

PRBL004 – Corporations Law

Lecture 2 - The Corporate Veil and the Constitution of a Company

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Drawing from last lecture...

- We looked at the different forms of business structures
- Different forms of registered companies
 - Liability, status and size
 - How to register a company
- Role of ASIC
- We understand a company is a "legal fiction" and has a "separate legal personality"

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Focus of lecture ...

- Meaning of "Separate legal entity"
- The notion of a "Corporate Veil"
- Lifting the veil of incorporation:
 - Common law
 - Statute
- Internal Rules of a Company - Company's Constitution / Replaceable Rules

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What is a “Separate Legal Entity”?

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Separate Legal Entity (‘SLE’)

■ When does this entity come into existence?

The moment a company is registered as per **s 119 CA** (i.e. Form 201 completed/approved by ASIC and complies with all the registration requirements under the CA)

■ Why is it a “legal personality/entity”?

It is a creature of statute/common law

s 119 CA – refers to company as a “body corporate” which is regarded as a ‘person’ for legal purposes

s 124 CA – a company has legal capacity and powers of an individual

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What is the effect of having a SLE?

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Separate Legal Entity ('SLE')

What is the effect of having a SLE?

- Co can sue and be sued
- Perpetual succession – co can continue to exist despite change in membership
- Co can acquire, hold and dispose of assets (members no proprietary interests in assets)
- Co can enter into contracts and incur liability in its name
- Members have limited liability
- Risk on creditors where Co business fails (subject to sufficient security)
- Risk on tort claimants

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Separate Legal Entity ('SLE')

What is the effect of having a SLE?

FUNDAMENTALLY:

CREATES THE NOTION OF THE CORPORATE VEIL!
(between the co and the members)

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The "Veil of Incorporation"

General rule:

Co is a separate entity from its members and members are not liable for its debts

- Courts are generally reluctant to look behind the "veil of incorporation" as long as the Co is duly created (also based on the notion of parliamentary supremacy)

The judicial perception to lifting the veil was first examined in the landmark decision of **Salomon v Salomon & co Ltd [1897] AC 22 (p27 of Lipton)**

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The “Veil of Incorporation”

Salomon v Salomon & Co [1897] AC 22

FACTS:

- Mr Salomon – sole trader – shoe maker and leather merchant
- Registered a limited Co – himself, his wife and 5 children as shareholders
- He and two sons were Co directors – he was the managing director
- He sold his business to company £39,000
- He was partly paid with 20,000 Co's shares and the rest by £10,000 secured debentures with security over Co's assets, remaining £9,000 treated as unsecured loan to co. by Salomon

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The “Veil of Incorporation”

Salomon v Salomon (cont)

- Co failing with insufficient funds to pay outsiders
- S tried to improve by advancing his own funds
- Then borrowed £ 5,000 from lender Boderip- on lent that to the Co
- Boderip was granted a mortgage over S's debentures
- Didn't pay interest on loan, floating charge crystallised- B had Liquidator appointed
- Salomon claimed he had priority over others in respect of the secured debentures
- Liquidator counterclaimed that S had acted as agent of Co all along

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The “Veil of Incorporation”

Salomon v Salomon (cont)

First Instance decision:

- Court said that the Co conducted its business as agent for Salomon
- S, as Principal, bound to indemnify his agent, the company
- Co (as agent) was entitled to lien on principal's assets
- That lien took priority over Salomon's debentures

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The “Veil of Incorporation” Salomon v Salomon (cont)

On appeal, Court of Appeal held:

- Co was conducting business on behalf of S not as an agent, but as trustee acting for S
- i.e. as if S had requested Co to conduct the business as trustee for him
- Such trustee is entitled to be indemnified for debts incurred whilst acting as trustee
- Therefore S liable to pay all the unsecured debts to liquidator

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The “Veil of Incorporation” Salomon v Salomon (cont)

Salomon appealed to House of Lords

House of Lords; Lord Macnaghten held:

- Company is a different person from the subscribers of the memorandum
- Though it may be after incorporation, the business is precisely the same as it was before, and the same persons are managers, and the same hands received the profits, the company is not in law the agent of the subscribers or trustee for them
- Nor are the subscribers as members liable, except to the extent and in the manner provided in the CA

Therefore:

- S not liable to indemnify Co
- Salomon's debentures ranked in priority over unsecured debts in distribution of Co's assets

