CACL 2022

Case studies and problem sets

**Problem Set 3**

*The following problems and questions should be answered after you have read Chapters 5 and 6.*

1. **The board of SAFPL is interested in producing a range of organic lamb. They have heard that a property in the Riverina is for sale; the land has already been appropriately certified for organic production by the relevant authorities. However, the venture is risky and the board has decided to incorporate a new subsidiary, to be called SA Organic Meat Pty Ltd (SAOM), to acquire the property. What decisions must be made, and what steps must be taken, to incorporate the new company?**

See [¶5-100] – [¶5-140] and s117 of the Corporations Act

See s117 of the Corporations Act and Form 201 for **registering a company** [¶27-100]. Form 201 and the registration fee must be lodged with ASIC. The following matters need to be addressed:

* The type of company - a proprietary company or a public company.
* Identify the member or members of the company, the number of shares and whether there are different classes of shares. All companies must have at least one member: s114 of the Corporations Act. The proposed members must consent in writing to becoming members of the company: s231 of the Corporations Act.
* Identify the director or directors of the company. A proprietary company must have at least one director ordinarily residing in Australia, and a public company must have at least three directors, with at least two ordinarily residing in Australia: s201A of the Corporations Act. The directors must give their consent in writing to being appointed as directors: s120 of the Corporations Act.
* Identify the secretary or secretaries of the company. All public companies must have at least one secretary, and the secretary must consent to the appointment: s204A of the Corporations Act.
* Choose an address to be the company’s registered office: s121 of the Corporations Act.
* Choose a constitution or replaceable rules as internal governance rules (IGR).
* Choose a name for the company: Pt 2B.6 of the Corporations Act.

Application of law

The board of SAFPL still has to make some decisions. You know that the company will be a proprietary company wholly owned by SAFPL, but you still need further details as to the proposed director and the registered office. Further, the name of the proposed company has been chosen but you need to check whether it is available to be used. For example, a name that is identical to another company’s name or a registered business name is not acceptable.

1. **Should SAOM adopt a constitution, or rely on the replaceable rules as its internal governance rules? Give reasons for your answer.**

See [¶5-300] – [¶5-320], [¶5-440], [¶5-520] and s135 and s141 of the Corporations Act

A company’s internal governance rules will consist of:

* the replaceable rules set out in the Corporations Act;
* a constitution; or
* a combination of the replaceable rules and a constitution.

It is open to the members of a company to decide the precise form of the rules to be adopted by the company. The Corporations Act provides a set of model rules, in the form of replaceable rules, which a company may adopt as its internal governance rules but it is not obliged to do so: s135 of the Corporations Act.

The replaceable rules are all listed in s141 of the Corporations Act.

The replaceable rules may not be suitable for companies in particular circumstances, or with particular needs, for example:

* Single member/director proprietary companies.
* Companies with two equal shareholders or in situations where each shareholder is to have particular rights, such as the right to representation on the board of directors.
* Where a company is proposing to issue classes of shares with particular rights attaching, it may need to supplement the replaceable rules with different rules setting out those rights.
* Where a company is proposing to issue partly paid shares, because they do not include the necessary provision for calls and forfeiture.
* ASX listed companies cannot rely on replaceable rules.
* Where a company needs to incorporate restrictions on the company’s objects, for example, companies that engage in charitable activities (s150 of the Corporations Act) or mining companies (s112 of the Corporations Act).

Application of law

In deciding whether it is appropriate to rely on the replaceable rules as the company’s internal governance rules, you need to look closely at each replaceable rule to determine whether that rule is an appropriate one for SAOM.

It seems that the replaceable rules are perhaps most suitable for an unlisted company with more than two members, in which it is proposed that the members be bound by a principle of ‘majority rule’ in relation to the internal administration of the company’s affairs. This is not precisely the situation that applies to SAOM.

Also, it might be a good idea to agree some other matters. It is usual for companies to include additional provisions dealing with directors’ indemnities and entitlements.

1. **Nick Henry has a real passion for the organic lamb project and would like SAOM to adopt a constitution that includes a provision guaranteeing his position as head of development at SAOM. Having regard to s 140 of the Corporations Act and the relevant case law, would Nick be able to enforce such as provision against SAOM?**

See [5-500], [5-620]

Section 140 specifies that the constitution of a company acts as a contract between the company and each member, between the company and each director and company secretary and between a member and each other member. If a constitution were adopted that included the provision guaranteeing his position as head of development at SAOM, this provision would only be enforceable between these parties.

