CHAPTER 2

Business Organisations

Useful Websites

(See http://legal.thomsonreuters.com.au/browse/mentor/corplawhub.asp for links to websites on the Topic of Business Organisations.)

Aim

At the end of this topic you should know:

Partnerships:

- what constitutes a partnership;
- the circumstances in which one partner can bind other partners in contract;
- the circumstances in which a partner can be liable in contract or tort;
- the legal duties partners owe to other partners; and
- how a partnership can be dissolved and the rights and liabilities of partners upon dissolution.

Incorporated associations:

- the characteristics and disadvantages of an unincorporated not-for-profit association;
- what constitutes an incorporated association;
- how to register an incorporated association;
- the basic structure and management of an incorporated association;
- the ongoing regulatory requirements;
- the rights and duties of members; and
- how an incorporated association can be wound up and what happens to any surplus assets.

Companies:

- how companies differ from other forms of association;
- how various incorporated bodies can be formed;
- how companies can be classified; and
- the differences between public and proprietary companies.

Related Topics

Chapter 3 Registration; Chapter 4 Consequences of Registration; Chapter 5 Internal Rules; Chapter 7 Corporate Liability: Contract, Tort and Crime; Chapter 11 Directors' Duties – Part 1 Duty of Care, Skill and Diligence; Chapter 12 Directors' Duties – Part 2 Good Faith and Proper Purpose

PRINCIPLES – GENERAL

[2.10] There exist a number of different types of business structures in the Australian economy.

Typically, a business will incorporate if a company structure provides the necessary advantages and flexibility for its day-to-day activities. However, at times other non-corporate business organisations may be appropriate. Whether a business decides to incorporate or not will usually depend on the needs of its operator. Companies have proven to be popular because they provide a number of advantages including taxation considerations, limited liability and succession planning. Non-corporate business structures such as partnerships, unincorporated associations, joint ventures, trusts and sole operators have also desirable qualities.

Corporations (Aboriginal and Torres Strait Islander) Act 2006 (Cth) (CATSI Act)

Prior to the CATSI Act, the *Aboriginal Councils and Associations Act 1976* (Cth) (ACA Act) allowed for two types of corporate bodies, that is, Aboriginal councils (Part III of the ACA Act) and Aboriginal associations (Part IV of the ACA Act). The former was aimed to meet the incorporation needs of Indigenous communities which provided government-type services. The latter was aimed at providing Indigenous people with an expedient business entity to achieve various objectives so they could conduct a business enterprise which generate profits for its members. The ACA allowed for Indigenous Australians to operate their businesses not only in a culturally appropriate manner but in accordance with Aboriginal and Torres Strait Islander custom. Following various reviews from 1989 to 2002 to reform the ACA Act (Cth), the CATSI Act was introduced in 2006. Unlike the ACA Act (Cth), the 2006 legislation disallowed for incorporations in the form of Aboriginal councils. However such Indigenous councils would still be created at the state and territory level.

The registration process and procedure of an Aboriginal and Torres Strait Islander corporation is found in Parts 2-1 to 2-4 of the CATSI Act. Division 37 of the CATSI Act deals with registration of an Indigenous corporation as a small, medium or large size corporation.

The *Dictionary* section in Part 17-3 Division 700 of the CATSI Act provides for the following meaning of key words:

Aboriginal and Torres Strait Islander person means the following:

(a) an Aboriginal person;

(b) a Torres Strait Islander;

(c) an Aboriginal and Torres Strait Islander person;

(d) a Torres Strait Islander and Aboriginal person;

(e) an Aboriginal and Torres Strait Islander corporation;

(f) a body corporate prescribed by name in the regulations for the purposes of this paragraph;

(g) a body corporate that falls within a class of bodies specified in the regulations for the purposes of this paragraph;

(h) a body corporate in which a controlling interest is held by any, or all, of the following persons:

(i) Aboriginal persons;

(ii) Torres Strait Islanders;

(iii) Aboriginal and Torres Strait Islander persons;

(iv) Torres Strait Islander and Aboriginal persons.

Aboriginal person means a person of the Aboriginal race of Australia.

body means a body corporate or an unincorporated body and includes, for example, a society or association.

entity: for the purposes of Part 6-6, an entity is any of the following:

(a) a body corporate;

(b) a partnership;

(c) an unincorporated body;

(d) an individual;

(e) for a trust that has only 1 trustee–the trustee;

(f) for a trust that has more than 1 trustee–the trustees together.

Otherwise, entity has the meaning given by section 694-40.

body means a body corporate or an unincorporated body and includes, for example, a society or association.

Non-corporate forms of association

[2.20] The main non-corporate forms of association are:

(a) sole trader;

(b) partnership;

(c) trust;

(d) unincorporated not-for-profit association; and

(e) unincorporated joint venture.

In order to better understand the nature of the different types of business entities, the following provides a general outline of unincorporated business structures. A comparative table is also provided at [2.240] which contains the key characteristics of each business association.

Sole trader

[2.30] Operating as a sole trader is the simplest form of business organisation (it is not strictly correct to describe a sole trader as an "association" because the concept of an association inherently involves more than one person). Nothing is required to establish a structure – one person simply "owns" the business, although they may employ others and operate under a business name. Because there is no separate body, the assets and liabilities of the business cannot be separated from those of the individual owner. Thus there is no real or genuine separation of ownership from management.

This form of organisation has the attraction of simplicity and control. Profits do not have to be shared and no-one (for example, members) has to be consulted or informed about how the business is running. Unlike a company or an incorporated association, the only public filing requirement is the need to obtain an Australian Business Number (ABN) and if necessary, register for the goods and services tax (GST). If the business is not to be carried on in the name of the sole trader, it will be necessary to register a business name with ASIC. This can now be done via ASIC Connect which is their new online service for interacting with ASIC's registers. See ASIC Connect, available at: https://www.connectonline.asic.gov.au/HLP/using-this-service/how-to-use-asic-connect/WelcometoASICConnect/index.htm. Hence, a sole trader enjoys a very high degree of commercial privacy.

The other side of the coin is that a sole trader is personally liable for any unpaid debts of the business, meaning that a sole trader's personal assets (such as her or his home) will be sold to meet any shortfall. There is also no formal legislative process to enable another person to inherit the business. Death or incapacity of the sole trader may bring the business to an end.

Partnership

[2.40] A "partnership" is generally defined as relationship that exists between people (which includes companies) who carry on a business in common with a view to making profits. See for example: *Partnership Act 1892* (NSW), s 1; *Partnership Act 1891* (Qld), s 5; and *Partnership Act 1958* (Vic), s 5.

A partnership can be viewed as an aggregate of individual people or traders who have come together for a joint, profit-making business purpose. The "people" can be either individuals, companies or other bodies corporate. It is important to distinguish partnerships from other unincorporated business associations, such as joint ventures.

Legal basis

[2.50] A partnership is essentially a matter of contract. The individual partners enter into a contract (the partnership agreement) as to how they will conduct the partnership business. Subject to any contrary statutory provisions, the mutual rights and obligations of each partner are governed by this agreement. A partnership agreement may be:

(a) a formal written agreement;

(b) partly in writing and partly oral; or

(c) may be purely oral or wholly or partly implied from the conduct of the partners.

Statutory regulation

[2.60] Each State and Territory has its own legislation governing partnerships. These Partnership Acts are not a Code, and are primarily a consolidation of the most important of the pre-existing general law rules applying to partnerships. References to section numbers in this part of Chapter 2 are to the *Partnership Act 1958* (Vic). The Partnership Acts expressly provide that the pre-existing rules continue to apply except in so far as they are inconsistent with the Partnership Acts: see for example, s 4 (Vic). To a large extent the Partnership Acts operate as default provisions and apply subject to, or in the absence of, any contrary provisions in a partnership agreement. In substance the Partnership Acts are almost identical, although the section numbers vary. For provisions in other State and Territory Acts see the Comparative Table 2.4 under Guide to Problem Solving section at the end of this Chapter and in KL Fletcher, *The Law of Partnership in Australia* (9th ed, Thomson Lawbook Co, 2007) pp xli-lii.

Formation

[2.70] Forming a partnership does not involve any initial formalities, such as registration and there are no ongoing requirements to lodge returns of any kind (although a partnership tax return would be completed). The partners may trade under their own names or may use a business name. This can now be done via ASIC Connect which is their new online service for interacting with ASIC's registers. See ASIC Connect, available at: https://www.connectonline.asic.gov.au/HLP/using-this-service/how-to-use-asic-connect/WelcometoASICConnect/index.htm

Additionally, each registration has an Australian Business Number: see http://www.abr.gov.au. The partners are collectively described as a "firm" and the name in which they carry on business is called the firm name: *Partnership Act 1958* (Vic), s 8 (for other States and Territories see the Comparative Table 2.4 under Guide to Problem Solving section at the end of this Chapter).

Legal nature

[2.80] A partnership is a relationship, it is **not a separate legal entity,** although, for procedural convenience, Rules of Court allow a partnership to sue or be sued in the partnership or firm name: see, for example, *Supreme Court (General Civil Procedure) Rules 2015* (Vic), O 17.

A partnership is not an entity in its own right – that is, the "partnership" does not exist separately from the partners themselves; and as a result:

- each partner pays tax at her or his individual rate (a return is lodged for the partnership, but only for the purpose of ascertaining each partner's share of the profit or loss);
- a partnership is automatically dissolved on the retirement, death or bankruptcy of a partner unless the partnership agreement provides otherwise; and
- a partner can assign her or his interest in the partnership but, unless all the other partners consent, the assignee only has the right to receive the assignor's share of profits and has no right to take any part in the management of the firm. Retiring partners remain liable for debts incurred while they were partners, unless creditors agree to a release.

The maximum size of a partnership is limited. Section 115 of the *Corporations Act 2001* (Cth) limits the number of members to 20. There are some exceptions allowing a greater number of members. For example, there is a maximum of 50 members for partnerships involving medical practitioners and stockbrokers, 100 for architects, chemists and veterinary surgeons, 400 for legal practitioners and 1,000 for accountants: see *Corporations Regulations 2001* (Cth), reg 2A.1.01. Any partnership that exceeds this size must register under the *Corporations Act 2001* (Cth).

What constitutes a partnership?

[2.90] A partnership does not exist unless each of the elements in the statutory definition is satisfied: s 5 (Vic).

This definition requires there to be:

- an existing relationship;
- between persons who are;
- carrying on a business in common; and
- have a view to profit.

If each of these elements are present, then a partnership exists regardless of the intention of the people involved. If the situation fits the definition in the Partnership Acts, **a partnership exists**: see *Canny Gabriel Jackson Advertising Pty Ltd v Volume Sales (Finance) Pty Ltd* (1974) 131 CLR 321.

It is necessary to examine each of these elements to determine the existence of a partnership. For example, when looking at the need to be "carrying on a business in common" the Partnership Acts define "**business**" as including every trade, occupation or profession s 3 (Vic). Then the element of **carrying on** a business can be explored even if the business has only one transaction. In *Re Griffin; ex parte Board of Trade* (1890) 60 LJQB 235 at 237 Lord Esher MR commented:

> I take the test to be this: if an isolated transaction … is proved to have been undertaken with the intent that it should be the first of several transactions, that is, with the intent of carrying on a business, then it is a first transaction in an existing business. The business exists from the time of the commencement of that transaction with the intent that it should be one of a series.

The Australian courts have also contemplated that a single transaction could, depending on the circumstances, amount to the carrying on of a business. In *United Dominions Corp Ltd v Brian Pty Ltd* (1985) 157 CLR 1 Dawson J espoused at 15 that:

> A single adventure under our law may or may not, depending upon its scope, amount to the carrying on of a business … Whilst the phrase "carrying on a business" contains an element of continuity or repetition in contrast with an isolated transaction which is not to be repeated … the emphasis which will be placed upon continuity may not be heavy.