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The “Veil of Incorporation” The application of Salomon v Salomon

- CA allows for the formation of public or proprietor companies with a single shareholder – s 114
- Common law also recognises that SLE may have an adverse effect on the person who formed the company
 - see Macaura v Northern Assurance Co Ltd [1925] AC 619 – shareholders of co do not own the co's property/assets
- Each company in a group or associated companies is treated as a separate legal entity
 - see Walker v Wimborne [1976] 137 CLR 1 – shifting of funds – directors within a group owe duties to the individual co – each within the group is separate
 - Industrial Equity v Blackburn [1977] 137 CLR 576 – declared special dividend – more than the co's current year profit – several shareholders sought declaration to set aside dividend as invalid - Mason J – statutory authority given to maintain consolidated accounts for a corp group did not result in all cos being treated as one

C/F

- Qintex Australia finance Ltd v Schroders Australia Ltd (1990) 3 ACSR 267 – where co consistently failed to maintain separation between cos – creditors invited to pick which co's to deal with – demonstrates tension between corp law and commercial practice

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Problems due to the Corporate Veil

- Shareholders are not personally liable to creditor's for company's debts
- Directors may do as they wish under the veil of protection of the company
 - leads to corporate debacles – Enron case; Firepower case

As a result...

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Lifting of the Corporate Veil

To meet the harsh reality of the abuse of the corporate veil, both statute and common law have developed instances where the corporate veil will be lifted

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Lifting the Corporate Veil

- Statute (ie in the CA)

- Director's liability for insolvent trading - **s 588G**
- Uncommercial transactions - **s 588 FB- FG**
- Unreasonable director-related transactions – **588FDA**
- Company officer charges - **s 267**
- Financial assistance - **s 260A**
- Trustee Co's: directors will be personally liable if they have not obtained indemnities from beneficiaries under trust funds - **s 233**
- Employee entitlements – **Part 5.8A Corporations Law Amendment (Employee Entitlements) Act 2000**

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Lifting the Corporate Veil

- Common Law

1. **Company set up for a fraudulent purpose**
Re Darby [1911] 1 KB 95 – 2 notorious undischarged bankrupts
– licence for a quite exhausted quarry
2. **Improper purpose/to avoid legal obligation:**
Gifford Motor Co Ltd v Horne [1933] All ER 109 - competing business – restrictive covenant
3. **Company's involvement in a director's breach of fiduciary duty**
Green v Bestobell Industries Ltd [1982] WAR 1 - breach of director's duty not to act in conflict
4. **Attributing mind and will of company**
Tesco Supermarket Ltd v Nattress [1972] AC 153
- attribution made to persons "directing mind and will" of a company rather than as mere employee

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Lifting the Corporate Veil

- Common Law

5. **Group companies**
- Australian courts generally reluctant to treat group companies as a **single economic unit** (per Walker v Wimborne)

What do courts consider in treating group companies as a single economic unit?

Eg.

- Consolidated financial statements
- Taxation consolidation
- The benefit to the group as a whole –
Equiticorp Finance Ltd v Bank of New Zealand
[1993] 11 ACLC (p38)

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Lifting the Corporate Veil

- Common Law

5. **Group companies (cont)**
Eg.
 - Treating subsidiaries as agent or partners
Smith, Stone & Knight Ltd v Birmingham Corporation
[1939] 4 All ER 116 (text p 39) – who was the proper party to sue for compensation – parent or subsidiary?

■ Atkinson J took into account the 6 points:

1. Profits of the subsidiary must be treated as the profits of the holding company
2. The persons conducting the business must be appointed by the holding company
3. The holding company must be the head and brain of the trading venture
4. The holding company must govern the venture and decide what should be done and what capital should be embarked on it
5. The profits of the business must be made by the holding company's skill and direction
6. The holding company must be ineffectual and in constant control

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Lifting the Corporate Veil - Common Law

6. Tort Liability

- make parent liable for subsidiary

- *Briggs v James Hardie & Co Pty Ltd (1989) 7 ACLC 841* - Briggs contracted asbestosis (a negligence claim after limitation period)
- *CSR Ltd v Young (1989) Aust Tort Reports 81-468*

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Lifting the Corporate Veil - Common Law

Important case law on corporate groups:

Partrick Stevedores Operations No 2 Pty Ltd v MUA (1998) 195 CLR 1

READ and discuss in tutorials

- See the CASAC Report on "Corporate Groups"

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Internal Rules of a Company

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Internal Rules of a Company

Purpose:

- To govern the "internal" relationship between the company and its 2 main constituents:
 - its members; and
 - officers

What are the 'SOURCES' of internal rules?