The current case mirrors *Eley v Positive Government Security Life Assurance Co* where the company constitution specified that Mr Eley should be appointed as the company solicitor. He was not appointed to the position and he took legal action as a solicitor, although he was also a member. It was found that he could not enforce the constitution as the constitution does not act as a contract between other persons and the company. The same principle is likely to apply in the current scenario.

1. **Nick is keen to get moving on the organic project so he contacts a friend and arranges for SAOM, once it is formed, to buy some rams. Will the contract made by Nick be binding on SAOM after the company is incorporated?**

See [5-200], [5-220]

While company registration in Australia is now relatively fast and efficient, it is still common for the people starting a company to enter into contracts prior to registering their company. As the company is a separate legal person, it is not possible for these contracts to be assigned to the company until such time as the company is registered. The result is that the person who has entered into the contract, called a ‘promoter’, is left with the legal relationship created by the contract.

The Corporations Act offers a mechanism by which the promoter may move the contract to the company once registered. Section 131 applies where a person enters into, or purports to enter into, a contract on behalf of, or for the benefit of, a company before it is registered. It says that the company becomes bound by the contract and entitled to its benefit if the company, or a company that is reasonably identified with it:

• is registered, and

• ratifies (ie adopts) the contract within the time agreed by the parties, or if there is no agreed time, within a reasonable time after the contract is entered into.

The new company’s ratification of the contract can be express or implied. Express ratification occurs when the company acknowledges that it is party to the contract, by unequivocal words or conduct. Implied ratification can occur in various ways; for example, the company might not expressly acknowledge that it is party to the contract, but if it acts in a way which can only be explained on the basis that it accepts the contract as binding on it, that may be sufficient. This will occur as per *Aztech Science v Atlanta Aerospace*, which stated that implied ratification occurs where the company acts in a way that shows to the other party that it intends to be bound by the contract.

If the company is not formed or chooses not to ratify the contract within the required time, then the person who entered into the contract is liable to pay damages to the other party. In proceedings for damages where the company has been formed but has not ratified the contract, the court can make various orders against the company where appropriate (for example, because the company has benefited from the contract).

Where a company ratifies a pre-registration contract but does not perform it, the person who made the contract remains liable for its performance.

1. **What is ‘corporate governance’? Why is ‘good’ corporate governance important to a company like AMGL? Like SAFPL?**

See [6-100] to [6-200]

Corporate governance is a term which has been given various definitions. At its narrowest, corporate governance may be considered the way in which shareholders ensure that directors and officers act in their best interests. Broader definitions may encompass a wider range of stakeholders, viewing corporate governance as the relationship between the stakeholders of a company and the directors. Monks and Minow define corporate governance as:

‘… the relationship among various participants in determining the direction and performance of corporations. The primary participants are:

• the shareholders,

• the management (led by the chief executive officer), and

• the board of directors … Other participants include the employees, customers, suppliers, creditors, and the community.’ [see 6-110].

 Good corporate governance practices are necessary to ensure that companies are directed and controlled in a manner that most efficiently protects and promotes the interests of the participants. Good corporate governance should be about protecting and balancing the interests of stakeholders by setting up the appropriate mechanisms to align these divergent interests where possible and to ensure adequate monitoring of management. Balancing those interests efficiently is the central concern of the current debate on corporate governance. Measures designed to ensure the accountability of officers and managers may impose costs on the company either directly, in the form of expensive procedures and requirements (such as requirements to provide directors with access to independent advice or to provide members with detailed information about the company and its management) or indirectly, through diverting management time from performance to conformance matters or by discouraging legitimate risk-taking behaviour that would ultimately have proved beneficial to the company.

AMGL and SAFPL share some reasons for implementing good corporate governance. At a simple level, every company benefits from procedures and rules which align the interest of shareholders and the directors and officers of the company. Aligning these interests should generate a positive return for the company and shareholders and ensure the ongoing success of the company. AMGL has more specific requirements for good corporate governance. As a publicly listed company, AMGL will need to meet the ASX Corporate Governance Principles and Recommendations. While it is open to AMGL not to, it must offer an explanation of why it has not met these principles.

