

TUTORIAL EXERCISES

70417 CORPORATE LAW
AUTUMN 2009

SUMMARY OF TUTORIAL SCHEDULE

Tutorial	Teaching Week	Topic	Page	Week Starting
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No 2	2	Partnerships	5	2.3.09
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No 7	7	Corporate Decision-Making	13	6.4.09
THERE ARE NO TUTORIALS FROM 13.4.09-24.4.09 DUE TO FACULTY NON-TEACHING WEEK (WHICH INCLUDES MID-SESSION EXAM) AND VICE CHANCELLORS' WEEK				
No 8	9	Corporate Decision-Making	15	27.4.09
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TUTORIAL NO 1 “Corporate Law and Ethics”

TUTORIAL OBJECTIVES

After completing the required reading for this class and working through the assigned exercises, students should be able to:

- Discuss possible ethical issues that can arise in corporate law practice
- Appreciate the role of ethics in situations where a separate legal entity is interposed between humans actors
- Outline the system of corporate regulation in Australia
- Explain how the Corporations Act 2001 (Cth) is organised
- Discuss the balance between statutory and case law in corporate law
- Identify where to find further information on particular corporate law topics
- Identify a methodology for answering problem questions in corporate law

Exercise 1.1 *Ethical Problem*

The sale of Alcopops

In 1995, several British brewers introduced a new range of alcoholic drinks, targeted at younger drinkers. The drinks are as intoxicating as strong beer, but are flavoured to taste like soft drinks such as lemonade and cherry soda-hence the name Alcopop. The labels on the bottles were designed to appeal to young people, carrying cartoon characters and bright colours and have humorous names. The product was a great success and commanded a market in the UK worth around \$578 million a year.

However a problem emerged. Although Alcopops were aimed at drinkers in the age range of 25 to 35 years old, it became apparent that they were very appealing to under-age drinkers. The newspapers carried stories of drunken children as young as 11-12 being found wandering the streets carrying bottles of Alcopops. The issue was widely debated in the media.

Brewers responded that their product was a legal one, appealing to a niche market of younger drinkers bored by the taste of more traditional beers and ciders. They were not responsible, they said, if these drinks were illegally sold to under-age young people.

In response to the media furor, a few national supermarket chains decided to refuse to stock Alcopops, and some public houses removed them from their stock. Sales in the first part of 1997 fell by around 11 percent as a result, but the brewers are confident that a buoyant market remains. (from McIntosh et al, *Corporate Citizenship* (1998))

1. **Discuss how the board of directors of the manufacturer of Alcopops should respond to this controversy. How would your answer be different if:**
 - a. **The rationale of the corporation is to maximise shareholder wealth**
 - b. **The rationale of the corporation is to serve the public interest**
 - c. **The rationale of the corporation is to behave ethically by being a good corporate citizen**
2. **Are these corporate purposes mutually exclusive?**
3. **Can you think of any recent examples that raise similar ethical/legal issues?**

Exercise 1.2 Discussion Question

Discuss the following statement:

“Corporations involve nothing more than bilateral negotiations between the owners and managers of capital. The sum of these bilateral relationships is therefore essentially private in nature and should be left to the parties involved to determine. The government should not interfere with the proper exercise of private property rights through increased corporate regulation.”

Exercise 1.3 Practical Exercise

- What section of the Corporations Act 2001 (Cth) regulates the duty of care owed by directors and officers?
- What section of the Corporations Act 2001 (Cth) provides the court with the power to grant a statutory injunction?
- What section of the Corporations Act 2001 (Cth) lists the “civil penalty provisions”?
- What companies are required to hold an annual general meeting (AGM)? Identify the relevant section of the Corporations Act 2001 (Cth).

TUTORIAL NO 2 “Partnerships”

TUTORIAL OBJECTIVES

After completing the required reading for this class and working through the assigned exercises, students should be able to:

- Determine in a given fact situation whether or not a partnership would be recognised in law
- Discuss whether or not the fiduciary duties that partners owe to each other have been breached
- Contrast fiduciary duties with contractual obligations (briefly)

Exercise 2.1 *Practical Question*

Max and Mary have been close friends for a long time and decide that they want to start a business together. Max has a great deal of experience in running business but due to recent business failure he has little money to put into the new venture. Mary has little business experience but considerable personal assets due to the death of her beloved husband, a wealthy mining tycoon. The business would involve a substantial capital outlay.

Max and Mary come to you for advise as to how they might structure their new business.

1. **Draw up a list of at least 5 questions that you would want to ask Max and Mary before giving your opinion.**
2. **Give advice to Max and Mary as to the legal differences between running their business through a partnership compared with a corporation.**

Exercise 2.2 *Problem Question*

Carey, Summers & Co (a partnership commonly known as "Carey's") is one of the principal stock and station agency firms in Orange, in central New South Wales. Its business consists of acting as professional agent, broker, manager and adviser in connection with rural property, stock and produce.