Another aspect of this definitional element is that the carrying on of the business is done "**in common**". Here it appears that the partners who are running the business must do so for all partners and not just for themselves. There is, therefore, a true mutuality of rights and obligations between the partners.

The definition's final element is that the partners "have a view to profit" and there will be a profit if a comparison of the balance sheet at two different times shows an increase at the later time. The requirement to have a view to profit serves to exclude clubs and societies that have their own legislative treatment elsewhere and are not governed by the Partnership Acts.

Because a partnership agreement need not be in writing, it may sometimes be difficult to determine whether a partnership exists. The statutory rules of construction provide some guidelines, but do not go as far as creating a presumption of partnership: s 6 (Vic). It is always necessary to look carefully at all the facts in any given case.

If a person shares in the **net profits** of a business, as opposed to the **gross returns**, that is prima facie evidence that the person is a partner in the business: s 6(2) – (3) (Vic). However, sharing in net profits does not necessarily make a person a partner, in particular in the circumstances listed in s 6(3) (Vic): see *Cox v Hickman* (1860) 8 HL Cas 268; 11 ER 431; *Re Megevand; Ex parte Delhasse* (1878) 7 Ch D 511; *Cox v Coulson* [1916] 2 KB 177.

The distinction between an agreement to share the gross returns as opposed to the net profits is well illustrated by the following High Court decision.

Cribb v Korn

[2.100] ***Cribb v Korn*** (1911) 12 CLR 205 (High Court of Australia)

FACTS: Cribb owned a farming property. He agreed to allow Rano to use two of the paddocks for farming purposes. Cribb agreed to provide the land,

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tools and the livestock while Rano would provide labour. They agreed to each take half of the gross proceeds of the sale of the eventual produce. Rano employed Korn to help work the land and Korn was injured in the course of his employment. Korn sued both Rano and Cribb, alleging that they were partners and so were jointly liable as his employers.

DECISION: The High Court held that Rano and Cribb were not partners as they had not agreed to carry on business in common. There was no evidence to show that Cribb had intended to be involved in farming the paddocks. All he had done was agree to allow Rano to use the paddocks and equipment in return for an agreed sum – half the *gross* proceeds of sale. Rano, not Cribb was entitled to the eventual profits.

Partnerships and outsiders

Authority of a partner to bind the firm

[2.110] Because partners carry on business in common with a view to profit, each partner is both a principal in the business **and** the agent of the firm and each of the other partners.

Transactions entered into by one partner which are within the usual scope of the firm's business will normally bind both the firm and the other partner(s). Whether or not the other partners have authorised that transaction is irrelevant. If the transaction is one which can be said to be "carrying on in the usual way business of the kind carried on by the firm", the other party is entitled to assume that the partner is authorised to act and the other partners and the firm will normally be bound: ss 9 – 12 (Vic). The exceptions are:

- if the partner was acting without authority and the other party knows this; or
- the other party does not know or believe that he or she is a partner in the business: s 9 (Vic).

See the discussion of actual and ostensible authority in **Chapter 7**; *Construction Engineering (Aust) Pty Ltd v Hexyl Pty Ltd* (1985) 155 CLR 541; *Goldberg v Jenkins* (1889) 15 VLR 36.

The following case illustrates what is meant by "carrying on in the usual way business of the kind carried on by the firm".

Mercantile Credit v Garrod

[2.115] ***Mercantile Credit Co Ltd v Garrod*** [1962] 3 All ER 1103 (Queen's Bench Division)

FACTS: Garrod and Parkin were partners running a garage. Garrod was a "sleeping partner" who took no part in running the business. The partnership agreement expressly excluded buying and selling motor vehicles from the scope of the partnership business. In breach of this agreement and without telling Garrod, Parkin fraudulently sold a car to a third party who later sued

cont.

both partners for the return of the purchase price. Garrod's argument that he was not liable because Parkin had no actual or ostensible authority to act on behalf of the firm, failed.

DECISION: The court held that even though the partnership agreement expressly excluded selling motor vehicles, this was the kind of business that would normally be carried on by a garage and so Garrod was liable.

People who are carrying on business together are often keen to argue that they are not in partnership. The main reason for this is that a partner can be liable for the actions of a fellow partner even when that partner has acted contrary to their express agreement. See for example: *Partnership Act 1892* (NSW), s 5; *Partnership Act 1891* (Qld), s 8; and *Partnership Act 1958* (Vic), s 9. Partners can be liable jointly and severally. See for example: *Partnership Act 1892* (NSW), s 12; *Partnership Act 1891* (Qld), s 15; and *Partnership Act 1958* (Vic), s 16.

Liability of partners in contract

[2.120] Partners do not have limited liability (compare the position of members in a limited liability company. If the firm's assets are insufficient, each partner is liable to the full extent of her or his personal assets for debts and other obligations incurred by a partnership.

Each partner is liable **jointly** with all the other partners for debts incurred by the firm while he or she is a partner: s 13 (Vic). This means that every partner is responsible, not just for her or his share of the debt, but for the whole amount. A creditor has the choice either to sue the firm by name or to sue any one or more individual partner or partners. In the latter case, judgment will be enforced against the nominated partner(s) only, and it is up to her or him to obtain contribution from the other partners. If they are bankrupt or have disappeared, the unfortunate partner sued must satisfy the whole claim.

Note: Because a partner's liability in contract is joint, not joint and several (except in respect of the estate of a deceased partner), a plaintiff has only one opportunity to sue. If a creditor sues and obtains judgment against an individual partner(s) without also naming the firm as a defendant, this will bar any subsequent proceedings against other partners: see *Kendall v Hamilton* (1879) 4 App Cas 504.

Liability of partners in tort

[2.130] In contrast, partners are **jointly and severally** liable in tort. Both the firm **and** all the partners will be bound by any tortious acts, provided the acts are committed by a partner(s):

- "in the ordinary course of the business"; **or**
- "with the authority" of the co-partners: s 14 (Vic).

See *Polkinghorne v Holland* (1934) 51 CLR 143; *National Commercial Banking Corp of Australia Ltd v Batty* (1986) 160 CLR 251.

If money or property of a third person is received:

- by a partner acting within the scope of her or his apparent authority; or
- by a firm in the course of its business; and
- is misapplied by one or more of the partners,

the firm will be liable to make good the loss: s 15 (Vic).

Note: Because liability for tort is joint **and** several, a plaintiff has more than one opportunity to sue: s 16 (Vic). A plaintiff can bring separate actions against the firm and/or some or all of the partners.

Limited liability partnerships

[2.50] Limited liability partnerships may be formed in New South Wales, Queensland, Tasmania, Victoria, South Australia and Western Australia. Unlike ordinary ("general") partnerships, they must be registered and a registration fee is payable. In Victoria, for example, limited and incorporated limited partnerships must be registered with Consumer Affairs Victoria (CAV).

Limited liability partnerships are similar to other partnerships but have two classes of partners. Active (general) partners run the business and are in the same position as partners in an ordinary partnership. Silent (limited) partners contribute capital to the partnership but, as long as they do not take any active part in running the business, they have the benefit of limited liability. Their liability is limited to the contribution they have made to the firm's capital. This encourages investors to contribute capital.

Limited partnerships were starting to become popular in the 1980s because of their ease of setting up, simpler documentation and ability to keep information confidential. However, since 1992 limited partnerships have been treated as companies for taxation purposes, which means that a limited liability partner can no longer claim a tax deduction for partnership losses. Recent amendments to the Corporations Act have meant that all but the smallest limited partnerships must now comply with the fundraising provisions: see ASIC Policy Statement 41: Limited Partnership Fundraising. The combined effect of these changes has greatly reduced the popularity of limited partnerships.

Holding out a person as a partner

[2.140] The doctrine of ostensible or apparent authority applies to partnerships as well as to companies: see **Chapter 7**. Partners and people who hold themselves out as partners, or who consent or acquiesce to being held out, may be liable in contract or tort if:

(a) there is a **representation** that the person is a partner, either by that person or by someone else;

(b) **credit is given to the firm**; and

(c) **that credit is given in reliance on** that representation.

See s 18 (Vic); *Martyn v Gray* (1863) 14 CB (NS) 824; 143 ER 667; *D & H Bunny Pty Ltd v Atkins* [1961] VR 31.

Holding out is often a problem in professional partnerships where a senior employee whose name appears on the firm's letterhead may be assumed by a third party to be a partner, even though that person is actually only a salaried employee.

Lynch v Stiff

[2.150] ***Lynch v Stiff*** (1943) 68 CLR 428 (High Court of Australia)

FACTS: Lynch was a "salaried partner" in a legal firm. This meant that although he was only an employee, his name appeared on the firm's letterhead. Stiff had been a client of the firm for many years and Lynch had always handled his business. When Stiff sold some property he entrusted the proceeds to Williamson, who was a partner in the firm, to be invested. Williamson misappropriated the money. Stiff then sued Lynch on the basis that he had been held out by the firm as a partner.

DECISION: The High Court agreed. The evidence indicated that Stiff invested the money through the firm because he believed, on the basis of the letterhead, that "Lynch, whom he trusted, was a partner": at 435. Stiff had relied on this representation.

Relationship between partners

[2.160] A fundamental principle of partnership law is that a partnership is a fiduciary relationship based on mutual trust and confidence between partners: see *Birtchnell v Equity Trustees, Executors & Agency Co Ltd* (1929) 42 CLR 384; *Chan v Zacharia* (1984) 154 CLR 178 and recently *Wright Prospecting Pty Ltd v Hancock Prospecting Pty Ltd (No 9)* [2010] WASC 44. As fiduciaries, partners have mutual rights and duties which generally require them to act in good faith and for the common good of the partnership. Compare the similar fiduciary duties which require directors to act in good faith and in the best interests of the company which are discussed in **Chapter 12**. Partners may modify these rights and duties in any way they wish in the partnership agreement: s 23 (Vic). More specifically, unless permitted by the terms of the partnership agreement, partners:

(1) must not use their position or any information gained as a result of that position for their personal profit;

(2) must not put themselves in a situation where there will be any conflict between their duty as partners and their personal interest;

(3) must fully disclose all matters likely to affect the partnership to the other partner(s) (s 32 (Vic); and see *Law v Law* [1905] 1 Ch 140);

(4) must account for any private profits made without the consent of the other partners as a consequence of any of the above (s 33 (Vic)); and

(5) must not compete with the firm: s 34 (Vic).

Subject to any express or implied agreement to the contrary, the following basic statutory rules govern the rights and duties of partners:

(a) all partners have a right to share equally in the capital and profits of the business and must contribute equally towards any losses (s 28(1) (Vic)) (Note this may not be what the partners want and so the partnership agreement will be drafted to address this);

(b) partners are entitled to be indemnified for payments and liabilities made or incurred in conducting the firm's business (s 28(2) (Vic));

(c) partners are entitled to interest on any money lent to the firm, but not to interest on their capital contribution (s 28(3), (4) (Vic));

(d) every partner has a right to take part in the management of the firm's business (s 28(5) (Vic));

(e) no partner is entitled to be paid for acting in the firm's business (s 28(6) (Vic));

(f) a new partner cannot be introduced without the consent of all other partners (s 28(7) (Vic)); and

(g) differences of opinion are to be decided by a majority of partners, but all partners must consent to any change in the nature of the business: s 28(8) (Vic).

A partner may assign her or his share in the partnership without the consent of the other partners, but the assignee will only be entitled to the assignor's share in the profits and has no right to interfere in the management of the business: s 35 (Vic).

A partner cannot be expelled from the partnership unless the partnership agreement expressly gives this power to a majority of partners: s 29 (Vic).