While SAFPL does not have the same level of enforced oversight, it is still essential that it has good corporate governance practices. Beyond aligning interests of shareholders and directors and officers, good corporate governance will ensure the ongoing relationship between the company and other stakeholders. Customers, suppliers, the environment and the animals used in their manufacturing process may all be harmed by a reckless corporation. Good corporate governance procedures will maintain the relationship with these stakeholders, ensuring that the company adopts a long term view.

**6. The ASX Corporate Governance Council is responsible for formulating the Corporate Governance Principles and Recommendations. Under ASX Listing Rule 4.10.3, listed entities like AMGL are required to benchmark their corporate governance practices against the Council’s recommendations and, where they do not conform, to disclose that fact and the reasons why, in their annual report. AMGL would like your help in reporting against Principle 2 on board structure. Have a look at the recommendations the Council has made on board structure, available at** [**https://www.asx.com.au/documents/regulation/cgc-principles-and-recommendations-fourth-edn.pdf**](https://www.asx.com.au/documents/regulation/cgc-principles-and-recommendations-fourth-edn.pdf)**. Does the AMGL board conform to those recommendations? What kind of disclosure should it make?**

See [¶6-150] and https://www.asx.com.au/documents/regulation/cgc-principles-and-recommendations-fourth-edn.pdf

**Principle 2 — Structure the board to be effective and add value:** A listed entity should have a board of an appropriate size and collectively have the skills, commitment and knowledge of the entity and the industry in which it operates, to enable it to discharge its duties effectively and to add value.

Principle 2 has six recommendations. In each case where AMGD doesn’t conform to the recommendations, it should state in its annual report as a disclosure that it had completed its benchmarking on Principle 2 (see below), listing instances where it had not complied with recommendations but had now taken action to meet the recommendation in future years. If further facts showed that there was a reason why AMGD didn’t need to comply, that reason could be stated instead (noting that the policy of the Governance Principles is to give ‘if not, why not’ justifications for not following the guidelines).

**Recommendation 2.1**

The board of a listed entity should have a nomination committee. Companies should disclose the process for evaluating the performance of the board, its committees and individual directors.

On the facts given, AMGL doesn’t appear to conform to this recommendation. It should appoint such a Committee as soon as possible.

**Recommendation 2.2**

A listed entity should have and disclose a board skills matrix setting out the mix of skills that the board currently has or is looking to achieve in its membership.

On the facts given, AMGL doesn’t appear to conform to this recommendation. It should prepare the matrix to comply.

**Recommendation 2.3**

A listed entity should disclose details about independent directors (name, length of service) as well as any interest, position, association or relationship of the type (described in the Guideline) which might raise questions about the guidelines. If there are independence-compromising facts, the Board can give reasons why it believes they don’t compromise the independence of the director.

In AMGL a significant percentage of the issued shares are held by directors or employees of the business or their associates. The number of genuinely independent directors should be increased; it is not a satisfactory reason to say the interests are closely held, because this is a publicly listed company which must act in the interests of all shareholders.

**Recommendation 2.4**

A majority of the board of a listed entity should be independent directors. AMGL conforms to this recommendation.

**Recommendation 2.5**

The chair of the board of a listed entity should be an independent director, and in particular should not be the same person as the CEO of the entity.

AMGL does not conform to this recommendation; Mr Adderson holds the position of Executive Chairman. The Board should, according to Recommendation 2.5, appoint an independent Deputy Chairman, or ‘senior independent director’. The list of directors for the Company includes Mr Boon, who is described as ‘Non-executive director and chief independent director’. The roles of chair and chief executive officer should not be exercised by the same individual.

**Recommendation 2.6**

A listed entity should have a program for inducting new directors and for periodically reviewing whether there is a need for existing directors to undertake professional development to maintain the skills and knowledge needed to perform their role as directors effectively.

On the facts given, we don’t know whether AMGL conform to this recommendation. If it doesn’t, it needs to comply in future.