Oscar Summers, a member of Carey's, lent \$250,000 to his daughter Lucinda under a document entitled "Loan Contract". Being something of an amateur lawyer, Oscar drafted the document himself. The purpose of the loan was to further the beef cattle stud which Lucinda conducts near Orange, called the "Canobolis Stud". Oscar did not inform his partners in Carey's about this. The contract says:

WHEREAS Oscar Summers wishes to further the prosperity of the Canobolis Stud without breaching his own obligations to Carey's, it is hereby agreed that:

1. Oscar and Lucinda are not partners and do not intend to be partners.
2. Lucinda hereby assigns to Oscar one-quarter of her interest in the Canobolis Stud, including the right to receive one-quarter of Lucinda's profits from the Stud.
3. Lucinda shall keep Oscar informed as to the affairs of the Canobolis Stud and shall consult with Oscar before taking any major decisions concerning the Stud.
4. For the further avoidance of any conflict of interest, the Canobolis Stud shall transact no business with Carey's and in particular shall not employ Carey's as commission agent for the sale of cattle or other property.

The contract has operated for three years and Oscar has received considerable profits from it.

- (1) **Would Oscar be liable to third parties for the debts of the Canobolis Stud?**
- (2) **Could Oscar set up a competing business if he wanted to?**

Now assume that the contract of loan creates a partnership between Oscar and Lucinda concerning the Canobolis Stud.

- (3) What redress (if any) will Carey's have against Oscar with respect to his participation in the stud?**
- (4) Would it make any difference to your answer if the partnership agreement between the members of Carey's included the following clause: "No member of the firm shall engage in any other business, or be a member of a firm which does so."?**

Exercise 2.3 Discussion Question

Discuss the accuracy of the following statement:

"If partners are fiduciaries because of the closeness of their relationship and joint venturers are not fiduciaries because they maintain separate businesses, directors of public companies should not be fiduciaries because they are separate from the company's shareholders."

TUTORIAL NO 3 “Contextual and Theoretical Issues”

TUTORIAL OBJECTIVES

After completing the required reading for this class and working through the assigned exercises, students should be able to:

- Outline the main theories that attempt to explain the nature of corporations and of corporate regulation
- Discuss the rationale for corporate law regulation
- Identify key themes in corporate governance and explain how theories can assist in understanding the regulation concerning those themes
- Explain the role of directors’ duties and shareholder remedies in corporate governance
- Assess the role of government regulation over corporate activity using at least 3 theories of corporate law

Exercise 3.1 *Discussion Question*

This required reading for this tutorial is provided on the UTS Library website.

Use the theories of the corporation, and hence perspectives of corporate law, to discuss the following questions:

- A. What is the purpose of the corporation as a legal entity?
- B. What is the objective of corporate law?

In the tutorial you will be asked to justify your preference for one theory over the others and expound its implications for corporate governance and regulation. Which theory of the corporation do you consider more adequately or accurately explains the publicly held business corporation and should inform its regulation? This will be a recurring question throughout the subject.

Exercise 3.2 *Practical Exercise*

You are working as a senior policy advisor for the new Federal Government. Given the turmoil in capital markets and a growing number of corporate collapses, the Prime Minister has asked you to head an investigation into redesigning Australia’s system of corporate law. Starting with a clean slate, answer the following questions:

- **Identify 3 issues that you believe should be top priority in the new corporate law**
 - Why are these your top priority?
 - What theoretical position best supports your view of the purpose of this new corporate regulatory framework?
- **Should directors, managers and/or shareholders be personally liable for any wrongs committed by the corporation (such as making dangerous products, or engaging in misleading conduct)?**
 - Identify the legal, commercial and economic implications of your answer.
 - Should companies be required to maintain minimum capital amounts to satisfy any potential liabilities that may arise?

TUTORIAL NO 4 “Contextual and Theoretical Issues”

TUTORIAL OBJECTIVES

After completing the required reading for this class and working through the assigned exercises, students should be able to:

- Determine whether or not a company is likely to be insolvent
- Identify the different practical and legal options open to a company that is in financial difficulties
- Compare and contrast these different options and advise the company on the most appropriate action to take.
- Explain the rationale for the current system of corporate regulation of companies facing insolvency
- Discuss the duties of company directors where the company gets into financial difficulties

Exercise 4.1 Short Problem Question

Acme toys is a manufacturing company based in Penrith NSW. It has 30 employees and has traditionally been very profitable. However, in recent years competition from cheaper imported toys and a slowdown in retail sales has created a strain on the company's finances. The directors have had to mortgage the company's land, and were forced by the bank to confer a floating charge over the company's remaining assets. As the company's trading position worsens the payment of some bills are being delayed or are going unpaid altogether. The company then receives a notice of amended assessment from the Australian Tax Office which states that the company owes \$2 million in incorrectly claimed tax deductions. The company's directors dispute this assessment and wish to appeal the ruling. The directors are hopeful that the coming Christmas trading period will generate sufficient revenues to pay all of its current and near term bills. Furthermore, the directors have engaged the services of Big Four Accountants who are confident that the tax assessment is invalid.

Advise the directors on their, and the company's, current legal situation.

Exercise 4.2 Long Problem Question

The Melick family has owned and managed the Country Stores Pty Ltd (“CS”) retail chain across regional NSW for over three generations. The Melick family owns all of the shares, and holds all of the board positions in the company. Some of the CS stores are operated in buildings owned by the company, whilst others are in rented premises.

With the drought and rural recession, the company's operations have not prospered in recent years. Indeed, the company has sustained significant trading losses in each of the past five years. State Bank has provided financial support through a constantly increasing overdraft limit. The bank is protected by a registered floating charge over the whole of the assets of the company. The floating charge instrument contains a negative pledge, which states that the company agrees not to grant any further securities over its assets without the bank's prior written consent. The company has numerous other unsecured trade creditors, some of which provide goods subject to a retention of title clause.