Partnership property

[2.170] Ownership of partnership property is one aspect of the partnership relationship that is specifically governed by the Partnership Acts: for example, ss 24 – 26 (Vic). The basic rule is that all property that was originally brought into a partnership, or is acquired by it later, is partnership property: s 24 (Vic). In the absence of any contrary intention, any property that is bought with partnership money will be deemed to have been bought for the partnership: s 25 (Vic). It is very important to distinguish between property that is partnership property and property that is being used in the business, but that remains the personal property of individual partners: see *Robinson v Ashton* (1875) LR 20 Eq 25; *Kelly v Kelly* (1990) 64 ALJR 234.

Harvey v Harvey

[2.180] ***Harvey v Harvey*** (1970) 120 CLR 529 (High Court of Australia)

FACTS: Harold Harvey was unable to run his pastoral property, Fonthill, himself because of illness. He agreed with his brother Horace that they would enter into a partnership. Under the agreement, Harold would provide the land, stock and machinery and Horace and his sons would provide the skill and labour. This arrangement would give Horace's sons experience in running a property and would keep Fonthill operating until Harold's young son was old enough to take it over. When the partnership was eventually dissolved there was a dispute as to whether Fonthill remained Harold's personal property or had become partnership property.

DECISION: The High Court held that Fonthill remained Harold's personal property. The evidence showed that Harold had never intended it to become partnership property. The partnership had only been formed to keep Fonthill going until Harold's son was old enough to run it himself.

Liability of incoming and outgoing partners

[2.190] Each time the composition of a firm changes because a partner retires or dies or a new partner is admitted, a new partnership relationship is created. Subject to any agreement to the contrary (including a written partnership agreement), an outgoing partner will still be liable for all debts and obligations incurred while he or she was a partner, and an incoming partner will only be liable for debts incurred after joining the firm: s 21 (Vic). This section allows a retiring partner to discharge her or his liabilities by obtaining a release from the continuing partners **and** the firm's creditors: s 21(3) (Vic). It is important for retiring partners to ensure that this is done, and that notice of any change in the firm's composition is given to all creditors and clients. Until notice is given, a person is entitled to treat all **apparent** members of the firm as partners: s 40 (Vic). For example, existing clients of a firm are entitled to assume that all the people listed as partners on a firm's letterhead are partners in the firm unless they have actual notice to the contrary: *Hamerhaven Pty Ltd v Ogge* [1996] 2 VR 488. What constitutes notice to **new** clients is set out in the Partnership Acts (eg, s 40(2) (Vic)).

Termination and dissolution

[2.200] A partnership is a contractual relationship so, unless the partnership agreement provides otherwise, a partnership will be automatically dissolved if a partner retires, dies or becomes bankrupt: s 37 (Vic). To address this, almost all partnership agreements make provision for the orderly restructure of a firm in these circumstances without requiring it to be formally dissolved and the business wound up. Any partnership which is, or which becomes, illegal – for example, because the number of partners exceeds the maximum allowed, will be dissolved by operation of law: s 38 (Vic); and see *Hudgell Yeates & Co v Watson* [1978] QB 451.

A partnership which is entered into for a fixed term or to carry out a single undertaking will be dissolved automatically at the end of that period or undertaking unless the partners agree otherwise: s 36(a) – (b) (Vic). If a partnership is entered int for an indefinite term, any partner may dissolve it by giving notice to the other partners: s 36(c) (Vic).

A partnership may also be dissolved by a court order on the application of one or more partners: s 39 (Vic). The grounds for making such an order are:

(a) lack of capacity due to mental illness;

(b) permanent incapacity;

(c) conduct which prejudicially affects the firm's business;

(d) wilful or persistent breach of the partnership agreement;

(e) the business can only be carried on at a loss; and

(f) it is just and equitable to dissolve the partnership.

See *Jenkins v Bennett* [1965] WAR 42.

Consequences of dissolution

[2.210] Dissolution of a firm ends the partnership relationship between the partners, but the business itself remains. Public notice of the dissolution of a firm (or the retirement of a partner) must be given: s 41 (Vic). The business of the firm may be taken over by one or more of the former partners who buy out the others, or it may be wound up. If the business is continued by some of the former partners without a final settlement of accounts, subject to any contrary agreement the outgoing partner(s) will be entitled to either a share of profits made after the dissolution or to interest on their share in the partnership: s 46 (Vic); and see *Pathirana v Pathirana* [1967] 1 AC 233; *Fry v Oddy* [1998] VSCA 26.

If the business is to be wound up, the winding up may be carried out by the former partners (s 43 (Vic)) or if necessary, by a receiver appointed by the court.

To enable the business to be wound up in an orderly manner, the rights and obligations of the former partners continue after dissolution as far as is necessary to wind up the affairs of the partnership and to complete any transactions which were in progress at the time the firm was dissolved: s 42 (Vic). If the former partners are unable to agree, any partner may apply to the court for the appointment of a receiver.

Once the business has been wound up and the firm's assets have been realised, its debts and liabilities are paid and any surplus assets distributed

CHAPTER 12

Directors' Duties – Part 2 Good Faith and Proper Purpose

Useful Websites

(See http://legal.thomsonreuters.com.au/browse/mentor/corplawhub.asp for links to websites on the Topic of Directors' Duties – Part 2.)

Recent Developments

Grimaldi v Chameleon Mining NL (No 2) [2012] FCAFC 6

Gerard Cassegrain & Co Pty Ltd (in liquidation) v Cassegrain [2013] NSWCA 455

Allco Funds Management v Trust Company (RE services) Ltd [2014] NSWSC 1251

Westpac Banking Corp v Bell Group Ltd (in liq) (No 3) [2012] WASCA 157
Barnes v Addy (1874) LR 9 Ch App 244

Aim

At the end of this topic you should know:

- the conduct expected of directors under their duties of good faith and loyalty;
- the overlap between the general law and statutory formulations of the duties of good faith and loyalty;
- the requirements under the general law and the *Corporations Act 2001* (Cth) for the duty of good faith and proper purpose; and
- the statutory formulation of the duty to retain discretions.

Related Topics

Chapter 6 Management of Companies; Chapter 11 Directors' Duties – Part 1 Duty of Care, Skill and Diligence; Chapter 13 Directors' Duties – Part 3 Conflict of Interest and Disclosure; Chapter 14 Members' Rights and Remedies

PRINCIPLES

Introduction

[12.10] This Chapter examines the duties of loyalty and good faith, the second of the two groups of legal duties of directors and company officers outlined at the start of **Chapter 11**. This Chapter assumes knowledge of and builds on the discussion in **Chapter 11**. It includes a discussion of two issues typically arising in connection with the duties of loyalty and good faith. They are:

- directors' disclosure obligations under the general law and the *Corporations Act 2001* (Cth) (Corporations Act); and
- how a director can be excused from a breach of her or his directors' duties.

Corporations (Aboriginal and Torres Strait Islander) Act 2006 (Cth) (CATSI Act)

Part 6-4—Duties and powers of directors and other officers and employees, Division 265-5—Good faith- civil obligations, Division 265-25—Good faith, use of position and use of information–criminal offences, Division 265-30—Interaction of sections 265-1 to 265-25 with other laws etc of the CATSI Act.

An example of case where the Registrar of ORIC laid charges against a former native title director is in relation to the Githabul Nation Aboriginal Corporation RNTBC.

Extract from the ORIC's website:

http://www.oric.gov.au/publications/media-release/registrar-lays-charges-against-former-native-title-director.

MR1516-25 – Registrar lays charges against former native title director

An investigation by the Registrar of Indigenous Corporations, Anthony Beven, has led to charges against a former director of the Githabul Nation Aboriginal Corporation RNTBC.

Mr Trevor John Close has been charged with three counts of dishonestly misusing his position as a corporation director to gain an advantage for himself.

It is alleged that Mr Close used the proceeds of sale from a Githabul Nation native title property to pay the rent for his private home in Sydney. It is alleged that two rental payments were made by Mr Close from corporation funds in July 2013 and one in August 2013.

Githabul Nation was incorporated in 2006 and is registered under the *Corporations (Aboriginal and Torres Strait Islander) Act 2006* (CATSI Act). It was established to manage the native title rights and interests of the Githabul people of northern New South Wales. On 29 November 2007 the Federal Court made a consent determination recognising the Githabul people's native title rights and interests over 1,120 square kilometres of national parks and state forests around Kyogle in northern New South Wales.

As part of the Githabul native title consent process the New South Wales Government transferred 20 parcels of public land to Githabul Nation. The proceeds of sale that Mr Close is alleged to have misused were from the sale of one of the parcels of land.

Mr Close was a director of the Githabul Nation Aboriginal Corporation RNTBC from May 2009 until July 2014, when the corporation was placed under special administration by the Registrar.

The charges against Mr Close have been laid under section 265-25(3)(a) of the CATSI Act. The section carries a maximum penalty of $340,000 or imprisonment for five years, or both, for two charges relating to the July 2013 payments and $360,000 or imprisonment for five years, or both, for one charge for the August 2013 payment.

"Native title rights and interests must be held and used for the benefit of all traditional owners, not one individual," said Mr Beven. "My office provides a range of services to native title bodies to improve their governance but will take action when there are failings in that governance."

MR1516-25 – Registrar lays charges against former native title director cont.

Mr Close is due to appear before the Downing Centre Local Court on 2 August 2016.

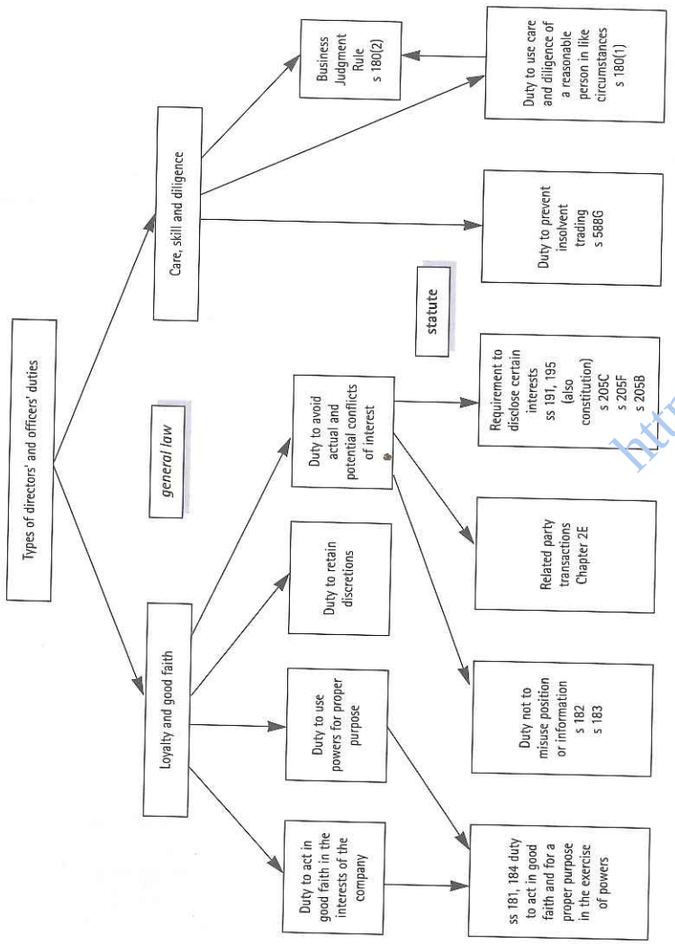
The Commonwealth Director of Public Prosecutions is prosecuting the matter.

Outline of duties of loyalty and good faith

[12.20] To refresh your memory, Figure 11.2 from **Chapter 11** is repeated.