**Guide to reporting on Principle 2**

The following material should be included in the corporate governance statement in the annual report (showing that it complies with Principle except in the instances noted, where it will include the explanation for its non-compliance):

* the skills, experience and expertise relevant to the position of director held by each director in office at the date of the annual report;
* the names of the directors considered by the board to constitute independent directors and the company’s materiality thresholds;
* the existence of any of the relationships listed in Box 2.3 and an explanation of why the board considers a director to be independent, notwithstanding the existence of these relationships;
* a statement as to the mix of skills and diversity for which the board of directors is looking to achieve in membership of the board;
* a statement as to whether there is a procedure agreed by the board for directors to take independent professional advice at the expense of the company;
* the period of office held by each director in office at the date of the annual report;
* the names of members of the nomination committee and their attendance at meetings of the committee, or where a company does not have a nomination committee, how the functions of a nomination committee are carried out
* whether a performance evaluation for the board, its committees and directors has taken place in the reporting period and whether it was in accordance with the process disclosed;
* an explanation of any departures from the Recommendations, with a statement that steps have been taken to ensure future compliance.

Application of law

Suggest to AMGL that you use the above Guide as a template to report on the matters required, and if there is not compliance, an explanation for why not. From the facts of the case study regarding the composition of the board, you know that AMGL has a majority of independent (NED) directors on the board; the roles of CEO and chair are split; and it has a NED chair (whether Addis is ‘independent’ in terms of ASX guidelines would need further investigation; to be independent means no significant relationships with the company such as a significant shareholder or prior executive position). The company has an audit committee and a remuneration committee but you do not know whether it has a nomination committee.

**7. Jason Jones owns 10 ordinary shares and five A class shares in SAFPL. He has heard about the proposed formation of SAOM and acquisition of the new farm, and thinks a move into organic meat production would be a mistake. What steps, if any, can he take to prevent SAFPL going ahead with the deal?**

See [¶6-300] – [¶6-440] and *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cunninghame*

Decision-making in solvent companies is divided between the directors and the members. The basis on which decision-making is divided depends on the law and the company’s internal governance rules. This is referred to as the **organic principle**. Each organ of the company has power to make particular decisions, so that neither organ has to follow the instructions of the other, and neither can usurp the decision-making power of the other: *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cunninghame*. The respective powers of each organ of the company are determined by the law and the company’s internal governance rules.

The scope of the directors’ power of management is determined by s 198A of the

Corporations Act (or a similar provision in the constitution). Section 198A(1) provides that ‘the business of the company is to be managed by or under the direction of the directors’. Section 198A(2) goes on to provide that ‘the directors may exercise all the powers of the company except any powers that [the Corporations Act] or the company’s constitution (if any) requires the company to exercise in general meeting’.

The broad effect of internal governance rules such as the replaceable rule in s 198A is to confer on the board of directors, the power to make decisions on all matters other than those that are expressly reserved to the general meeting by the Corporations Act itself or by express provisions of the company’s internal governance rules.

Application of law

You need to look at the type of decision. Here, the decision to acquire an asset is a business decision that is within the power of the board of directors. In these circumstances the members do not have the right to interfere with the board’s decision - see *Automatic Self-Cleansing Filter Syndicate v* *Cunninghame* and *John Shaw and Sons*. So Jason Jones, who is a minority shareholder, is unable to prevent SAFPL from going ahead with the deal.

If members disagree with a decision made by the board on a matter that the board has power to decide, what options are available to them? Members can only use the specific decision-making power available to them, in general meeting, such as removing the director or directors from office and, where they have power to appoint new directors, replacing them with directors who are amenable to the members’ wishes. Alternatively, the members may be able to alter the company’s internal governance rules to restrict the directors’ future power to act without first obtaining member consent.

**8. Canny Ltd is a shareholder in AMGL. It would like the shareholders to pass a resolution instructing the board of AMGL to sign up to the United Nations Principles of Responsible Investment. Can the shareholders do so?**

See [6-400] to [6-540]

The board of directors is given the general powers of management of a company. Members of the company generally do not have the power to second guess or intervene in these decisions, other than through the appointment of directors whose interests are aligned with their own. While members retain power over certain matters, they are not vested with power to intervene in the day to day managed of the company.

It is necessary here to consider the type of decision being made. The resolution does not appear to go to the constituent elements of the company. Instead, this appears to be the type of matter that would generally fall within the power of the directors. A similar situation arose in *Australasian Centre for Corporate Responsibility v Commonwealth Bank of Australia* where a member sought to have the board adopt resolutions that would create reporting requirements about greenhouse gas emissions. It was held that these amendments were invalid, except for one proposed amendment which was an amendment to the constitution of the company.

If Canny Ltd wishes to have these principles incorporated in the company, it would be best to seek to have the constitution amended to include reference to them. It may also seek to have directors appointed who may share their interest in this matter.