OXFORD LAW GUIDEBOOKS

BUSINESS LAW GUIDEBOOK

SECOND EDITION

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CHAPTER 10: INTRODUCTION TO COMPANY LAW

TEST YOUR KNOWLEDGE

1. What is company law concerned with?

ANSWER

Company law is concerned with the legal principles applying to companies. A company is essentially an association of people set up for a common object to carry on a business or other activity such as the manufacturing of some goods. Becoming a company is termed registration which is the new word for incorporation. When it is registered, a company assumes the position of a separate legal person which includes a corporate or an individual or 'natural' person'.

2. Discuss the body that is involved in the regulation and administration of companies?

ANSWER

Under the *Australian Securities and Investments Commission Act 2001* (Cth) was established the Australian Securities and Investments Commission, better known by its acronym ASIC. This body has the sole responsibility for the administration and enforcement of the *Corporations Act* and for policing the activities of companies. To put it in another way, ASIC is in fact the main regulator of companies, and the body responsible for carrying out the administrative functions set out in the legislation. It formulates policy for the effective implementation of the *Corporations Act*. It publicises through media releases, policy statements on the operation of provisions of the Act.

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The most easily recognised role of ASIC comes from its general powers of investigation (ASIC Act s 13), encompassing its powers to examine persons (ss 19–27), inspect books (ss 28–39A) and demand information to be disclosed about financial products (ss 40, 43). These general powers are used when ASIC has reason to believe that there is a contravention of the law. Here ASIC would have the competence to determine that either criminal (s 49) or civil (s 50) proceedings be initiated as a result of its investigations.

3. Identify the major differences between a public and a proprietary company.

ANSWER

A public company is any company other than a proprietary company, that is, any company which is not registered as a proprietary company: s 9. A public company is characterised by an absence of restriction on the number of members.

A public company can incorporate with one shareholder (s 114) but must have three directors: s 201 A (2). It may invite the public to subscribe for any shares in, or debentures of, the company and it may be required to prepare disclosure documents when it issues shares. If it is a limited liability company, it includes the word 'limited' or its abbreviation, after the name of the company (for example, Hallmark Ltd).

A public company may or may not be listed on the Australian Stock Exchange (ASX).Where a company is listed, shares are bought and sold on the ASX. Shares of listed companies will normally be more marketable because of the information such companies must supply before listing will be permitted.

Proprietary companies must not, on the other hand engage in any activity, such as issuing shares that would require disclosure to investors. This would prevent a proprietary company from lodging a prospectus and from being listed on the stock exchange. The vast majority of companies are proprietary companies. They are generally relatively small in size –well suited for small to medium-sized businesses. A proprietary company is sometimes referred to as a private company.

4. What are the main features of a company?

ANSWER

A company is a group of persons united or incorporated for joint action, especially for business. In this sense, it is an association of a number of persons with a common object, for example, of conducting business. A company is therefore a business or a professional association. For the purposes of the *Corporations Act 2001* (Cth), the term is limited to an

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association registered under the Act. A company can have limited liability. It is a separate legal entity from the shareholders and members. It can sue and be sued. It has perpetual succession, and its shares are transferable.

5. Explain the different types of companies that may be created.

ANSWER

Most companies are incorporated with limited liability. What this means is that the liability of the members is limited to the extent ascertained by the type of company. There are four types of companies that may be created. They are classified according to the extent of the liability of the members (s 112 (1)):

Companies limited by shares

These are the most common types of companies. They may be public companies or proprietary companies. Such companies are formed on the principle that the liability of its members is limited to the respective amounts that the members undertake to contribute to the property of the company if it is wound up. What this means is that the extent of a member's liability to contribute to the debts of the company, in the event of the company failing, is restricted to the amount unpaid on the issue price of the shares. Since the members of a company limited by shares have limited liability as mentioned, creditors of such a company do not have access to their personal property if the company is wound up. This is why there must be 'Limited' or 'Ltd' after its name, this being a way of giving notice to creditors of the extent of the liability of the shareholders.

Companies limited by guarantee

Such companies do not have share capital. Members do not have to contribute capital while the company is operating. They can be differentiated from companies limited by shares in that the liability of their members is limited to the amount they undertake to contribute to the company in the event of its winding up, and not upon their acquisition of membership: ss 9, 112(1). In that event, members agree ('guarantee') to provide to the company funds, up to a specified limit per member to be used in the satisfaction of the company's debts. These companies are suitable for non-profit organisations such as clubs, charities and other non-trading groups whose capital can be acquired from, for example, donations and subscriptions.

Unlimited companies

Unlimited companies are defined by s 9 as companies whose members have no limit placed on their liability to contribute to the assets of the company in order to discharge the company's debts. They may be public or proprietary companies, depending on whether they

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have share capital. If they do not have share capital, they must be public companies, and if they do have a share capital, they may be either public or proprietary companies.

