than those in proprietary companies.[29] This reduces the protection that should be afforded to the resources of a company. Moreover, the examples in s. 243N(2) are only direct benefits. Section 243N does not appear to apply where the financial benefit is conferred on the related party indirectly, through an interposed entity.[30]

The difficulties which may arise from self-assessment were demonstrated in *Linter Group Ltd v. Goldberg*[31] where Goldberg was found to have moved funds between two companies within the same group.[32] Southwell J stated that:

> Basically the relevant duty was owed to the company of which the members and creditors formed an integral part. The duty was owed to each individual company and not to other companies within the group. So, the directors of each company had to look at the interests of each

28 CCH, fn. 21 at para. 63-398.

29 Lipton, P., 'Has the "interested-director cloud" been lifted' (1994) 4(2) *AJCorpL* 239 at 254.

30 Ford & Austin, fn. 11 at 352.

31 (1992) 7 ACSR 580.

32 Bosch, fn. 1 at 24.

> individual company in determining what was good for the company in relation to the transaction.[33]

To meet the object of s. 243A, directors would be well advised to seek independent and/or shareholder advice to ensure that their actions do not constitute a breach. However, the concern is that they are not required to do so, which has the potential for abuse, particularly as courts are traditionally reluctant to look at the merits of commercial transactions.[34]

(ii) Section 243K—Remuneration of officers

A public company or its child entity may provide 'reasonable' remuneration to directors and other parties in their capacities as officers without shareholder approval. While the term remuneration is not exhaustively defined in the section, specific particulars are given at ss. 243K(4)-(7) which include salary, wages, superannuation and termination benefits.

In *Mott v. Mount Eden Gold Mines (Aust) Ltd*[35] the question whether a one-off issue of shares as an incentive to join a board of directors was 'remuneration' was considered. Owen J stated that it would be arguable that such an issue would not be 'remuneration' within the meaning of the section.[36]

The other important issue is what is 'reasonable' within the scope of the section. No definition is provided, and the application of the section is again at the discretion of the directors. The only guidance provided is that it must be reasonable 'to pay or provide that remuneration to an officer in the person's circumstances'.[37] Ford states this could only refer to the character of the office held, rather the domestic situation or personal wealth of the officer.[38] However, Part 3.2A does not operate in isolation, requiring common law, equity and other statutory directors' duties to be taken into account. This was demonstrated in *Cummings & Anor v. Claremont Petroleum NL; Fuller & Anor v. Claremont Petroleum NL*[39] where both appellants were found to have inserted remuneration clauses for their own benefit and were aware of the obvious conflict of interest with Claremont.

33 Id.
34 Greenwood, 'A significant liberalisation of the present law in favour of directors' commercial judgment' (1992) 21 BLCB 285.
35 (1994) 12 ACLC 319.
36 CCH, fn. 21 at para. 63-392.
37 Section 243K(1).
38 Ford & Austin, fn. 11 at 353.
39 (1993) 11 ACLC 118.

Importantly, the application of this section is subject to other provisions within the *Corporations Law*, discussed below, which would result in reasonable disclosure to the parties affected by the transactions entered into by the company.

(iii) Sections 243Q—243T: Shareholder approval for financial benefits

Division 5 sets out the circumstances in which the shareholders of a public company can approve financial benefits to be made to related parties. By fulfilling the conditions of Subdivision B, a general meeting can exempt certain financial benefits from the prohibition of s. 243H.

While Subdivision B details the procedure to be followed, ss. 243Q and 243R require that the benefit is approved by a resolution of the company in a general meeting within 15 months before the benefit is given or the contract made.

The approval can only be used for the related party transaction to which it is intended. Therefore, a resolution permitting a public company to give a financial benefit to a related party does not exempt it from prohibitions against conferring similar benefits in a different related party transaction.[40]

The procedure requires the Australian Securities Commission (ASC) to be notified of the proposed resolution so that it can, if it wishes, make written comment.[41] The proposed resolution cannot be varied from that submitted to the ASC[42] and related parties to the recipient of the benefit are unable to vote.[43]

The restrictions on voting have important ramifications for the public company as, in many cases, the major shareholders will be joined to the related party and unable to vote. This may leave the company in the untenable position where the minority shareholders decide the fate of the resolution. This minority may dissent from the majority viewpoint and, unless ASC permits voting by related parties and associates, will result in action being taken against the will of the majority shareholders who have provided most of the share capital of the company.[44]

However, this procedure does afford some protection to the corporate structure, and ensures that the company's resources are protected, consistent with s. 243A.