The poor trading results have meant that the company has had to rely upon substantial financial support from its main shareholder and chair of the board, George Melick. George Melick is an independently wealthy man with numerous investments, and has consistently bailed out the company in times of financial difficulty because of the pride he has in

continuing on the family business. George has lent increasing sums to the company on an unsecured basis over the past six years.

Over the past year the company has faced the possibility that it might not be able to see out the drought. The bank has indicated that the company should not assume its continuing financial support. On some occasions, the company has been forced to sell assets to pay overheads such as wages and trade invoices. George Melick has had to provide loan funds to the company, and has also agreed to provide personal guarantees to cover the company's most recent overdraft extensions by the bank.

CS's board has taken other measures to secure its financial security. To induce George Melick to make his most recent loan to the company and to secure repayment of his earlier loans, the company gave him a floating charge over the historic building in Goulburn from which the company's store operates. The security document gives him the option to call for the transfer to him of the Goulburn property at the value shown in the last Valuer-General's valuation of the unimproved capital value of the land plus the sum for which the building is insured by the company. George may offset outstanding loan moneys against the purchase price upon the exercise of the option.

Under the terms of her service contract as chief executive and managing director of the company, Gemma Melick, George's daughter, was paid a bonus in 2006 for securing asset disposals and the continuing operation of the company. She had agreed to reduce the cash component of her salary package in exchange for the performance-based component of remuneration.

Recently, however, trading has gotten worse and the board is concerned about the continuing solvency of the business. George has raised the idea of formulating a deed of company arrangement to give the business time to restructure.

Advise the board of the options available to the company as well as the potential risks involved in continuing to trade the business in its current state.

Exercise 4.3 Discussion Question

Should directors owe legal duties to the company's creditors? Do creditors deserve greater legal protection from the risk of the company becoming insolvent?

TUTORIAL NO 5 “Corporate Existence”

TUTORIAL OBJECTIVES

After completing the required reading for this class and working through the assigned exercises, students should be able to:

- Explain what is meant by the term “the corporate veil”
- Explain how the corporate form allows for limited liability
- Understand the legal consequences that flow from the incorporation of the company as a separate legal entity
- Discuss when the corporate veil may be lifted

Exercise 5.1 Short Problem Question

Andy has run a small corner store as a sole trader for many years. However, his adult children pester him to set up a company so that they can share in the prosperity of the business as shareholders. Andy complies and sells the business into a newly created company with 2 classes of shares: A class shares that have voting rights and B class shares that have no voting rights but may receive dividends. Andy holds the sole A class share, whilst his children and spouse hold the B class shares between themselves. The company’s purchase of the business from Andy was financed by a loan provided by Andy secured by a charge over all of the company’s assets. Unfortunately, the economic slowdown puts pressure on the business and the new company is unable to service the loan to Andy. Andy takes possession of the company’s assets as secured creditor leaving the business creditors with nothing. **What corporate law issues arise in this situation?**

Exercise 5.2 Long Problem Question

Aztec Pty Ltd is a large proprietary company involved in the manufacture and processing of industrial chemicals. The CEO of Aztec is Bill Rogers, a brash young executive who is moving his way up in the corporate world. The other 5 directors consist of the company’s Chief Financial Officer (Jane) and 3 independent non-executive directors from outside the company.

Bill has devised a plan to rapidly expand Aztec’s operations by buying up its competitors and growing internally. To put this plan into action Bill proposes to the board to purchase the Sydney plant of its main competitor in Sydney, ABC Chemicals. The board approves of the proposed purchase and Bill begins to negotiate with the ABC board to acquire the asset. The negotiations continue over several weeks and finally result in the factory (and a long term lease for the property where the factory is situated) being sold to a related company of Aztec with contracts signed on 1 July 2008. Aztec did not acquire the assets in its own name for tax reasons and used one of Bill’s personal family companies XCel Pty Ltd to purchase the asset on behalf of Aztec. Bill signed the contract as sole director of XCel, which was acting as agent for Aztec. The settlement date for the purchase will occur on 1 September 2008.

Unfortunately for Aztec, one of their most popular chemicals has been found to be defective and has allegedly caused extensive damage to hundreds of their customers machines. Maurice Blackmon and Associates (a well know plaintiff class action firm) has launched a class action against Aztec claiming \$200 million in damages. This will put significant pressure on the company and may (if ordered by the court to pay this sum) bankrupt the company. Bill is now desperate to avoid the completing the contract with ABC. When settlement arrives on 1 September XCel Pty Ltd refuses to pay the balance of the purchase price of \$50 million. XCel has already paid a deposit of \$1 million, but is willing to forgo that rather than paying the full amount. ABC may sue XCel Pty Ltd for damages for breach of contract, but XCel is effectively a \$2 company with no substantial assets. Bill is however a wealthy man and Aztec has sufficient assets to meet a compensation payment to ABC. ABC would ideally like an order for specific performance rather than damages. **Advise ABC as against whom they may commence legal action, and whether they may be able to obtain an order for specific performance.**

Exercise 5.3 Discussion Questions

1. What is the rationale for limited liability? In your view, is this justifiable?
2. Who are the winners and losers from the current system of limited liability? Should the law do more to protect those who are vulnerable to corporate limited liability?