- Constitution of the company (on or after registration);
- Replaceable rules ("RR") in the Corporations Act; or
- A combination of both: s 134

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The "Statutory Contract" – s 140(1)

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Internal Rules of a Company

Effect of the constitution and RR

- "Have effect as a contract" – s 140(1)
- A contract between:
 - co and each member of the company
 - co and each director and co secretary; and
 - the members themselves

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Internal Rules of a Company

Effect of the constitution and RR (cont)

1. Contract between co and members

Eg. Hickman v Kent [1915] 1 Ch 881

2. Enforcement of the constitution by members

- Not all provisions of co's constitution has a contractual effect
- Members may enforce only those provisions which that confer rights on members in their capacity as members (per Hickman)

Eg. Pender v Lushington [1877] 6 Ch D 70

- members have right to enforce provisions that give them the right to have their votes counted at a GM

Wood v Odessa Waterworks Co [1889] 42 Ch D 636

- right to enforce payment of declared dividend

- s 1322(2) – enables court to invalidate procedural irregularity that causes substantial injustice

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Internal Rules of a Company

Effect of the constitution and RR (cont)

3. Outside capacity

- members cannot enforce rights in some other capacity other than a member, such solicitor or promoter

Eg. Eley v Positive GSLS Co [1875] 1 Ex D 20

c/f right and obligations under a contract outside the statutory contract – “special contract”

Bailey v New South Wales Medical Defence Union Ltd [1995] 184 CLR 399

Allens v Gold Reefs of West Africa Ltd [1900]

1 CH 656 – bona fide test in altering the constitution

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Internal Rules of a Company

Effect of the constitution and RR (cont)

4. Non-members

- non-members cannot enforce member's rights even if constitution give them rights

Eg. Forbes v NSW Trotting Club [1977] 2 NSWLR 515

5. Contract between members

- as per s 140(1)(c)

Eg. Re Caratti Holding Co Pty Ltd [1975] 1 ACLR 87

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Internal Rules of a Company

Effect of the constitution and RR (cont)

6. **Contract between the Co and its directors and the secretary**
- as per s 140(1)(b)

Eg. Director's contract of service
Shuttleworth v Cox [1927] 2 KB 9 – director for life clause
c/f Carrier Australasia Ltd v Hunt [1939] 61 CLR 534 – service agreement – separate contract

Remedies

- cannot obtain equitable remedies of injunction or specific performance to enforce employment contracts.

Lipton: as such directors cannot prevent co from terminating their appointment but can only obtain damages for wrongful dismissal

Southern Foundaries Ltd v Shirlaw [1940] AC 701 – co cannot be precluded from altering its articles – nor can an injunction be granted to prevent the adoption of the new articles - but may render co liable in damages to previous engagements

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Internal Rules of a Company

Difference between the statutory contract ("s140 (1)) and other contracts:

- Remedies limited to breach are generally limited to a declaration or an injunction, not damages
- the parties are bound whether or not they agreed to the terms of the contract (eg. member joins after co. is formed)
- It can be modified without consent of every party **NRMA v Snodgrass (2000) 37 ACSR 382**
- It is a written contract notwithstanding that each party does not sign a copy of it
- No consideration has been given

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RR and the Constitution

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Internal Rules of a Company

How do we know which 'SOURCE' applies?

Depends on:

- The type of company; and

- Whether the company was registered before or after 1 July 1998

- substantive reforms introduced by the **Company Law Review Act 1998** (which came into effect 1 July 1998)

What are the reforms?

"Replaceable Rules" ("RR") see ss 134-136 CA and s 141

- Deal with internal matters such as the appointment and removal of directors, convening and conduct of meetings and share transfers.
- Reflects the current "best practice" – amended from time to time
- Applies "in default" of members adopting a constitution that provides for a different rule
- Saves the company from keeping its constitution up to date with CA

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Internal Rules of a Company

When RR apply?