[12.30]

Figure 12.1: Overview of duties of directors



Directors owe duties of loyalty and good faith because they are in a fiduciary relationship with the companies on whose behalf they act. As the diagram illustrates, these duties can be divided into various categories:

(a) to act in good faith in the interests of the company;

(b) to use powers for their proper purpose;

(c) to retain discretionary powers; and

(d) to avoid actual and potential conflicts of interest and duty.

The duties arise under the general law and under ss 181 – 184 of the Corporations Act. The language used to describe the duties in these sections may differ from the language used by judges in law reports to describe the general law duties. Despite these differences, the general law and statutory duties are similar.

The duty to avoid conflicts of interest and duty gives rise to a number of disclosure obligations for directors under the general law and the Corporations Act. These obligations will be discussed later in **Chapter 13**.

To whom are the duties owed?

[12.40] According to *Percival v Wright* [1902] 2 Ch 421, the duties of loyalty and good faith are owed to the company, not to individual members. A number of developments have eroded this principle. Some examples are given in the following table.

[12.50]

TABLE 12.1 Extension of fiduciary duties

Persons to Whom Duty May Also be Owed	Requirements	Case Examples
individual members	In special circumstances, eg • where members dependent on info or advice given by directors; or • close relationship of confidence between members and directors	*Coleman v Myers* [1977] 2 NZLR 225; *Chequepoint Securities Ltd v Claremont Petroleum NL* (1986) 4 ACLC 711; *Glavanics v Brunninghausen* (1996) 14 ACLC 345; on appeal *Brunninghausen v Glavanics* (1999) 46 NSWLR 538
creditors	Duty arises where company is insolvent or nearing insolvency, but duty does not give creditors the right to sue directors for breach of duty	*Walker v Wimborne* (1976) 137 CLR 1; *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722; *Grove v Flavel* (1986) 43 SASR 410; *Sycotex Pty Ltd v Baseler* (1994) 51 FCR 425; *Addstead Pty Ltd (in liq) v Liddan Pty Ltd* (1997) 70 SASR 21; *Spies v The Queen* (2000) 201 CLR 603; *Geneva Finance Ltd v Resource and Industry Ltd* (2002) 169 FLR 152
beneficiaries of trust	Where trust is managed by directors of company – beneficiary may be able to sue for breach of trust	*Hurley v BGH Nominees Pty Ltd (No 2)* (1984) 37 SASR 499; *ASC v AS Nominees* (1995) 62 FCR 504

Persons to Whom Duty May Also be Owed	Requirements	Case Examples
employees	Duty may be imposed by other laws dealing with labour, consumer or environmental protection	No case law or Corporations Act examples

Note: In March 2005 the Commonwealth Government asked CAMAC to examine the issue of directors' duties and whether the Corporations Act should be amended to require directors to take account of the interests of other stakeholders, including employees and customers.

Duty to act in good faith in the interests of the company

Description of duty

[12.60] The duty to act in good faith in the interests of the company requires directors to act "bona fide [in good faith] in what they consider – not what the court may consider – is in the interests of the company": *Re Smith & Fawcett Ltd* [1942] Ch 304 at 306 per Lord Greene MR. This quote reflects the two competing concerns in this area:

- the concern that directors must give proper consideration to the interests of the company in their dealings; and
- the reluctance of courts to interfere with the internal management of companies by "second guessing" their management decisions.

Source of duty

[12.70] The duty arises under:

- the general law – in particular, from principles of equity collectively known as "fiduciary law"; and
- ss 181 and 184 of the Corporations Act.

Examples of breach of duty

[12.80] Depending on the circumstances in which they take place, the following actions by directors may amount to a breach of the duty to act in good faith in the interests of the company:

- controlling members treating company assets as if they are assets held in their own names;
- providing personal benefits to directors or particular members;
- undertaking transactions with directors or particular members on terms very favourable to them;

- forgiving debts owed to the company by directors or particular members; or
- transferring company assets to others in an attempt to avoid recovery by creditors or receivers.

Scope of duty

[12.90] The duty requires directors to act for the benefit of "the company as a whole", not just the majority of members: *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286. It is often difficult to work out what this expression means in the context of a transaction or dealing undertaken by the company. In particular, which stakeholders can be considered to be part of "the company" for the purpose of this duty? Does it include:

- the members?
- the creditors?
- other companies within a group of companies?
- employees and the community?

Each will be briefly explored in the following paragraphs.

Members

[12.100] In *Darvall v North Sydney Brick & Tile Co Ltd* (1988) 6 ACLC 154, Hodgson J, at first instance, said that the duty required directors to have regard for the interests of both:

- the company as a commercial entity; and
- the members of the company.

This view is reinforced by Pt 2F.1 of the Corporations Act which provides remedies to members where the affairs of the company are conducted in a manner which is "contrary to the interests of the members as a whole".

Classes of shares

[12.110] In companies with two or more classes of shares (for example, ordinary and preference shares), directors may make decisions which affect the different classes in different ways. One class of shares may benefit and the other suffer from the transaction. In those situations, the courts have focused on whether the decision was fair as between the different classes of members: see the discussion in *Mills v Mills* (1938) 60 CLR 150 at 164 per Latham CJ.

Creditors

[12.120] If the company is insolvent or nearing insolvency then "interests of the company" includes the interests of **creditors** (who are, in a sense, the

"owners" of the company at that time). The directors must avoid action contrary to their interests. Refer to *ANZ Executors & Trustee Co Ltd v Qintex Ltd* (1990) 8 ACLC 791; *Walker v Wimborne* (1976) 137 CLR 1; *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722; *Grove v Flavel* (1986) 43 SASR 410; *Equiticorp Finance Ltd (in liq) v Bank of New Zealand* (1993) 32 NSWLR 50; *Lyford & Glenisia Investments Pty Ltd v Commonwealth Bank of Australia* (1995) 13 ACLC 900; *Addstead Pty Ltd (in liq) v Liddan Pty Ltd* (1997) 70 SASR 21; *Linton v Telnet Pty Ltd* (1999) 17 ACLC 619; and *Spies v The Queen* (2000) 201 CLR 603. Section 588G reinforces the requirement that directors are to be mindful of creditor rights. However, while creditors have some limited statutory rights against directors for breach of s 588G, creditors have no right to sue directors for breach of their general law duties: *Sycotex Pty Ltd v Baseler* (1994) 51 FCR 425. Directors do not owe an independent duty to creditors which is enforceable by creditors: *Spies v The Queen* (2000) 201 CLR 603 at 1282; *Geneva Finance Ltd v Resource and Industry Ltd* (2002) 169 FLR 152.

Corporate groups

[12.130] The duty to act in good faith in the interests of a company also applies to dealings between companies in a corporate group, such as an inter-group loan or guarantee given by one company on behalf of another within the group. Prior to the introduction of s 187 in 2000, there was some uncertainty as to the interests that a director could take into account in this context.

- In *Walker v Wimborne* (1976) 137 CLR 1, the High Court of Australia held that the interests of the individual company to which the director was appointed were paramount, not the interests of the group of companies. To fulfil the duty, there must be evidence that the director considered the interests of the individual company, separate and alone from the interests of the group: see also *ANZ Executors & Trustee Co Ltd v Qintex Ltd* (1990) 8 ACLC 791; and *Equiticorp Finance Ltd (in liq) v Bank of New Zealand* (1993) 32 NSWLR 50.
- However, in *Charterbridge Corp Ltd v Lloyds Bank Ltd* [1970] Ch 62, a less stringent test was applied. The test applied was: whether an intelligent and honest person in the position of the directors could have reasonably believed that the transaction was for the benefit of the company as a separate entity. This test permits directors to have regard to group interests in addition to the interests of the separate entity. It has been applied in Australia in *Farrow Finance Co Ltd (in liq) v Farrow Properties Pty Ltd (in liq)* [1999] 1 VR 584 and *Maronis Holdings Ltd v Nippon Credit Australia Pty Ltd* (2001) 38 ACSR 404 and in the context of creditors' interests in *Linton v Telnet Pty Ltd* (1999) 17 ACLC 619.

Section 187 is intended to resolve these difficulties for directors of **wholly-owned subsidiaries** by allowing them to make decisions which are in the best interests of the holding company, but not necessarily the best interests of the subsidiary. However, the difficulties remain for directors of partly owned subsidiaries.

SECTION 187

Directors of wholly-owned subsidiaries

A director of a corporation that is a wholly-owned subsidiary of a body corporate is to be taken to act in good faith in the best interests of the subsidiary if:

(a) the constitution of the subsidiary expressly authorises the direction to act in the best interests of the holding company; and

(b) the director acts in good faith in the best interests of the holding company; and

(c) the subsidiary is not insolvent at the time the director acts and does not become insolvent because of the director's act.

Nominee directors

[12.140] Acting in the best interests of the company also raises a vexed issue for **nominee directors** – conflict can arise between the best interests of the company of which they are a director and the interests of the group or company (for example, a holding company) that has appointed them. Section 187 permits directors of wholly owned subsidiary companies, who were nominated by the holding companies, to have dual loyalties provided that they satisfy the requirements described at [12.130]. Difficult problems may still arise for other nominee directors including directors appointed to partly-owned subsidiaries: see Company and Securities Advisory Committee (CASAC, now CAMAC), "Corporate Groups Final Report" (2000), Ch 2. The present Australian view would seem to be that dual loyalty is possible but, in the event of an actual conflict, a nominee director's foremost duty is to the company of which he or she is a director: contrast *Scottish Co-operative Wholesale Society Ltd v Meyer* [1959] 3 AC 324 and *Bennetts v Board of Fire Commissioners of New South Wales* (1967) 87 WN (Pt 1) (NSW) 307, with *Levin v Clark* [1962] NSWR 686.

Employees and the community

[12.150] It was clearly established in *Parke v Daily News Ltd* [1962] Ch 927 that the interests of employees should not be considered by the directors ahead of the interests of the company as a whole. However, if the interests of current, as opposed to past, employees (for example, in industrial matters) can be regarded as affecting the interests of the company, then they could be taken into account.

Corporate sponsorship and donations can also be justified in this way. A sponsorship deal may benefit **the public** but it also, indirectly, benefits the company by way of good public relations and advertising.

Parke v Daily News

[12.155] ***Parke v Daily News Ltd*** [1962] Ch 927 (Chancery Division of the High Court of England and Wales)

FACTS: The Daily News Ltd was the owner of two newspapers. Both newspapers had declining sales and the board decided that it was in the best interests of the company to sell the newspapers to an external party. The board further decided to sell not only the intangible assets of the company, namely the mastheads, but also all plant and equipment. The sale of the newspaper business led to widespread job losses. Sympathetic to the past employees, the board decided to distribute the surplus funds from the sale of the business to the staff that were no longer employed by the Daily News. A minority shareholder objected to the distribution of the surplus proceeds to the past employees.

DECISION: The board was not entitled to distribute the surplus proceeds from the sale of the business to its past employees because to do so would not be in the best interests of the company. This was especially the case with past employees who were no longer employed and therefore, did not provide any current or future benefit to the company.

Impact of company's internal rules

[12.160] The scope of the duty to act in good faith in the interests of the company may be affected by a company's internal rules – the company's constitution may permit directors to take account of a particular stakeholder's interests ahead of others: *Berlei-Hestia (NZ) Ltd v Fernyhough* [1980] 2 NZLR 150; and *Japan Abrasive Materials Pty Ltd v Australian Fused Materials Pty Ltd* (1998) 16 ACLC 1172.

Duty to use powers for proper purposes

Context

[12.170] The duty concerns how directors, in managing a company, exercise the powers given to them by their employment contract, the company's internal rules and the Corporations Act: for example, s 198A, a replaceable rule listing powers of directors, and s 198C, a replaceable rule listing powers of managing directors. Depending on the particular company, directors' powers may include the power to hire employees, to refuse to register a transfer of shares, to acquire premises, to borrow money and to issue shares and debentures.