TUTORIAL NO 6 “Corporate Existence”

TUTORIAL OBJECTIVES

After completing the required reading for this class and working through the assigned exercises, students should be able to:

- Explain how the intention and mental state of a corporation is determined
- Discuss how liability may be distributed between the corporation and individuals
- Explain how a corporation can sign a document
- Assess the legal position of third parties who wish to impose liability on a corporation for the conduct of its human agents
- Discuss the scope of the statutory assumptions in attributing legal liability

Exercise 6.1 Short Problem Question

Byron Pty Ltd operates a commercial printing business and has two directors, Mark and Graham. Alice is the marketing manager but in recent times has been doing a lot of the company’s legal compliance work as it has not replaced the last company secretary since he left 3 months ago. The company’s constitution provides that documents may be executed without a common seal but they must be signed either by both of the directors, or by one of the directors and the company secretary.

Alice decides to order a new company car for herself as she is tired of driving to client meetings in an old and unreliable company car. Alice signs a motor vehicle lease with a local car dealer “for an on behalf of Byron Pty Ltd, Alice Mills Company Secretary and Marketing Manager”. The lease is for an expensive car, but it is a very reliable model and the terms of the lease reflect current market prices. No payments have yet been made on the car lease.

Alice also decides to purchase \$10,000 worth of photocopying paper which PaperCo Pty Ltd is selling at a greatly reduced price for a short period of time, and employs a new personal assistant for herself to “ease her workload”.

When Graham discovers what Alice has done he refuses to pay for the bills and tells her that she will be personally liable. She resigns immediately.

Discuss whether Byron Pty Ltd may be liable for either of these contracts.

Exercise 6.2 Short Problem Question

ABC Pty Ltd owns all of the shares in XYZ Pty Ltd and the two companies have the same directors and officers, although they employ separate employees and have separate assets. ABC has substantial assets but XYZ has almost no assets, although it is assumed that ABC as sole shareholder will provide financial support to XYZ whenever needed.

ABC manufactures furniture and XYZ sells the furniture to both retail and wholesale clients. ABC furniture has a solid reputation for building quality furniture so the sales agents of XYZ emphasise that they are representing ABC, although all sales contracts refer to XYZ as the contracting party. The sales agents’ business cards refer to ABC Furniture in large bold writing, with a small by-line noting XYZ as sales agent for ABC.

With the economic downturn putting pressure on sales, ABC management has introduced an attractive incentive for XYZ staff to sell more furniture. This sales incentive results in a small number of sales staff giving misleading statements about the qualities of ABC furniture in order to attract more sales. These sales staff mislead customers deliberately in order to secure their bonus from ABC by hitting critical sales targets.

- 1. Would ABC be liable for misrepresentations made by XYZ staff? Why/why not?**
- 2. How relevant is the fact that such conduct could be within the scope of the sales agents' authority?**

Assume that there is a criminal provision prohibiting deliberately misleading statements. Also assume that the national manager for ABC (who is not a director) was aware that some XYZ sales staff were misleading customers but did nothing as the increased sales helped him earn his quarterly bonus.

- 3. Could ABC and/or its directors be criminally prosecuted for the action of the rogue XYZ sales staff?**

Exercise 6.3 *Discussion Question*

To what extent does the Corporations Act 2001 (Cth) codify the "indoor management rule"?

TUTORIAL NO 7 “Corporate Decision-Making”

TUTORIAL OBJECTIVES

After completing the required reading for this class and working through the assigned exercises, students should be able to:

- Explain the division of power between the different corporate organs
- Discuss the extent of the powers that the board of directors may exercise
- Explain the role of the corporate constitution in regulating the division of powers within corporations

Exercise 7.1 Short Problem Question

Adam, Brad and Charles are the only shareholders of Delta Pty Ltd (Delta). Adam and Brad each hold 40 percent of the shares, whilst Charles owns the remaining 20 percent. Adam and Brad are directors of the company and Charles is in charge of sales.

Delta is involved in a mail-order enterprise which has an extensive customer mailing list. Delta is in partnership with Vineyards International Ltd (Vineyards), which uses the Delta mailing list to contact customers with offers for the sale of high quality wines. Vineyards and Delta are currently negotiating for the use of Delta’s customer list to sell specialty food items, such as olive oils and cheeses.

Aside from working for Delta, Charles has an interest in a family company that supplies restaurants with high quality dairy products. Charles did not disclose this to Delta as he saw no conflict between wine and dairy products. However, when he becomes aware of the proposed deal to expand Delta into other business lines including dairy, Charles becomes concerned about his family company.

Unknown to Adam and Brad, Charles has been including promotional material for his family company’s products in the letters he sent to Delta clients to shore up support before Delta broadens its business.

Eventually Adam and Brad discover what Charles has been doing. They call an urgent shareholders’ meeting, and Charles is not informed that this is to take place. At the meeting they pass a resolution to alter Delta’s constitution, to enable shareholders with a greater than 30 percent holding to compulsorily acquire the shares of any other shareholders. They seek a valuation of the shares which are valued by an independent accounting firm at \$3 per share which they will offer Charles to buy out his shares. After buying out his shares they will terminate his employment, but (of course) they don’t inform Charles of their intention to do this.

Charles seeks your advice as to whether this is a valid action by Adam and Brad.