- Every co after 1 July 1998 (unless members opt out of them by adopting a constitution)
- Co's pre-1998 that repeal their entire existing internal rules and do not adopt a new constitution

Companies that must have a constitution:

- because of requirements of CA and/or ASX listing rules:
- No liability companies;
- Companies limited by guarantee that want to be registered without the word "limited" in their name
- Public companies listed on the ASX
- Proprietor company that has the same person as its sole director and sole shareholder: s 135(1)

Other co's may choose to adopt a constitution – which modifies or replaces the RR

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Internal Rules of a Company

Different RR – public v proprietary

Some RR only applies to Pty co's:

- Pre-emption rights for existing shareholders – s254D
- Dividend rights – s 254W(2)
- Additional discretion for directors to refuse to register transfer of shares – s 1072G

Some RR are mandatory for Public co's:

- Appointment of proxies – s 249X (as of Dec 2004)

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Having an understanding of RR,
why do you think companies
may still prefer to have their own
constitution?

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Internal Rules of a Company

Why is the Constitution important?

- A business planning tool
- Enables stakeholders to personalise the co's structure to suit particular needs e. new JV may require weighted voting rights or maintain safeguards for the minority vote
- Not all RR would be appropriate for the new Co
- Example of specialised provisions considered in the constitution of a co include:
 - different classes of share for different types of participants;
 - different voting rights for different classes of shares;
 - provisions for certain key decisions to be passed by majority in each class (eg. take over exercise; dissolve a co, etc.)

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Internal Rules of a Company

Examples of situations where a constitution is adopted instead of RR:

- a co. with different classes of shares with different voting rights
- an "incorporated partnership" where partners transfer an existing business to a co. but intend to each continue to take active part in its management
 - **Ebrahimi v Westbourne Galleries Ltd [1973] AC 360**
- a foreign co. that is incorporated outside Australia
- a co. that intends to or has issued partly paid shares
- proprietary co.'s with a single shareholder who is also the sole director (as per s 135) unless another director is appointed/ shareholder added.

Why? Because while there is a single director/shareholder, all the decision making power rests with that person – s 198E(1)

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Internal Rules of a Company

Background to RR

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Internal Rules of a Company

BACKGROUND to RR

Companies registered before 1 July 1998

Prior to 1.7.98, co's internal rule comprise of:

- the memorandum of association; and
- the articles of association

Memorandum of association ("MA")

- Sets out the co's objects and powers
- Company Law review Act 1998 abolished it
- Basic info contained in MA can be found co's registration application
- Any objects or restrictions on powers that may still be required can be included on co's constitution

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Internal Rules of a Company

BACKGROUND to RR

Articles of Association ("AA")

- Set out the internal rules that would be covered by the RR or a constitution.

Impact of 1998 reforms

- MA & AA of co. registered prior to 1.7.1998 are taken together to be the "constitution" of the co
- The RR will only apply if and when the co repeal the entire MA & AA [s 135 (1)]

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Internal Rules of a Company

Alteration of the Constitution/RR

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Internal Rules of a Company

Alteration of the constitution and RR

S 136(2) – co has power to alter its constitution

What does “alteration” include?

- insertion of new provision
- deletion of old provision
- amendments to existing provisions

How can the constitution be altered?

- By special resolution (“SP”) – this requires 75% of majority of members entitled to vote (s 9)

Effective date of alteration

- Comes to effect the date the resolution is passed or any later date specified in, or determined according to the resolution (s 137)
- If constitution requires any repeal to satisfy an additional requirement, the SP does not take into effect until that additional requirement is complied with [s 136(3)] eg. Where written consent is required before alteration

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Internal Rules of a Company

Displacing or modifying RR

- S 135(2) – RR can be displaced or modified if the co adopts a constitution that has such an effect

- The constitution could expressly displace RR or by inference eg. where Pty co’s constitution provides directors can only be removed by SP – displaces RR in s 203C(a)

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Internal Rules of a Company

Limits on alteration of internal rules

1. Statutory limits – The modification:

- cannot, unless a **member gives written consent**, require that member to
 - take up more shares
 - increase their liability to the co
 - impose (or increase) restrictions on the right to transfer their shares unless the modification is connected with the co's change from a public co to a Pty co: s 140(2)
- must comply with any further requirement in the co's constitution (eg. consent of a particular person required)
- cannot if it is a provision that deals with special rights of members (except by means of procedure)
- cannot be oppressive

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Internal Rules of a Company

Limits on alteration of internal rules (cont)

2. General law limits

i. **Gambotto v WCP Ltd [1995] 13 ACLC 324 (Must read this case!)**

- could majority shareholders use their majority voting power to amend the constitution in order to give themselves the power to buy out the minority?