Description of duty

[12.180] Directors are under a duty to the company to exercise their powers according to certain standards. As Dixon J said in *Mills v Mills* (1938) 60 CLR 150 at 180:

> Directors of a company are fiduciary agents, and a power conferred upon them cannot be exercised in order to obtain some private advantage or for any purpose foreign to the power.

Source of duty

[12.190] The duty arises under:

- fiduciary law, which is part of the general law; and
- ss 181 and 184 of the Corporations Act.

Determining whether breach of duty

[12.200] The onus of establishing that the directors have acted improperly rests on the person(s) making the allegations: *Australian Metropolitan Life Assurance Co Ltd v Ure* (1923) 33 CLR 199. Courts adopt a two-step approach to determine whether there has been a breach of this duty:

1. ascertain the nature of the power and the purpose(s) for which it was conferred ("the **legal purpose**" – there may be more than one); and
2. ascertain from the circumstances the **actual** purpose or reason for which the power was exercised by the directors.

The court compares the actual purpose (Step 2) for the exercise of the power against the legal purpose(s) (Step 1). If the actual purpose for the exercise of the power is within the range of legal purpose(s), the directors have acted properly and discharged their duty. If the actual purpose is outside the legal purpose(s), a breach of duty will have taken place.

Scope of duty

Legal purpose (Step 1)

[12.210] The first step – ascertaining the intended purpose of the power – involves analysing the provision that confers the power. It is normally found in the internal rules of the company. The internal rules may limit the circumstances in which the power is to be exercised. The court interprets the power in light of any such restrictions and the other internal rules of the company. In the absence of any guidance from the internal rules, courts infer what the purpose of the power is from the type of company, its internal structure and activities.

Actual purpose (Step 2)

[12.220] The second step is to ascertain the directors' actual reason or purpose for exercising the power. This requires the court to determine what the directors subjectively believed at the time they exercised the power. It can be very difficult for the court to ascertain this information. It must be shown that the substantive purpose of the directors was improper or collateral to their duties as directors. Honest or well-intended actions by directors do not prevent the court from finding that their conduct amounted to an improper use of their power: see *Permanent Building Society (in liq) v Wheeler* (1994) 11 WAR 187.

Multiple purposes

[12.230] What if several purposes can be ascribed to the directors' actions? The rule seems to be that the mere presence of an improper purpose will not of itself make the directors' act invalid: *Mills v Mills* (1938) 60 CLR 150. If the **substantive or dominant** objective is improper, however, the act will be invalid: *Mills v Mills* at 186 per Dixon J. A gloss was added to this point in *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285, to the effect that if there are a "number of significantly contributing causes", you must ask whether, "**but for**" that impermissible purpose, the directors would not have exercised the power.

Example – power to allot shares

[12.240] The most contentious power is the power to allot shares: s 124(1)(a). This issue often arises in the context of directors defending the company against a hostile takeover, or a battle for control of the company between existing members. *Kokotovich Constructions Pty Ltd v Wallington* (1995) 13 ACLC 1113 is a good illustration: see below. In *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483, the High Court said shares could be issued for purposes other than that of raising finance.

In *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821, for example, the Privy Council said of a power to issue shares, that it was impossible to say in advance what would be a proper or improper purpose. However, if the predominate purpose of the allotment of shares was to defeat a hostile takeover or to dilute the holdings of a particular shareholder the allotment would be invalid.

Howard Smith v Ampol Petroleum

[12.242] ***Howard Smith Ltd v Ampol Petroleum Ltd*** [1974] AC 821 (House of Lords)

FACTS: Ampol Petroleum Ltd owned 55% of the issued capital in RW Milller Ltd. RW Miller became a takeover target for Ampol when Ampol made a formal bid for the remaining issued capital of Miller. The bid was made public at the time Ampol made the announcement to the Australian Securities Exchange. Howard Smith Ltd, a rival company to Ampol, announced a counterbid for Miller. In attempting to resist Ampol's takeover Miller's board decided to allot 4.5 million additional shares. The allotment had the practical effect of reducing Ampol's holding in Miller to 36.6%. Ampol challenged the validity of Miller's share allotment, claiming that the allotment was principally designed to interfere with Ampol's hostile takeover. Miller's board, in turn, claimed that the allotment of shares was necessary to provide the company with additional capital.

DECISION: The House of Lords decided that although the Miller board may have had honest intentions by issuing additional shares they had no power to make the allotment and it was therefore invalid. The allotment had the predominate effect of reducing Ampol's majority holding and was designed to interfere with its attempted hostile takeover of Miller.

[12.244] An allotment of shares may be invalid if:

- the shares were allotted with the aim of transferring control of a major company asset (*Bailey v Mandala Private Hospital* (1988) 6 ACLC 43);
- the dominant purpose of the allotment was to preserve the position of the existing majority members, or to displace them (*Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821; *Pierce v Mills & Co* [1920] 1 Ch 77 (see above); *Ngurli Ltd v McCann* (1953) 90 CLR 425; *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285); or
- the purpose of the share issue was to make the rights of the existing members valueless and there is no other demonstrable benefit to the company: *Kokotovich Constructions Pty Ltd v Wallington* (1995) 13 ACLC 1113.

CHAPTER 23

Takeovers

Useful Websites

(See http://legal.thomsonreuters.com.au/browse/mentor/corplawhub.asp for links to websites on the Topic of Takeovers.)

Aim

At the end of this topic you should be able to:

- describe the main allowable takeover methods and their differences;

- outline generally the information required to accompany takeover offers and responses; and
- explain briefly the sanctions against contravention of the takeover provisions.

Related Topic

Chapter 22 Financial Services, Products and Markets

PRINCIPLES

Introduction

[23.10] A "takeover" is the acquisition of sufficient shares to gain control of a company. Chapter 6 of the *Corporations Act 2001* (Cth) (Corporations Act) restricts acquisitions of shares that result in a person acquiring more than 20% of the voting power in a company.

In this Chapter we use the expressions "bidder" and "target". A "bidder" is the person or company seeking to acquire shares or other securities in the target. The "target" is the company which is the subject of a takeover bid. If the directors of the target welcome the bid, it is referred to as a "friendly" takeover. If the directors of the target do not welcome the bid, it is referred to as a "hostile" bid. In such a case the target may undertake defensive actions to try to thwart the bid: see defensive conduct, discussed in [23.290].

Another method of obtaining control of a company is to undertake a scheme of arrangement under s 411. This has become an increasingly common method of acquisition in the past few years. It is only used to acquire 100% of the shares in the company and can usually only be used in a friendly takeover because the process is carried out by the target company.

Corporations (Aboriginal and Torres Strait Islander) Act 2006 (Cth) (CATSI Act)

Corporations registered under CATSI cannot issue shares or debentures.

Types of control

[23.20] It is important to distinguish different types of control. For instance, a bidder might wish to acquire all the shares in the company (**total control**). There may be a number of reasons for wanting total control, for example, there will be no need to deal with minority interests, but the main reason is usually to take advantage of tax treatment for wholly-owned groups of companies. Under current tax laws, a **wholly-owned** corporate group may be treated as a single taxpayer under the consolidation rules that came into force on 1 July 2002. This means that transactions between members of the group, such as payments for goods or services or receipts, such as dividends, will not give rise to any tax consequences. As a result, considerable tax savings will be enjoyed. If a bidder seeks to acquire total control, it is normal to include a condition (a minimum acceptance condition, see [23.160]) that the offer must result in the bidder being entitled to 90% of the shares. Once 90% is reached, the compulsory acquisition provisions can be used: see [23.260].

Sometimes the bidder will only require sufficient shares to give it **voting control** – that is, more than half of the voting shares. In this case, the bidder may make the offer subject to a minimum acceptance condition of, say, 51%. The bidder acquires **effective control** of the company but does not have to pay for all the shares. In some companies, effective control may even pass with a lesser percentage, particularly if the shareholding is widely spread.

Why make a takeover bid?

[23.30] Takeovers occur for various reasons. For example, a bidder may wish to:

- take advantage of a favourable share price or surplus cash or valuable assets;
- acquire a competitor or secure a distribution or sales network (vertical or horizontal integration);
- expand in new areas (growth through diversification);
- take advantage of accumulated tax losses (although this is not always possible) or other tax considerations; or
- take advantage of the target's listed status and use that vehicle to run the acquirer's business.

As previously noted, Ch 6 applies to acquisitions of shares that result in a person acquiring more than 20% of the voting power in a company. The legislative requirements are an attempt to ensure fair and equal treatment to all shareholders. Acquisitions of shares below that threshold are not restricted.

Regulation

[23.40] The main aim of the legislation is not to prohibit takeovers, but to ensure that all target shareholders have access to relevant information and the opportunity to sell on equal terms. Without restrictions on takeovers, small shareholders would often be excluded from obtaining the same price for their shares as the bidders would deal only with large shareholders in order to

obtain voting control. Small shareholders would not be informed about the identity and credentials of bidders and would have no say about the change of management. They would also be unsure of the company's future and whether to keep their shares or not.

As part of the information process, the provisions relating to substantial shareholders and requirements for disclosure of beneficial ownership aim to ensure early warning of an impending takeover: see **Chapter 9**. If it is likely that a bidder will acquire less than 100%, then shareholders can decide whether they would be happy with a different person (or company) in control and, if not, they can sell their shares.

Despite the reasons for restricting share acquisitions, some commentators believe regulation of takeovers is unnecessary because:

- proper regulation is either impossible to achieve or produces as many problems as it overcomes;
- regulation interferes with market forces, causing inefficiencies; and
- there is nothing wrong with large shareholders receiving preferential treatment.

Share acquisitions may also be regulated by other Commonwealth legislation including the *Foreign Acquisitions and Takeovers Act 1975* (Cth), *Broadcasting Services Act 1992* (Cth), *Insurance Acquisitions and Takeovers Act 1991* (Cth) and *Financial Sector (Shareholdings) Act 1998* (Cth).

Restrictions on takeovers

General prohibition

[23.50] The general rule is that a person is prohibited from acquiring a relevant interest in voting shares above the threshold limit of 20% of the issued capital. Twenty per cent is an arbitrary figure, chosen because it is assumed that a person with less than that proportion cannot exercise control over the company.

Section 606 is the key section.

SECTION 606(1)

Prohibition on certain acquisitions of relevant interests in voting shares

Acquisition of relevant interests in voting shares through transaction entered into by or on behalf of person acquiring relevant interest

(1) A person must not acquire a relevant interest in issued voting shares in a company if:
  (a) the company is:
    (i) a listed company; or
    (ii) an unlisted company with more than 50 members; and
  (b) the person acquiring the interest does so through a transaction in relation to securities entered into by or on behalf of the person; and
  (c) because of the transaction, that person's or someone else's voting power in the company increases:
    (i) from 20% or below to more than 20%; or
    (ii) from a starting point that is above 20% and below 90%.

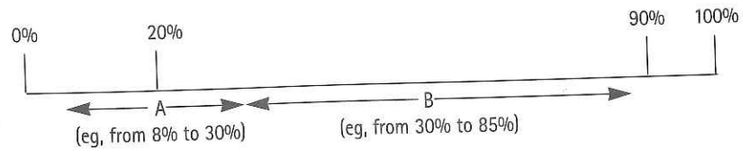
Note 1: Section 9 defines **"company"** as meaning a company registered under this Act.

Note 2: Section 607 deals with the effect of a contravention of this section on transactions. Sections 608 and 609 deal with the meaning of **"relevant interest"**. Section 610 deals with the calculation of a person's voting power in a company.