Exercise 7.2 Long Problem Question

In 1968 Leopold Bloom incorporated Bloom's Books Pty Ltd to take over the family business of dealing in second hand books through its retail store in Sydney. The company has an issued capital of \$100. Leopold and his wife Molly are the only directors and shareholders, holding 60% and 40% of the issued capital, respectively.

In 2002, Leopold and Molly's youngest son, James, finishes his marketing degree at UTS and convinces his parents that a cafe beside the book store (where customers could browse through the books) would complement the book store and be good for its business. A second company, Troy Pty Ltd, is incorporated to purchase vacant premises beside the book store. It has the same issued share capital as Bloom's Books Pty Ltd save that the issued capital is held by James (48%) and Bloom's Books Pty Ltd (52%). ASIC records indicate that the directors of the company are James and Molly.

The cafe is managed by James with some assistance from Molly. However, there is an informal understanding that any major financial decisions concerning the cafe are not to be made without the approval of Leopold. Leopold goes so far as to cause Bloom's Books to amend (with agreement from James, who dare not disobey his father Leopold) Troy's constitution to include a provision that provides for "all decisions involving more than \$10,000 are to be undertaken only in consultation with Leopold Bloom". Troy's constitution also contains a provision with similar wording to s 198A.

For the first two years the profits from the cafe were treated as the profits of the bookstore. In 2004, Troy Pty Ltd started to declare and issue dividends in accordance with the company's share structure for tax reasons. Unlike Bloom's Books Pty Ltd, Troy Pty Ltd has a policy of not retaining any profits (driven largely by Leopold's wishes).

In December 2006 the coffee machine in the cafe exploded badly injuring Brendan Behan, a customer who was having a cup of tea there while browsing through an early edition of James Joyce's *Ulysses* from the book store. Neither Troy Pty Ltd nor Bloom's Book Pty Ltd has any insurance but the latter is heavily capitalised.

Mr Behan successfully sued Bloom's Books Pty Ltd after the trial court pierced the corporate veil. Leopold now wishes to sue the manufacturer of the coffee machine to recover losses. James and Molly are against this plan as the manufacturer is Molly's brother and any legal action against him will drive him out of business whereas the bookstore and cafe will survive the losses suffered. Leopold, acting as a director and the majority shareholder in Bloom's Books Pty Ltd, which is in turn the majority shareholder in Troy Pty Ltd, commences an action in the name of Troy Pty Ltd against the manufacturer.

Molly seeks your advice as to whether she, in any of her capacities in Bloom's Books Pty Ltd or Troy Pty Ltd, or whether James as a director or shareholder in Troy Pty, has any remedy to stop Leopold. **Advise her.**

Exercise 7.3 Discussion Questions

- Was the High Court in *Gambotto* right to characterise a share as "more than merely a capitalised dividend stream"? Why do you think investors buy shares in public corporations?
- How has the relationship between shareholders and management changed since *Salomon's* case?
- Is there a difference between the distribution of power between shareholders and management in proprietary as opposed to public corporations?
- Is the corporate constitution really like a contract?

TUTORIAL NO 8 “Corporate Decision-Making”

TUTORIAL OBJECTIVES

After completing the required reading for this class and working through the assigned exercises, students should be able to:

- Explain the role and purpose of different types company meetings
- Identify who may convene a company meeting
- Explain the relevance of company meetings for company members
- Discuss how a company meeting may be conducted
- Outline what rights and powers members have in relation to meetings
- Identify what may be done in respect of defective company meetings

Exercise 8.1 Short Problem Question

Maxine is a disgruntled shareholder in Megabucks Ltd, a large retailer listed on the ASX. Maxine is unhappy because she believes that Megabucks purchases its stock from businesses that exploit workers in developing nations. Maxine has launched a public campaign to name and shame Megabucks in an attempt to have the company source its products from labour friendly suppliers. Maxine believes that she could embarrass the company by calling an extraordinary members' meeting to force the directors to answer questions about the company's labour practices.

Advise Maxine

Exercise 8.2 Long Problem Question-Former Exam Question

Maxim Ltd is a media company listed on the ASX with major shareholders in Australia, Asia and North America. The CEO of Maxim is George who has engaged the company in a prolonged period of aggressive expansion through acquisitions fuelled by debt. This is despite the fact that corporate debt markets have been very constrained due to the turmoil in financial markets worldwide. The cost of debt is going up and the acquisitions are starting to hurt profits. Some of the major institutional investors in Maxim are concerned about the company's ability to continue servicing its debt obligations and have been petitioning Maxim's board to reign-in the CEO's aggressive behaviour with little effect. Meanwhile the company's share price has halved in the past 9 months.

A group of small but vocal investors (going under the name of the 'Australian Shareholders Alliance') decides to mount a campaign to remove both the CEO (George) and Chairman (Bill) from the board of directors. The group (comprising a diverse group of 60 shareholders) requisitions the company to convene an extraordinary members' meeting to consider the following resolutions:

- a) that CEO George Gilligan and Chairman Bill Boxwell are both incompetent and should be removed from office
- b) that the new CEO and Chairman should be chosen by corporate governance advisory firm 'Institutional Shareholders Advisory'
- c) that the company should take on no new debt for the next 12 months

In addition, the group wants the company to distribute an information booklet entitled "Bored Incompetence: a history of Maxim under George Gilligan".