High Court held: Test for invalidating constitutional alterations:

- if it involves removal of an important membership right; or
- where the shares of members to be acquired without member's consent
- need to satisfy "**tests of fairness**" (see Gambotto)

ii. **Ding v Sylvania Waterways Ltd [1999] 46 NSWLR 424 (must read!)**

- whilst minority members may not be able to prevent changes to the constitution, they are protected from such changes by s140(2)

iii. **Allen Gold Reef of West Africa Ltd [1900] Ch 656**

- co has power to amend its constitution to confiscate shares provided that the use of that power was **bona fide** for the benefit of the co as a whole

iv. **Peters' American Delicacy Company Ltd v Heath [1939] 61 CLR 457**

- Latham CJ, stated various principles of assessing validity of constitutional alterations:

Please read this case – identify 5 principles

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Internal Rules of a Company

Object clauses & Doctrine of UV

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Internal Rules of a Company

Object clauses and limitation on powers

S 124 – confers on a co the legal capacity and powers of an individual and also powers of a “body corporate”

S 125 - if a co has a constitution it can limit its powers by stating an express restriction on, or prohibition of, the exercise of any of its powers
eg. restrict power to borrow money in some way

5 types of companies will still have constitutions setting out objects or restricting the co's powers:

- not-for-profit organisations
- JV companies
- no liability companies
- various professional practices – due to statutory/membership requirements
- companies that were registered prior to 1998 and have not altered their MA

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Internal Rules of a Company

Doctrine of “ultra vires” (“UV”)

- Where a co has a constitution that includes an objects clause, the co's powers are limited to the purposes stated in it
- This means co cannot act outside the powers, if it does those acts are said to be “ultra vires” (outside the power)
- Ultra vires acts are void

Abolition of doctrine of UV

S 125

- Abolishes the doctrine of UV
- No act that is beyond any object, or contrary to express prohibition in the co's constitution, is **invalid merely for that reason**
- **Effect:** protects outsiders dealing with the co. Co cannot simply claim UV to get out of a dealing beyond its powers

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Internal Rules of a Company

Doctrine of “ultra vires” (“UV”) (cont)

Companies without stated objects and powers:

- No question of UV arises
- because co has legal capacity and powers of an individual plus special powers under the CA

Companies with stated objects or restriction on powers

- It is necessary to decide whether a particular act complies with restrictions in the constitution
eg. Object of co is to research into cancer – does it include testing new drugs for cancer?
- If court decides that an act is outside the express objects, the act is not invalid, but may be ratified/asserted in certain proceedings under the CA

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Internal Rules of a Company

Enforcement of the constitution and RR

- Breach of a provision in the constitution or RR is not a contravention of the CA
- It is not an offence which could lead to the imposition of criminal or civil liability
- Though s 140(2) provides that the constitution and RR form a "contract" between co and members, it is the general law that enables co to enforce the statutory contract

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Internal Rules of a Company

Enforcement of the constitution and RR (cont)

Q: Can an individual member or group of members bring an action to enforce the provision?

Bailey v NSW Medical Defence Union Ltd (1995) 184 CLR 399
High Court:

"Special facts" enabled the member to enforce terms of the constitution on which he was sued by an outsider
Read the case: What were the "special facts"?

Q: Can an outsider obtain/enforce rights under the constitution?

NO, unless the those non-members are directors or the co secretary
Lipton & Herzberg: members can only enforce those provisions which affect them in their capacity as members so far as they apply to that person

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Internal Rules of a Company

Consequences of a breach of objects clause or limitation on powers clause

- Is not itself a contravention of CA
- Treated the same way as any breach of co's constitution
- However, breach may still be asserted in other actions under the CA:
 - an action against the director or other officer for breach of duty under Part 2D.1
 - an action for oppression under Part 2F.1
 - a winding down application under s 461(1)(k)
- No statutory injunction available for breach of internal rules unless contravention of the above provisions
- A completed transaction will be valid despite non-compliance of stated objects or restriction on powers
- Not clear whether member can obtain general law injunction to prevent execution of contract in breach of stated objects

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