Note 3: If the acquisition of relevant interests in an unlisted company with 50 or fewer members leads to the acquisition of a relevant interest in another company that is an unlisted company with more than 50 members, or a listed company, the acquisition is caught by this section because of its effect on that other company.

In other words, the prohibition applies to an **acquisition** which takes a person over the 20% limit, or which increases a person's holding to any percentage between 20% and 90%.

By way of example, this section prohibits a person from acquiring a "relevant interest" in issued voting shares in a company if, as a result of that acquisition, either A or B as shown below occurs.



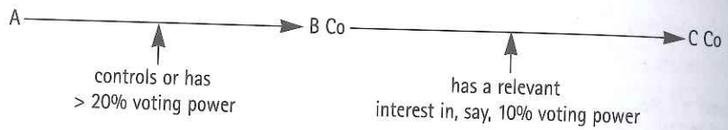
The person must acquire the interest through a **transaction**. A person will be taken to enter into a transaction if they enter into or become a party to an agreement, or if they exercise an option to have shares or securities allotted (that is, the option relates to unissued shares or securities): s 64.

Key concepts in the prohibition are **relevant interest** and **voting power**.

Relevant interests

[23.60] In determining whether a person has a relevant interest, the **basic rule** is that they will have a relevant interest if they are the holder of the securities, or they have the power to vote or to dispose of the securities: s 608(1). Joint holders of shares will each have a relevant interest.

Relevant interests may also be held **through bodies corporate**. This can arise where a person has more than 20% of the voting power in the body corporate or where the person controls the body corporate. In such cases the person will have the same relevant interest as the body corporate: s 608(3). For example, if:



That is:

- A controls B Co (or has more than 20% of the voting power in B Co); and
- B Co has a relevant interest in C Co; then
- A will have the same relevant interest in C Co, that is, 10% of voting power.

A person will be taken to "control" a body corporate if they have the capacity to determine the outcome of decisions about the body's financial and operating policies: s 608(4).

A relevant interest can also arise **in anticipation of agreements**. Where a person has a relevant interest in securities and enters into an agreement, gives or is given an enforceable right, or grants or is granted an option in relation to issued securities, the other party to the transaction will be deemed immediately to have a relevant interest in the securities: s 608(8). This means that the relevant interest can arise before performance of the agreement, enforcement of the right or exercise of the option.

There are also a number of situations where the legislation states that **no relevant interest arises**. They include situations where the parties have entered into an agreement conditional on shareholder approval under s 611, Item 7 (discussed at [23.110]) and where pre-emptive rights (that is, rights of first refusal in relation to securities) are granted under the constitution of the body: s 609(8).

Voting power

[23.70] Having explained when a relevant interest is acquired, not all such acquisitions will breach s 606. Section 606 is only concerned with acquisitions of relevant interests in issued voting shares **which result in an increase in a person's voting power**. A person's voting power in a body corporate is determined under s 610 as follows:

$$\frac{\text{Person's and associate's votes}}{\text{Total votes in body corporate}} \times 100 = \text{person's voting power \%}$$

where:

- **person's and associates' votes** is the total number of votes attached to all voting shares in the body corporate that the person or an associate has a relevant interest in; and
- **total votes in body corporate** is the total number of votes attached to all voting shares in the body corporate.

For example, if T Co has 10,000 shares that are all voting shares and A (and A's associates) have a relevant interest in 1,000 voting shares, A's voting power in T Co is 10%.

In *Queensland North Australia Pty Ltd v Takeovers Panel* (2015) 230 FCR 150, it was held that the number of votes attached to voting shares is to be determined by reference to the company's constitution, which usually prescribes voting rights. The number of votes is not affected by a deed poll or an agreement with a third party limiting the exercise of the voting rights.

Associates

[23.80] The term "associate" is very broadly defined (ss 10 – 16). Where the relevant person is a company, a director or secretary will be an associate. Related companies such as a parent, a subsidiary or a co-subsidiary, as well as directors and secretary of those related companies will be associates. A person is also an associate of another person if they control the relevant person or have entered, or propose to enter, into an agreement for the purpose of influencing the composition of the body's board or conduct of the body's affairs.

Exceptions to the general prohibition

[23.90] There are a number of exceptions to the s 606 prohibition: s 611. Some of the exceptions permit an acquisition of shares, provided certain requirements are met. The most important is:

- an acquisition that results from the acceptance of an offer under a **takeover bid**.
- Other significant exceptions include:
  - an acquisition of no more than 3% every six months – known as a **"creeping takeover"**;
  - an acquisition which gains **approval from the general meeting** of the target; and
  - an acquisition of shares (the **downstream acquisition**) through the acquisition of a relevant interest in another company (the upstream company), where the upstream company is listed on the ASX or a foreign exchange approved by ASIC.

These four exceptions are dealt with under "Main takeover methods": see [23.100]-[22.130].

A number of other exceptions deal with what might be described as inadvertent acquisitions – where the acquirer is clearly not trying to acquire control. They include:

- an acquisition of shares that results from an issue of shares under a disclosure document (s 611, Item 12, see **Chapter 21**);
- an acquisition of shares under a compromise or arrangement approved by the court, for example, a court-approved scheme of arrangement under s 411 (s 611, Items 17 and 18); and
- an acquisition of shares under a will: s 611, Item 15.

An acquisition of shares in a target which is an unlisted company with no more than 50 members is not subject to Chapter 6: s 606(1)(a)(ii).

Main takeover methods

Creeping takeovers

[23.100] The bidder is allowed to acquire not more than 3% every six months: s 611, Item 9.

This is permitted only if the bidder has been entitled to more than 19% of the shares for a continuous period of at least six months. This means that if a bidder is entitled to 18%, they would need to get to more than 19% and then after 6 months, could acquire another 3%. The bidder is not required to disclose any information to the shareholders of the target. This is referred to as "creeping" because of the length of time it would take to obtain any real control.

In a large company, less than 20% can give the holder a right to one or more board positions. In 2012, Gina Rinehart acquired almost 19% of shares in Fairfax Media Ltd following criticism of the editorial direction of newspapers run by Fairfax. It was reported that the company was not prepared to offer her a seat on the board of Fairfax Media on the basis that she had not agreed to accept the principle of editorial independence. The case gave rise to a call to abolish the creeping takeover rule on the basis that it supported aggressive stake building. Treasury released a scoping paper in 2013 but no legislation was forthcoming.

In 2013, ASIC released revised guidance on a range of takeover matters, including creeping takeovers:

Regulatory Guide RG 6 *Takeovers: Exceptions to the general prohibition* (June 2013)

RG 6.48.... The 3% creep exception was originally introduced as an alternative procedure to a takeover bid–allowing persons who may be seeking to acquire a level of control over an entity to do so through gradual increases in their interests over time. The purpose of the exception at the time of its introduction was to limit the speed with which control of companies could be acquired other than by formal takeover or similar procedures that ensure equality of opportunity. A key premise underlying the rationale for permitting only gradual increases in voting power under the exception is that any change in control should occur slowly enough for those affected to make informed decisions in response: see also RG 6.55–RG 6.58.

RG 6.49 In the absence of any other changes to a person's voting power and the voting capital of a company, the 3% creep exception allows a person to increase their holding by 3% every six months from a starting point above 19%. However, the exception is not designed to automatically allow a person to make unrestricted acquisitions of 3% every six months irrespective of the circumstances. The exception is cast in terms of two basic features, which depend on voting power over time:

(a) voting power must have been maintained above 19% for a continuous period of six months prior to any acquisition in reliance on the exception; and

(b) the extent to which a person may increase their interests under the exception depends on the voting power of the relevant person or persons as at the date six months prior to the acquisition.

....

RG 6.51 One result of the particular formulation of the 3% creep exception is that it is not cumulative with the other exceptions in s 611. For example, to determine today how far a person's voting power is above the level it was six months prior (and therefore how much further a person may be able to "creep"), the following must be counted: (a) any voting shares or interests

cont.

acquired in the previous six months under a rights issue to which the exception in item 10 applied; and (b) any other securities contributing to voting power. Similarly, acquisitions as an underwriter or sub-underwriter in reliance on item 13 must also be counted.

RG 6.52 We will not give relief to allow a holder to exclude from the 3% calculation in item 9(b) securities or interests acquired in reliance on other exceptions in s 611. Allowing a holder to acquire a further 3% immediately following an acquisition under another exception in s 611 does not promote the policy underlying the 3% creep exception, which is premised on a gradual increase in voting power over time.

....

RG 6.57 Creeping acquisitions and strategies may have a significant impact on the market for securities in the relevant entity and the decision making of other investors and interested parties. Full and ongoing compliance with the substantial holding and other disclosure requirements is therefore essential to ensuring that acquisitions under the 3% creep exception take place: (a) as far as practicable, in an efficient, competitive and informed market: s 602(a); and (b) in accordance with the underlying policy of the 3% creep exception, which is premised on gradual and open increases in voting occurring slowly enough for those affected to make informed decisions (see RG 6.48).

RG 6.58 Acquisitions made in reliance on the 3% creep exception may give rise to unacceptable circumstances if a failure by the acquirer to comply with their disclosure or other obligations means that the acquisition may not have occurred in a fully informed market. We may apply to the Takeovers Panel if an acquirer purports to rely on the 3% creep exception in these circumstances.

Acquisitions approved by a general meeting

[23.110] A bidder can acquire shares if the acquisition is agreed to by a resolution passed at a general meeting of the target at which no votes are cast by:

- the bidder;
- the seller; or
- any associates (ss 10 to 16) of either the bidder or the seller (s 611, Item 7); (for discussion of who is an associate, see [23.80]).

A bidder who wishes to rely on this exception must provide certain information to shareholders to ensure that the decision whether to approve the acquisition is an informed one.

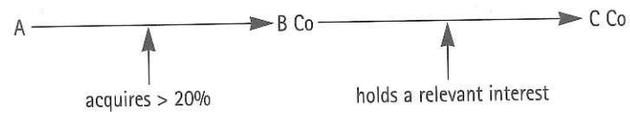
The requirement that no votes be cast by the bidder or the seller (or their associates) effectively means that the exception cannot be used if a bidder wishes to acquire all the outstanding shares in a company, but ASIC has indicated that it may grant approval in some cases: see ASIC RG 74: *Acquisitions Approved by Members* (Dec 2011), [RG 74.53]-[RG 74.55].

Downstream acquisitions

[23.120] An acquisition of a relevant interest in one company that arises as a result of an acquisition of a relevant interest in another company may be exempt. The acquisition of the relevant interest in the downstream company will be exempt provided the upstream company is:

- listed on a prescribed financial market, for example, the ASX; or
- listed on a foreign exchange approved by ASIC: s 611, Item 14. A list of approved foreign exchanges is in Legislative Instrument, ASIC Corporations (Approved Foreign Financial Markets) Instrument 2015/1071.

For example, if A acquires more than 20% of the shares in B Co and B Co has a relevant interest in C Co:



then s 608(3) would normally apply so that A would also acquire the same relevant interest as B Co in C Co. The acquisition of a relevant interest in C Co is referred to as a "downstream acquisition". However, where B Co (the upstream company) is listed on the ASX or an approved exchange, the exemption applies so that the acquisition by A does not breach s 606.

ASIC's Regulatory Guide RG 71: *Downstream Acquisitions* (updated May 2012) discusses the purpose of the exemption and how it operates. ASIC notes that it has discretion to modify provisions of Ch 6 to permit acquisitions in circumstances that are not strictly within the exemption. It states that it will not do so if the purpose of the upstream acquisition is to obtain control of the downstream company.