The board is not going to take this insubordination from shareholders and responds by calling a snap members' meeting to be held 21 days later. The notice of meeting does not specify the proposed resolutions or contained the information booklet. The meeting is held at a conference centre in Hobart (which is unusual as normally the meetings are held in Sydney). The board undertakes this action to ensure that the attendance at the meeting is very low, and voting is done mainly by undirected proxies (controlled by the Chairman, as is usual for undirected proxy voting). At the meeting, the Chairman refuses to allow any of the members of the shareholder group to speak and the resolutions are defeated after the Chairman votes the undirected proxies. The Chairman then proposes a matter of special business (which was not detailed on the notice of meeting) which is to propose an alteration of the company's constitution in the following manner:

- all future meetings that are requisitioned by members will require board prior approval and 6 months notice
- the company will issue a new class of 'super voting' shares to the current board which will carry 3 votes per share
- dividends will be suspended for the next 12 months to fund internal growth in the company.

Investors (including the Australian Shareholders Alliance) are furious and want to challenge the outcome of the extraordinary members' meeting and its constitutional alteration. In addition, many investors are calling for a class action against the board of directors.

You are a lawyer with well-respected plaintiff firm Slattery and Flannigan and have been asked by your supervising partner to put together a brief outline of what corporate law issues arise in this situation. (This question was worth 15 marks)

Exercise 8.3 Discussion Question

Given the cost of convening meetings of large public companies, the limited opportunities for individual members to speak and the small voting power exercised by most members, are company meetings still relevant? Can't information simply be distributed over the web?

TUTORIAL NO 9 “Corporate Governance”

TUTORIAL OBJECTIVES

After completing the required reading for this class and working through the assigned exercises, students should be able to:

- Explain how directors and officers may be identified by applying the statutory definition of those terms to a problem question
- Understand the sources of directors’ duties and the range of possible sanctions that may be imposed for contravention of those duties
- Explain who may enforce directors’ duties
- Discuss the role of the duty of care in corporate governance
- Identify the required elements for establishing a case that a breach of the duty of care has occurred
- Apply the Business Judgment Rule, and reliance defence in s 189 to a problem question
- Outline the available remedies for a breach of the duty of care

Exercise 9.1 Short Problem Question

ACN Ltd is a large operator of childcare centres and is listed on the ASX. The board of ACN consists of Maryanne (the executive Chairwoman), her husband Richard (who is CFO) and 3 non-executive directors (who are close friends with Maryanne. Maryanne built the company from a single centre in the western suburbs of Melbourne and runs the company as her own business, even though she only owns 25% of the shares. Steven is the newly appointed company secretary, who was warned by his predecessor “just do whatever Maryanne wants.”

In recent times Maryanne has been focussed (some would say obsessed) with expanding the business into Asia and North America. This has resulted in her being away from the company for prolonged periods of time. The other directors on the board have traditionally followed Maryanne’s lead and are reluctant to make any major decisions without her approval. Only 1 board meeting is held during the 3 months that Maryanne is overseas. During this time Maryanne has acted through her investment banking advisor George. George gives instructions to senior ACN executives as “directives from Maryanne”. The executives and the board members simply follow George’s instructions as they dare not disobey Maryanne. Steven also carries out instructions given by Maryanne through George the investment banker.

In early June it becomes apparent that things are starting to fall apart without Maryanne and the company is having trouble paying its debts.

Advise the members of the Board, Steven and George about their potential liability for breach of directors’ duties

Exercise 9.2 Long Problem Question

Ace Constructions Ltd is a public company listed on the Australian Securities Exchange with a market capitalisation of approximately \$1 Billion. The Chair of the board of directors is Max Millions, a non-executive director and former auditing partner of a major accounting firm. Max is also a member of the company's remuneration committee and the risk management committee. The CEO of the company is Rick Manwell, a daring corporate executive who is known for taking risks and making lots of money for the company through acquisitions funded by big debts. The company's Chief Financial Officer is Emma Beancounter, who is an experienced finance expert, but is slightly overwhelmed by the complex structure that Rick has forced upon Ace and its board of directors. Both Emma and Max get most of their information from Rick and his associates. Emma is not a director of the company.

In May 2007, Rick makes his most ambitious plan to expand Ace by proposing a hostile takeover for one of Ace's biggest competitors (Multibuild). Rick does not consult any other directors before putting the proposal to the board at their June board meeting. The directors receive no independent advice outside of the documents prepared by Rick. However, the board is impressed by Rick's presentation and agrees to go forward with the takeover after a four-hour board meeting. The takeover proposes to purchase Multibuild at a 30% premium to its current market price. This is seen as being a very expensive bid and the management of Ace is heavily criticised in the media. The bid is enthusiastically accepted by the Multibuild shareholders.

The takeover proposal is funded almost entirely by debt amounting to \$5 Billion. This is substantially more debt that Ace has previously carried and will put significant pressure on the company's profitability, particularly if there is a downturn in the construction industry. In addition, much of the debt will be raised from a syndicate of overseas banks, which creates a significant risk of movements in the foreign exchange rate. Despite advice from senior managers within the company that foreign exchange hedges should be entered into, Emma decides that they are not necessary and too expensive. When the Australian dollar falls against the Euro in late 2007, the cost of funding the takeover skyrockets and the company is left with huge losses.

To make matters worse, Ace has been experiencing cash flow problems for most of 2007. Rick has failed to disclose these problems to the Ace board of directors, and has withheld information from Emma (the CFO) to conceal the mounting losses. Whilst Ace has been able to service the repayment obligations it has had to renegotiate with some major creditors. Rick starts cashing in his share options as he is fearful of the company's financial future.