It is possible that liability of members may extend to their personal assets. As the liability is unlimited, this type of company is generally not suitable for trading purposes. It is, however, suitable for professional firms, such as solicitors' or accountants' firms, which often use this type of company because professional association rules give the members some of the advantages of incorporation.

No liability companies

These companies, which must be public ones, are a special type of company, the activities of which are limited to mining. They are unique in that the members are not legally liable for calls made by the company. These companies have 'No Liability' or 'NL' in their name as a warning to persons dealing with such a company. Since the shares do not carry any liability to pay calls, investors will be willing to acquire partly paid shares with a high issue price and low paid up amount. This kind of share is suited for the highly speculative nature of mining which demands large injections of capital from time to time. If the calls are not met within a specific period, the shares will be forfeited.

6. Discuss the principle that came out of *Salomon v Salomon*. You can explain the principle using the facts of *Salomon v Salomon* or an alternative case.

ANSWER

The principle that came out of *Salomon v Salomon* is that a company or corporation is recognised as a separate or distinct legal entity with independent existence from its members. It has perpetual existence. Its acts are therefore not the acts of its members and its assets and property belong to it and not its members. In *Salomon*'s case, Salomon formed a company which was duly incorporated under the applicable *English Companies Act*. After the transactions were completed, Salomon held 20 001 of the 20 007 issued shares in his company. As a result of strikes in the industry, the company experienced financial difficulties. Despite the infusion of funds through loans, the business continued to decline. Later the company was wound up because of its insolvency and there were not sufficient funds to pay all the debts due. The House of Lords held that the company was a legal entity separate from its members, so the debts of the company were not the debts of Salomon. The company conducted business in its own right, and was not just an alias of Salomon. Accordingly, Salomon was not liable to indemnify the company.

7. Explain the concept of the corporate veil.

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ANSWER

The *Salomon v Salomon* case laid down the principle that control and management of a company remain distinct from its owners. The recognition that a company is a separate entity is often depicted as the 'veil of incorporation'. This is because once a company is incorporated, the courts will usually not look behind the 'veil' to inquire why the company was formed. It is as if a veil hides and separates the shareholders and the directors from the company. As a consequence, persons behind the company do not become personally liable for the company's debts. In the case of a company limited by shares, their liability is limited to the amount, if any, that remains unpaid on the nominal value of their shares: s 516.

In certain cases, however, the court may lift the 'corporate veil' and accord rights and obligations to parties who would not have those rights and obligations. This can be seen where the company is being created, for example, to facilitate fraud by knowingly participating in a director's breach of fiduciary duties, breach a contract, or avoid tax.

8. A company is created through registration. Discuss.

ANSWER

A company is created through registration which leads to its incorporation. To register a company, a person must lodge an application with the ASIC: *Corporations Act*, s 117(1). The application must include a diversity of information, including the type of company that is proposed to be registered, the company's proposed name, the name and address of each person who consents to become a member, details of initial members, directors and the company secretary, the address of the company's proposed registered office and the proposed principal place of business, the number and class of issued shares and the proposed company name: s 117(2).

After the application is lodged (which these days can be done on-line), and the Australian Securities Investment Commission (ASIC) is satisfied that the application has been made in accordance with s 117(2), it will register the company and issue it with a Certificate of Registration: s 118. The company can choose to have a common seal, and if it does, the seal must contain the Australian Company Number (ACN) in the company name: s 123(1).

A company will come into existence as a body corporate at the start of the day on which it is registered with the name stated in its certificate of registration: *Corporations Act*, s 119. The Certificate of Registration operates as a 'birth certificate' of the company. It signifies the fact that all requirements under the *Corporations Act* have been satisfied and that the company is registered from the date the certificate was issued: s 1274 (7A).

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9. Is it a fact that a company today must have a memorandum and articles of association? Discuss in some detail.

ANSWER

Prior to the *Company Law Review Act 1988* (Cth) all companies were required to have a constitution consisting of the memorandum and articles of association, two fundamental documents upon which the registration of any company was based. However, since July 1998, the Corporations Law was amended to remove the requirement for a memorandum and articles of association. Companies no longer need a constitution. *The Corporations Act 2001* now requires a set of rules, called the 'replaceable rules'.

10. Explain what replaceable rules are.

ANSWER

Replaceable rules are basic rules relating to the internal administration and management of companies. The replaceable rules, located in various parts of the *Corporations Act*, apply to companies formed after July 1988 and those companies formed before that date which have repealed their constitutions: s 135 (1) (a) (i) and (ii). They are replaceable in that they can be displaced or modified by the company's constitution: s 135 (2).

The companies that are formed recently may be governed by the replaceable rules and or the company's constitution. Those companies that were formed before the amendments to the legislation have a constitution with a memorandum and articles of association.