Takeover bids

[23.130] Probably the most important exception to the prohibition in s 606 is an acquisition of shares that results from acceptance of an offer under a takeover bid: s 611, Item 1. This means that provided the bidder has complied with the requirements of the legislation relating to the making of a takeover bid, any resulting acquisition is permitted. There are two types of takeover bids:

- an **off-market bid** for quoted or unquoted securities; or
- a **market bid**, only available for quoted securities, that is where the company is listed on the ASX.

Chapter 6 contains detailed requirements for an offer to be made under a takeover bid. The requirements differ depending on whether the bid is an "off-market bid" or "market bid" and are outlined below.

Requirements for an off-market bid

[23.140] An off-market bid is basically an offer in writing and can be used whether the securities are quoted on the ASX or not. It is the most common type of bid.

The requirements for an off-market bid generally reflect principles that are sometimes referred to as "the Eggleston principles" (Eggleston being the name of the Chair of the Committee that originally formulated the principles in 1969). Those principles are now set out as the purposes of Ch 6 in s 602.

SECTION 602

Purposes of Chapter

The purposes of this Chapter are to ensure that:

(a) the acquisition of control over:
  (i) the voting shares in a listed company, or an unlisted company with more than 50 members; or
  (ii) the voting shares in a listed body; or
  (iii) the voting interests in a listed managed investment scheme;
takes place in an efficient, competitive and informed market; and

(b) the holders of the shares or interests, and the directors of the company or body or the responsible entity for the scheme:
  (i) know the identity of any person who proposes to acquire a substantial interest in the company, body or scheme; and
  (ii) have a reasonable time to consider the proposal; and
  (iii) are given enough information to enable them to assess the merits of the proposal; and

(c) as far as practicable, the holders of the relevant class of voting shares or interests all have a reasonable and equal opportunity to participate in any benefits accruing to the holders through any proposal under which a person would acquire a substantial interest in the company, body or scheme; and

(d) an appropriate procedure is followed as a preliminary to compulsory acquisition of voting shares or interests or any other kind of securities under Part 6A.1.

Note 1: To achieve the objectives referred to in paragraphs (a), (b) and (c), the prohibition in section 606 and the exceptions to it refer to interests in "voting shares". To achieve the objective in paragraph (d), the provisions that deal with the takeover procedure refer more broadly to interests in "securities".

Note 2: Subsection 92(3) defines "securities" for the purposes of this Chapter.

The issue of what constitutes a substantial interest under s 602 was considered by the Federal Court: *Glencore International AG v Takeovers Panel* (2005) 220 ALR 495; and *Glencore International AG v Takeovers Panel* (2006) 151 FCR 77. In both *Glencore* decisions, Emmett J of the Federal Court held that equity swaps that had been acquired by Glencore over securities in another listed company and takeover target, Austral Coal Ltd, did not amount to a substantial interest within the meaning of s 602. The Federal Court decisions overturned the Takeovers Panel's findings, in two instances (*Re Austral Coal Limited 02 (R)* [2005] ATP 16; *Re Austral Coal Limited 02 (RR)* [2005] ATP 20), that Glencore, by reason of the position it held with equity swaps in the securities of Austral Coal Ltd, did in fact have a substantial interest and was required to disclose its interests to the market, see further [23.270].

Section 602A, inserted by the *Corporations Amendment (Takeovers) Act 2007* (Cth) as a result of the decisions in the *Glencore* cases further elaborates on what it is meant by the concept of a "substantial interest" in s 602.

SECTION 602A

Substantial interest concept

(1) A reference in this Chapter to a **substantial interest** in a company, listed body or listed managed investment scheme is not to be read as being limited to an interest that is constituted by one or more of the following:
  (a) a relevant interest in securities in the company, body or scheme;
  (b) a legal or equitable interest in securities in the company, body or scheme;
  (c) a power or right in relation to:
    (i) the company, body or scheme; or
    (ii) securities in the company, body or scheme.

(2) A person does not have a **substantial interest** in the company, body or scheme for the purposes of this Chapter merely because the person has an interest in, or a relationship with, the company, body or scheme of a kind prescribed by the regulations for the purposes of this subsection.

(3) The regulations may provide that an interest of a particular kind is an interest that may constitute a substantial interest in a company, listed body or listed managed investment scheme for the purposes of this Chapter.

Requirements

[23.150] Section 617 provides that an off-market takeover bid must relate to **securities in a particular class**. This means that if there are separate classes of shares, separate offers will need to be made. Offers made under a takeover bid must be on the **same terms**: s 619. The **offer period** (that is, the period during which shareholders may accept offers) must be for a minimum of one month and a maximum of 12 months: s 624.

An off-market bid may be either a **full bid**, that is, a bid for all the shares in the bid class, or a **partial bid**: s 618. A partial bid must be for a specified proportion of all shareholders' shares. For example, if a bidder wishes to acquire say 50% of the shares of a company, they could make an offer to acquire a proportion from each shareholder. The proportion chosen will need to be higher than 50% because all shareholders may not accept. This creates uncertainty for the bidder and so partial bids are not common in practice.

Conditions

[23.160] An offer under an off-market bid may be subject to conditions. Common types of conditions include "minimum acceptance" conditions, that is, a condition that the bid will fail unless the bidder receives acceptances from a specified minimum proportion of shareholders. The specified percentage may be 51%, that is, enough to give the bidder effective/voting control, or 90%, enough to enable the bidder to compulsorily acquire the remaining shares and obtain total control. Other common types of conditions include approval conditions. For example, a foreign bidder may make a bid conditional on approval from the Foreign Investment Review Board (FIRB) under the *Foreign Acquisitions and Takeovers Act 1975* (Cth).

Some types of conditions are prohibited. These include conditions that depend on:

- the bidder's opinion (s 629);
- maximum acceptance conditions (that is, that the bid will fail if more than a specified percentage accept) (s 626); or
- conditions that allow the bidder to acquire securities from some, but not all, shareholders who accept the offer (that is, discriminatory conditions): s 627.

Consideration

[23.170] Under an off-market bid, a bidder may offer any form of consideration. This may include cash, securities or a combination of cash and securities: s 621(1). The minimum consideration that may be offered is the amount provided (or agreed to be provided) by the bidder (or an associate) in the four months preceding the bid: s 621(3). In other words, a bidder cannot offer $1.50 per share and then two months later make a takeover bid at $1.20 per share: see RG 163: *Takeovers: Minimum bid price principle: s 621*. There are also restrictions on offering any benefits to shareholders that are not offered to all shareholders: s 623; and see [23.250]. This implements the purpose stated in s 602(c): see [23.140]; and Takeovers Panel, *Guidance Note 21: Collateral Benefits* (Apr 2008).

Information to be provided to shareholders

[23.180] One of the most important requirements for a takeover bid is the obligation to provide certain information. This obligation applies to the bidder and the target.

Bidder's statement

[23.190] Section 636 sets out the content requirements for a bidder's statement. The statement must include:

- the identity of the bidder;
- in relation to any cash consideration offered, details of:
  - amounts held by the bidder; and
  - arrangements under which cash will be provided by another person;
- if securities are offered as consideration – all material that would be required for a prospectus for an offer of those securities under ss 710 – 713 (or for simple corporate bonds ss 713C – 713E) in Ch 6D;
- details of the bidder's intentions regarding:
  - the continuation of the target's business;
  - any major changes to the target's business; and
  - the future employment of the target's present employees; and
- any other information that is material to the making of a decision whether to accept the offer and that is known to the bidder. This could include, for example, information about a parent company.

For an off-market bid, the statement must also state that the bidder's statement has been lodged with ASIC, but that **ASIC takes no responsibility for its content**.

Target's statement

[23.200] Section 638 contains the content requirements for the target's statement. However, rather than containing a list of matters that must be included, it provides that the target's statement must include all information that shareholders and their advisers "would reasonably require to make an informed assessment whether to accept the offer under the bid".

Section 640(1) requires that an expert's report accompany the target's statement if:

- the bidder is connected with the target; or
- the bidder is already entitled to 30% or more of the shares.

The expert must report on whether the takeover offer is "fair and reasonable". ASIC's Regulatory Guides RG 111: *Content of expert reports* and RG 112: *Independence of experts* provide guidance on the commissioning and preparation of experts' reports.

Requirements for a market bid

[23.210] A market bid is basically an announcement on a financial market (such as the ASX) that the bidder is willing to acquire all shares in the target at a stated price. This type of bid will only be available to a bidder where the target is listed. A market bid is subject to many of the same requirements as an off-market bid. There are also some requirements that only apply to a market bid. For example, a market bid must be for all securities in a particular class. It must relate to all securities in the bid class that exist or will exist at any time in the bid period: s 617(3). A market bid must be a **full bid**, that is, unlike the situation with an off-market bid, it is not possible to make a partial bid: s 618(3). A market bid must also be **unconditional** (s 625(1)) and the consideration may only be **cash** (s 621(2)), reflecting the fact that the offers are made on the exchange.

A bidder making a market bid must prepare a statement (the bidder's statement), although there are some differences as to what must be disclosed (see s 636(1)(k) and (l)) and the target must prepare a statement (the target's statement): s 638.

[23.220]

TABLE 23.1 Main differences between off-market and market bids

	Off-market bids	Market bids
Type of target	Listed or unlisted	Listed only
Partial bid	Yes	No
Consideration	Cash and/or securities	Cash only
Conditions	Generally yes, but some types of conditions not permitted	No

This table highlights that there is less flexibility in the form a market bid can take – cash only, no conditions. This is one of the issues a bidder's advisers would consider in determining which form of takeover method to recommend to their client.

Truth in takeovers

[23.230] Before we leave the issue of information to be provided to shareholders, consider the purposes outlined in s 602 (see [23.140]) in the light of the following ASIC guidance on last and final statements, which are statements made by market participants (bidders, targets and substantial holders) that they will or will not do something in the course of the bid:

ASIC Regulatory Guide 25

Takeovers: false and misleading statements

...

Underlying principles

RG 25.9 Market participants that make a last and final statement should be held to it, as with a promise. Holders of securities in the target are entitled to expect that market participants will act consistently with their last and final statement. Some market participants have even cited the legal significance of their last and final statement to reinforce it. (Of course, the statement has legal significance regardless of whether the market participant cites it.)

RG 25.10 Where a bidder makes a last and final statement to press holders to accept its offer, then departs from this statement, the statement may:

(a) mislead holders – the statement has the tendency to lead holders and the market into error (see *Parkdale Custom Furniture Pty Ltd v Puxu Pty Ltd* (1982) 149 CLR 191); or

(b) coerce holders into accepting early, so that the holders' opportunity to benefit from the change of control is not reasonable or equal (see s 602(c)).

RG 25.11 In addition, if a market participant makes a last and final statement and departs from it, the following purposes behind Chapter 6 may be undermined:

(a) that the acquisition of control takes place in an efficient, competitive and informed market (see s 602(a)) – an informed market maintains market integrity, which promotes the confidence of investors; and

(b) that holders are given enough information to enable them to assess the merits of the proposal (see s 602(b)).

Holders will be misinformed about what the market participant will or will not do in the course of the bid.

ASIC Regulatory Guide 25 cont.

RG 25.12 The market participant makes the last and final statement voluntarily. It should assume the risk for its statement. It can protect itself by a clear qualification.

[Footnotes not reproduced.]

[23.240] The Takeovers Panel has also released Guidance Notes dealing with changes made to the information provided in takeover documents indicating that failure to provide clear and unambiguous information can amount to "unacceptable circumstances": see [23.310].