---

40 CCH, fn. 18 at para. 63-410.

41 Section 243W.

42 Section 243ZA.

43 Section 243ZF.

44 Ford & Austin, fn. 11 at 354.

Enforcement

Whilst it is important that restrictions are in place to protect the resources of the company, it is equally important that they are subject to enforcement provisions. These are set out in Division 6. Section 243ZE states that where s. 243H is contravened the related party and everyone involved (either directly or indirectly) is held to have contravened Part 3.2A. The public company and the child entity may not necessarily commit a criminal offence, but by their actions in the contravention, may be exposed to civil liability for that contravention.[45]

Section 243ZE is a civil penalty provision,[46] and a contravention of s. 243H will not result in the transaction being void.[47] The court is, however, able to make an order of payment up to $200,000 for a breach of Part 3.2A,[48] but the breach must be serious.[49] Further, if the court is satisfied that a person who is guilty of the breach did so 'knowingly, intentionally or recklessly' with dishonesty or intent to deceive, defraud or gain advantage from someone, the breach will give rise to a criminal proceeding.[50]

5. Application of other provisions within the *Corporations Law*

As stated earlier, the limitations identified in Part 3.2A do not necessarily relieve the directors of their obligations to the company. Section 243ZI(3) states that the application of Part 3.2A does not relieve a person from any duty imposed in the *Corporations Law* any other law, or the constitution of that company. For example, directors are still required to act honestly, with care and diligence.[51]

There may also be interaction with other provisions within the Act. 'Golden handshakes' upon retirement authorised by s. 237 may also require approval under s. 243K to determine that it is 'reasonable' in light of the person's circumstances. In some instances, the provisions of Part 3.2A are inconsistent with other requirements of the *Corporations Law*. For example, s. 205, which considers a company financing dealings in its shares, requires a

45 Ibid.
46 Sections 243ZE(5) & 1317DA.
47 Section 103.
48 Section 1317EA(3).
49 Section 1317EA(5).
50 Section 1317FA.
51 Section 232.

different procedure for approval of finance than that set out in Part 3.2A.[52]

6. Conclusion

Section 243A was developed to protect the resources of public companies from the difficulties and abuse experienced in the past. At the time of the release of the Corporate Law Reform Bill, Part 3.2A was considered the most controversial part of that Bill.[53]

The protection to creditors and members was to be achieved through a central prohibition on certain financial transactions to related parties. However, in the event that informed shareholders wished to approve certain exempt transactions, the necessary procedures were put in place.

CCH states that Part 3.2A effects a greater range of transactions and persons than the former s. 234.[54] While this may be the case, Part 3.2A still has some serious deficiencies:

- s. 243A purports to provide protection for the company's resources, yet creditors are still subject to the actions of directors and shareholders;
- the relationship between parent and child entity is not recognised for the purposes of the Part;
- the related parties concept of 'control' is too narrow;
- extended domestic relationships within the director's family are not captured;
- shareholders are not required to approve transactions to related firms considered to be 'at arm's length', or where the remuneration to officers is 'reasonable'; and
- provisions of the Part are inconsistent with other provisions within the *Corporations Law*.

Part 3.2A was created to provide specific provisions in the *Corporations Law* to supplement general law principles, and operates in conjunction with the common law and statutory duties to ensure that directors do not abuse their positions.[55] The Explanatory Memorandum achnowledges that one cannot prevent dishonesty by legislation, but declares the intention to establish an environment

52 Ford & Austin, fn. 11 at 355.
53 Lipton & Herzberg, fn. 5 at 625.
54 CCH, fn. 21 at para. 63-355.
55 Ford & Austin, fn. 11 at 349.

which makes dishonesty less likely to result in losses for investors.[56] While Part 3.2A aims to create a regime of greater disclosure and accountability for directors concerning related parties transactions of public companies, the exceptions and deficiencies in the Part have seen it fail to completely fulfill the objects set out in s. 243A. Ultimately, the change from s. 234 to Part 3.2A may have little practical effect on related public company transactions, potentially leaving creditors and members of public companies in the same vulnerable position they faced in the 1980's.

56 Ibid.