11. Can a company negotiate contracts through an agent? Discuss.

ANSWER

Section 126 of the *Corporations Act* covers the situation where a company can contract through an agent. Where this applies, the law of agency takes over the company's contractual rights and obligations. This brings into play the crucial issue of whether the agent has actual authority to act on behalf of and to bind the company. Actual authority may be express or implied. An agent's express actual authority may derive from a principal expressly giving the agent authority to do particular acts on the principal's behalf. An agent's implied actual authority is not expressed between the agent and the principal. The authority is implied from the conduct of the parties. Implied actual authority usually arises when an agent is placed in a particular position by the principal. For instance, an agent who

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is appointed to manage a business has implied authority to do all those acts that a manager in such a position customarily has.

The company will be liable for the acts of its agents acting within their apparent or ostensible authority (the terms 'apparent' and 'ostensible' authority having the same meaning) which is the authority the agents would be expected to have in the circumstances, given the company's holding out. A 'holding out' is a representation made to the outside contracting party that the agent has authority to enter into a contract on behalf of the company.

An agent's apparent authority or ostensible authority brings into existence the agency relationship because of the appearance of authority bestowed on the agent and does not depend on any agreement between principal and agent. The outsider must be induced by the representation (or holding out) to enter into the contract. What this means is that the outsider must in effect rely on the representation.

12. Terry is the majority shareholder and managing director of Titan Pty Ltd. This company operates a business. Titan Pty Ltd has few assets with little realisable value.

The company owed a builder, William, who extended its premises. The company's assets are not sufficient to cover the debt. William is concerned.

Advise William as to whether he can sue Terry personally.

ANSWER

As shareholder of Titan Co Pty Ltd, which is a company limited by shares, Terry cannot be made responsible for the debts of Titan Pty Ltd: *Salomon v Salomon and Co Ltd* [1897] AC 22.

According to the facts, the company's assets are insufficient to cover its debt. In the event of the company being wound up without adequate funds to repay all its debts, Terry, as shareholder of the company has limited liability. He may have to contribute to the company any amounts that he still owes on his shares. However, if Terry holds fully paid shares, he will not be liable as a shareholder to contribute any money to meet the company's debts.

As managing director of the company, Terry could be made liable if he has breached duties to the company. Terry may be liable under s 588 G of the *Corporations Act* to prevent insolvent trading by the company. (Section 588 G of the *Corporations Act* is discussed in Chapter 11.)

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PROBLEM QUESTION

Before you attempt the following problem, make sure you read the 'Guidelines for answering problems' and be acquainted with the IPAC method of writing answers to problem questions.

Students are reminded that questions based on this chapter will ask about:

• The nature of a company: Is a company an independent legal entity with rights and powers of its own? Does this distinguish a company from say a partnership? What are the characteristics of a modern company?

• The powers of a company: Does a company have full legal capacity of a natural person? Can the agents of a company execute documents on its behalf, using express or implied actual authority?

• Classification of companies: What are the kinds of company that may be registered under the *Corporations Act*? What is the most appropriate form of company for a particular kind of business? What is the difference between a small and large proprietary company?

• The company's constitution and rules: Does a company need to have a constitution consisting of a memorandum of association and a set of articles of incorporation? What are the implications of having replaceable rules and can these be displaced?

• Statutory assumptions: What are these assumptions? Are people entitled to make such an assumption if they know or suspect that the assumption was incorrect?

PROBLEM

Zita set up her own delicatessen 'New Deli' after getting a loan from Eastpac Bank. She is worried that Woollies the big retail giant which is going to be built nearby may 'kill' her business. Zita is concerned that she would be faced with unlimited liability. She realises that her business is too small to be formed into a public company. She would nevertheless like to know what her best option is. Advise Zita.

ANSWER

The issue here is whether Zita should form a proprietary company. **(Issue)**

Under s 45 A of the *Corporations Act* there are two kinds of proprietary company—small proprietary company and large proprietary company. **(Principle)**

A company under s 45A (2) is a small proprietary company if it satisfies at least two of the following three criteria:

• the consolidated gross operating revenue for the financial year of the company and the entities it controls (if any) is less than $10 million

• the value of the consolidated gross assets at the end of the financial year of the company and the entities it controls (if any) is less than $ 5 million, and

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- the company and the entities it controls (if any) have fewer than 50 employees at the end of the financial year.

Looking at Zita's situation, and applying what has been said above about the criteria for establishing a small proprietary company, it appears that Zita should think of such a company as an option. **(Application)**

In conclusion, it is recommended that Zita form a small proprietary company. On the basis that Zita's company qualifies as a small proprietary company, it will not be required to prepare formal accounts or have them audited with ASIC. **(Conclusion)**

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