Takeovers Panel, Guidance Notes 4 and 5

Takeovers Panel

Guidance Note 4: Remedies General

Revised on 27 May 2015

Background

1. This guidance note has been prepared to assist market participants understand the Panel's approach to remedies generally. The examples are illustrative only and nothing in the note binds the Panel in a particular case.
2. If the Panel makes a declaration of unacceptable circumstances, it may make orders:
   (a) to protect rights or interests affected by the unacceptable circumstances or
   (b) to ensure (as far as possible) that a bid proceeds as if the unacceptable circumstances had not occurred.
3. The Panel may not make an order directing a person to comply with a requirement of Chapter 6, 6A, 6B or 6C.
4. The Panel may make interim orders. These can be to the same effect as final orders, can operate for up to 2 months and do not require a declaration of unacceptable circumstances to be made first.
5. The Panel does not seek to punish when deciding on a remedy. But the remedy may adversely affect a person, provided it is not unfairly prejudicial. In addition, a declaration, [order] or other statement (for example, reasons) may expressly or impliedly involve a reprimand of a party or adviser.

Guidance Note 5: Specific Remedies – Information Deficiencies

Revised on 1 October 2008

Introduction

...

2. The Panel's primary focus is on the quality and accessibility of information for target shareholders and the market. Complete, accurate and relevant information is fundamental to Australian takeover regulation. This is reflected throughout Chapter 6 and in the Panel's approach.
3. In this guidance note the Panel discusses possible responses to information deficiencies, namely:
   (a) restraining dispatch of documents until corrected and
   (b) subsequent corrective disclosure.
4. This guidance note should be read with GN 4 *Remedies – General*.

[Footnotes not reproduced.]

Takeovers Panel, Guidance Notes 4 and 5 cont.

Other provisions

[23.250] Under s 654A, the bidder must not sell shares in the target during a takeover unless a rival bid is made. This is to prevent manipulation of the market price.

Bidders must not provide extra benefits as inducements to particular target shareholders: s 623. This is to ensure equal treatment of all target shareholders consistent with the purposes of Ch 6 stated in s 602: see [23.140]. The rule applies even where the extra benefit relates to the purchase of shares other than the target's, and where consideration is provided by the bidder's parent: *Sagasco Amadeus Pty Ltd v Magellan Petroleum Australia Pty Ltd* (1993) 177 CLR 508. The predecessor of s 623 (s 698 of the *Corporations Law*) has been the subject of consideration in a number of cases: see *Boral Energy Resources Ltd v TU Australia (Queensland) Pty Ltd* (1998) 43 NSWLR 638; and *Aberfoyle Ltd v Western Metals Ltd* (1998) 84 FCR 113. See also RG 9: *Takeover bids* (Section E – Collateral benefits).

An offer can generally only be withdrawn with ASIC's written consent: ss 652B, 652C. However, certain variations may be permitted – for example, an increase in the offer price: s 649B (for a market bid), s 650B (for an off-market bid) or to extend the offer period: s 649C (market bid), s 650C (off-market bid).

A person who publicly proposes to make a takeover bid for securities must make offers within two months of the proposal on the same or substantially the same terms: s 631(1). It is a criminal offence to announce a takeover bid if the person knows, or is reckless as to whether, a bid will or will not be made or is reckless as to whether they will be able to fund their obligations under the bid: s 631(2); see also *ASIC v Mariner* (2015) 327 ALR 95. In *ASIC v Mariner*, Beach J held that the "reckless" test is a subjective test, and s 631(2) does not require certain or guaranteed funding to be in place when the public proposal is made. His Honour noted (at para [244]) that the consistent theme in the legislative history of s 631(2) is that the legislature "intended to prevent the

announcement of a takeover where the person had little if any *intention* of following through with it." Contravention of either of the above provisions can also result in civil liability: s 670E. However, it will be a defence if the person making the proposal establishes that they could not reasonably be expected to comply, either because they were unaware of particular circumstances, or because circumstances have subsequently changed through no fault of their own: s 670F.

In 2012, a case involving retailer David Jones Ltd demonstrated that a bidder, in particular an off-shore bidder, may be able to influence the market and then claim that circumstances have changed.

ASIC Confirms Investigation into EB Bid for David Jones

Blair Speedy, *The Australian*, 3 July 2012

THE Australian Securities and Investments Commission (ASIC) confirmed that it was examining the proposed $1.65 billion takeover offer that played havoc with David Jones's stock.

In a statement today, ASIC said that it had been monitoring the bid developments closely since it was made public by David Jones on Friday.

"Consistent with its usual practice, ASIC is looking at potential issues regarding disclosure and trading in David Jones stock both by domestic and international parties," the markets regulator said.

"ASIC's priority is to ensure market integrity is maintained and that markets are fair, orderly and transparent and that, if there has been a breach of the law, those responsible are held to account."

Shares in the retailer were trading up 1.3 per cent at $2.36 each today.

A spokeswoman for David Jones today said representatives from the company met with ASIC yesterday and that it was co-operating fully with the regulator. "David Jones was the one that initiated contact with ASIC and the ASX (Australian Securities Exchange)," the spokeswoman said.

"We raised our concerns with both organisations about the letters we received and their authenticity."

Questions over the bid's credibility were fuelled after it was widely reported in Australia that EB Private Equity's website didn't include any phone-contact details, or information on previous deals it may have been involved in.

On the website, EB Private Equity said it is a real-estate investor and developer, and a private-equity partner, with a presence in Britain and Luxembourg.

EB Private Equity's website has since been updated with a new statement concerning David Jones.

The EB statement said: "Our intention was to hold preliminary discussions with the David Jones board while financial partners continued to be approached. Recent unfounded, inaccurate and ill-informed publicity around our proposal has made it difficult for these discussions to take place."

ASIC Confirms Investigation into EB Bid for David Jones cont.

"Our proposal was made in an effort to engage with the board. However, the board has made it clear it does not intend to engage in these discussions based on our proposal. This is our only statement on this matter and we are not giving further interviews and comment in any way."

Yesterday, institutional shareholders were split over David Jones's decision to disclose the approach from mystery British firm EB Private Equity, despite having serious doubts about whether the company existed.

DJs belatedly imposed a trading halt on its shares yesterday afternoon, after watching them surge as much as 19 per cent on Friday to a three-month high, in order to announce that EB had withdrawn its proposal.

More than 25 million shares were traded on Friday, and another 10 million yesterday as the share price gave up almost all its 14 per cent gain, in an extraordinary story that focuses corporate Australia's attention on continuous disclosure rules.

Compulsory acquisitions: Chapter 6A

[23.260] Chapter 6A accepts that once a person reaches a certain level of ownership, the person should be able to access the administrative and other advantages, such as tax advantages, associated with full ownership. Where a bidder (with associates) has relevant interests in 90% or more of the shares, and the bidder has acquired at least 75% of the shares that the bidder offered to acquire, the bidder may compulsorily acquire the outstanding shares: s 661A.

Within one month of the end of the bid period, the bidder must give notice to the remaining shareholders that it intends to acquire the shares. The terms of the compulsory acquisition must be the same as under the takeover bid.

A minority shareholder may apply to the court for an order that the securities not be compulsorily acquired. The court can make such an order if it is satisfied that the consideration is not fair value for the shares: s 661E. The onus will be on the applicant to show that the offer is unfair: *Teh v Ramsay Centauri Pty Ltd* (2002) 42 ACSR 354. This may be difficult if a significant number of other shareholders have accepted the offer.

In *Austrim Nylex Ltd v Kroll* (2002) 170 FLR 265 and *Energex Ltd v Elkington* (2003) 47 ACSR 442, the courts considered whether the price offered to minority shareholders constituted "fair value" as required by s 667C. The courts held that the price offered should be based on market value at the time of the compulsory acquisition and should not include a premium reflecting benefits or cost savings associated with acquiring 100% of the company.

The legislation is also concerned that minority shareholders not be "locked in" as a minority. Section 662A provides that a bidder and its associates who have relevant interests in at least 90% of the shares must offer to buy out the remaining holders of the shares.

The legislation also contains powers of compulsory acquisition which are not confined to the making of a successful takeover bid. Section 664A provides that a person who has "full beneficial interests" in at least 90% of the shares in a company (compared with someone who acquires 90% under a takeover bid) may compulsorily acquire the outstanding securities within six months of acquiring that threshold. The expression "full beneficial interest" is not defined but would appear to require ownership rather than just relevant interests in securities.

Substantial holding disclosure: Chapter 6C

[23.270] One of the requirements that extends to a person or company that acquires a substantial holding is that the person or entity must provide disclosure to the company in question as well as the market operator: s 671B. Section 9 defines a substantial holding to be 5% or more of the total number of issued voting shares. The purpose of disclosure under s 671B is to keep the company, as well as the market, informed of any possible takeover activity. The information that must be given with a substantial holding notice is contained in s 671B(3). Breach of the substantial holding disclosure requirement under s 671B exposes the person or entity to a compensation order under s 671C (and to criminal liability under s 671B(1A)). ASIC's Regulatory Guide RG 5: *Relevant interests and substantial holding disclosure* (reissued November 2013) discusses substantial holding disclosure.

The Takeovers Panel considered the application of the substantial interest/holding concept in *Re Austral Coal Limited 02 (RR)* [2005] ATP 20. In that case, the Takeovers Panel was asked to consider the use of equity swaps. Glencore International AG held 4.99% of the issued capital in Austral Coal Ltd. Glencore purchased a form of derivative, cash settled swaps, over a further 7.4% of the issued capital. Glencore did not disclose its interests in Austral Coal Ltd, arguing that it was not required to do so under Ch 6C because the equity swaps did not give Glencore control over Austral securities and it held only 4.99% of the issued capital. Since its holding was less than the 5% substantial holding requirement, it was not required to formally notify Austral Coal Ltd nor the ASX. Only after Glencore acquired more of the issued capital in Austral Coal Ltd through on-market trades did it lodge substantial holding notices with the ASX. On the issue of whether Glencore was required to disclose its interests under the swap agreements the Takeovers

Panel disagreed with Glencore's submissions and held, at para [256], that Glencore's swap exposure gave Glencore:

> a degree of de facto power to prevent the banks from disposing of the hedge shares. Although not enough to give rise to relevant interests over those shares, the banks' economic incentive not to dispose of the shares has enabled Glencore to prevent Centennial from achieving compulsory acquisition. Glencore's degree of control over disposal of the hedge shares and the aggregate size of Glencore's swap exposure and its direct holding are such that it is appropriate to consider Glencore's position as one substantial interest for the purposes of sections 602 and 657A.

On application to the Federal Court seeking judicial review of the Takeovers Panel's decision, the Federal Court overturned the Takeover's Panel ruling and held that Glencore did not have a substantial interest in the securities of Austral Coal Ltd: *Glencore International AG v Takeovers Panel* (2006) 151 FCR 77. According to Emmett J in the Federal Court, the Takeovers Panel had erred in concluding that Glencore had acquired a substantial interest in Austral's shares by reason of the equity swaps Glencore had purchased. Consequently, the Takeovers Panel had erred in concluding that Glencore's non-disclosure of its equity swaps in the securities of Austral Coal Ltd amounted to unacceptable circumstances under s 657A.

Following the Federal Court decisions in *Glencore* and the subsequent amendment to the Corporations Act (s 602A, introduced by the *Corporations Amendment (Takeovers) Act 2007* (Cth) see [23.140]), the Takeovers Panel issued a Guidance Note on the treatment of equity derivatives:

Takeovers Panel, Guidance Note 20

Takeovers Panel

Guidance Note 20: Equity Derivatives

Issued 11 April 2008

Disclosure

35. Adequate disclosure of equity derivatives should enable the market to fully understand the nature of the taker's long position.

36. In deciding whether the level of disclosure gives rise to unacceptable circumstances, the Panel will take into account whether the following information has been disclosed (as applicable):

- a. identity of the taker (but not the writer)
- b. relevant security
- c. price (including reference price, strike price, option price etc as appropriate)
- d. entry date
- e. number of securities to which the derivative relates
- f. type of derivative (e.g. contract for difference, cash settled put or call option)