All of these problems become public knowledge when rising interest rates in Australia cause a slump in the construction industry and a major share price collapse for Ace. This collapse triggers a loan review clause in the company's financing arrangements that allows for the debts to be repaid possibly within 90 days, which would be very difficult. This puts further negative pressure on the share price, culminating in an 85% drop in the company's share price in the 2007 calendar year.

The company teeters on the brink of bankruptcy and investors are furious that Rick and the management team could have been so reckless in mounting the takeover for so high a price and with so much debt during a time of tightening credit markets. Particular criticism has been levelled at Rick, as his remuneration includes a balloon payment of \$2 million if the company's national market share of large new constructions projects exceeded 25% (which it did following the takeover of Multibuild). ASIC has made public statements that it is investigating the company's management team for possible breaches of directors duties under Australian law. **Advise Rick, Max and Emma as to their potential liability for breach of the duty of care.**

Exercise 9.3 Discussion Question

Should there be an extension of the statutory business judgment rule to give directors greater protection against liability for breach of their statutory duties?

TUTORIAL NO 10 “Corporate Governance”

TUTORIAL OBJECTIVES

After completing the required reading for this class and working through the assigned exercises, students should be able to:

- Explain what is meant by acting in good faith for a proper purpose in the best interests of the company as a whole
- Determine whether a director has acted in good faith
- Determine whether a director has acted for an improper purpose, particularly where a director’s actions involve mixed purposes
- Discuss how directors can act in good faith but for an improper purpose
- Assess whether a director has acted in the interests of the “company as a whole” and whether *any* element of self-interest automatically means the directors has not acted in the best interests of the co as a whole.

Exercise 10.1 Short Problem Question

Elliott is the managing director of Acme Finance Ltd, an ASX listed financial services company. Elliott has recently been criticised in the media for receiving a \$40 million bonus, and several vocal shareholder activists have complained that this is unjustified and the company should do more for charitable and other social causes. A small group of shareholders has threatened to call a members’ meeting to pass a resolution at the meeting directing the company to donate a fixed percentage of its profits to charity and to reduce Elliott’s compensation package. Elliott has responded that to donate profits to charity would be a breach of directors’ duties to act in the best interests of the company.

Discuss the corporate law issues raised in this situation.

Exercise 10.2 Long Problem Question

Western Estates Ltd (Western) is a large commercial wine producer listed on the ASX. Western has been investigating various expansion opportunities in recent months and has decided to launch a takeover of one of its competitors, EastVale Wines (EastVale). Senior executives of Western engage in a prolonged period of discussions with their counterparts at EastVale in an attempt to negotiate a friendly merger. However, these discussions do not result in agreement and Western decides to launch a hostile bid for EastVale at a 20% premium to the company’s recent trading price.

The board of EastVale are not happy with the hostile bid and begin to seek out a friendly ‘white knight’ bidder. The EastVale board are concerned about the potential impact of the hostile bid on the company’s stakeholders, particularly the employees and grape growing family’s whose livelihoods depend upon EastVale. Western has a notorious reputation in the wine industry for being ruthless at cutting costs and underpaying growers.

The board of EastVale find a friendly bidder (Amco Wine and Spirits) who is prepared to take a substantial stake in the company of 11% (sufficient to prevent Western from succeeding in its takeover). The board of EastVale agree to issue Amco with 11% of the company’s shares through a new share issue at current market price. Amco has indicated it will only seek 1 board seat and will not attempt to interfere in management of EastVale as a substantial shareholder.

In order to assist with securing the purchase by Amco of 11% of the company, the EastVale board agrees to sign a 5 year exclusive licensing agreement with Amco of EastVale’s top 10 wine brands at commercial rates. This effectively prevents Western from realising the value of buying EastVale because it will not gain 90% ownership nor will it gain control over the top selling products. Western argues that the EastVale directors have acted in breach of their duties by frustrating the takeover.

Advise the EastVale directors. Do not consider the takeover provisions in Ch 6 of the Corporations Act 2001 (Cth).

Exercise 10.3 Discussion Question

Are company directors legally compelled to consider interests beyond those of the shareholders? Should they be?

TUTORIAL NO 11 “Corporate Governance”

TUTORIAL OBJECTIVES

After completing the required reading for this class and working through the assigned exercises, students should be able to:

- Discuss the role of directors duties in Australia
- Explain how directors duties are enforced and what sanctions may be imposed for breach of those duties
- Understand the overlap between duties of fidelity and care
- Apply the principles underpinning both statutory and general law duties to a problem question

Exercise 11.1 *Short Problem Question*

Mary is a non-executive director of ABC Media Ltd, a medium sized ASX listed company. The CEO has recently devised a plan to merge the company with another media business to increase market share. The deal will be very expensive and will drive the company into high levels of debt and will dramatically increase gearing levels. The CEO has also told the board that he has a substantial shareholding in the other company and will not participate in the board deliberations on the merger proposal. There will no doubt be criticism from the media and from some shareholders who would rather see profits returned to shareholders rather than building market share. In light of these factors, the Chairman has requested that a due diligence committee be established to ensure that the transaction will provide long term benefits to shareholders. The Chairman also wants to ensure that any litigation against the board would attract the business judgment rule defence.

As a non-executive director, you have been asked to serve on the due diligence committee with 2 other non-executive board members. Complete the following tasks:

1. What are the litigation risks to the company and board, from ASIC and from shareholders if the deal results in excessive losses?
2. What steps could the board take to ensure that they obtain the protection of the business judgment rule?
3. Are there any defences other than s 180(2) that may protect the board from litigation in respect of the decision to pursue the merger?

Exercise 11.2 *Long Problem Question*

Barry Badler is the managing director and majority shareholder of Dodgy Insurance Ltd (DIL) which is a large insurance company listed on the Australian Stock Exchange (ASX). DIL has approximately 20% of the professional indemnity insurance market in Australia. Lately, DIL has been experiencing serious cash flow problems with the result that many legitimate insurance claims made by DIL policy holders have been denied without good reason. These problems have not prevented DIL continuing to offer insurance contracts to new clients. The internal auditors of DIL estimate that the company is incurring losses of \$1 million per week. They compile this information in an internal memo to Barry Badler, but he does not read the memo as he has not been into his office for the last two weeks.

Barry has been very busy lately so he has not been attending any of the board meetings of DIL and has no idea about the current financial status of the company. Barry is busy because he is a director of many different Australian companies, including Here to Help Ltd (HTHL) a large insurance company listed on the ASX with approximately 30% of the general insurance market.

HTHL is keen to expand its Australian insurance business and is actively looking to acquire other insurance companies. The possibility of HTHL acquiring another insurance company in Australia is raised at a HTHL board meeting in June 2008 which is attended by Barry, who never misses HTHL board meetings. At the board meeting Barry suggests that HTHL takeover DIL and thereby acquire a larger share of the professional indemnity insurance market in Australia. The members of the board know that Barry is a director and major shareholder in DIL and assume that he is fully aware of the company's financial position. When they ask Barry if DIL is good value, Barry responds by saying "absolutely it is". If the takeover is successful Barry is likely to make a large profit on the shares he owns in DIL.

Ray Milligans is the managing director of HTHL and is also a close personal friend of Barry Badler. Ray is very excited about the prospect of taking over his friend's insurance company because he knows that DIL has not been performing well and believes that his excellent management can make DIL profitable again. Ray directs HTHL's company lawyer to draw up a takeover agreement to allow HTHL to buy DIL, without performing the usual due diligence checks to verify the financial status of DIL. Ray is relying solely on Barry's advice that DIL is good value. Ray does not allow any further audits or investigations to be undertaken by HTHL even though it is common knowledge that the professional indemnity insurance market in Australia is not very profitable.

As part of the purchase agreement, Barry agrees to resign his position as managing director of DIL and take up a consultancy for 6 months to HTHL for a \$20 million fee. The fee was negotiated personally between Barry and Ray Milligans, with no other directors of HTHL aware of the large consulting fee being paid to Barry. Ray has agreed to such a large consulting fee for Barry because Barry has undertaken to use half of the fee to buy shares in HTHL in order to boost HTHL's share price.

By August 2008 HTHL completes its successful takeover of DIL. In February 2009, reports emerge in the financial press that DIL may have been insolvent at the time of the takeover by HTHL. Barry Badler and Ray Milligans are now concerned about possible ASIC investigations into the takeover.

Advise both Barry and Ray as to their potential liability under the *Corporations Act 2001* (Cth).

Exercise 11.3 Discussion Question

Are directors subject to too much regulation in Australia? There is no other equivalent regulator to ASIC in the world with most countries leaving the enforcement of directors duties to companies and their shareholders. Are our corporate governance standards too tough?

TUTORIAL NO 12 “Corporate Governance”

TUTORIAL OBJECTIVES

After completing the required reading for this class and working through the assigned exercises, students should be able to:

- Explain the scope of the no-conflict rule
- Identify practical measures that directors can take to manage conflicts of interest
- Outline the sanctions that are available in respect of conflicts of interest and misappropriation
- Discuss the enforcement mechanisms available in respect of breaches of directors statutory and general law duties

Exercise 12.1 Short Problem Question

Axl is the managing director of Xcel Finance Pty Ltd, a family company involved in providing mortgage broking and other financial services to clients in Sydney. Axl also has interests in other personal businesses that are not share by his family. These businesses include an office supply company, a bottled water company and several property developers. Axl has not told the other directors or shareholders in Xcel about this interests. His view is that “it is my personal business. I started this company [Xcel], I run it and if anyone has a problem with me that can leave the business.”

Mary is one of Axl’s cousins who is a director and minor shareholder in Xcel (holding 5% of the shares) and she has grown tired of Axl’s domineering style. **She comes to you for advice as to what action she may take against Axl in light of the above facts.**

Exercise 12.2 Long Problem Question

Ted Egan opened a hardware shop at Waverley in 1965. A couple of years later he employed young Laurie Adams, fresh from school, to work in the store. Laurie proved to be a smart boy and they got on very well. In 1970 when Ted decided to open a second store, in Randwick, he asked Laurie to come into the business in partnership with him. They formed Egan’s Hardware Pty Ltd with Ted holding 55% and Laurie 45% of the 50,000 ordinary shares that were then issued. They appointed themselves joint managing directors of the company; Ted ran the Waverley store and Laurie the Randwick store. Both stores prospered over the following decades. There were no other directors.

Ted retired from active involvement in the business in 1996 although he has remained as a non-executive director of the company. Ted also then sold some of his equity to Laurie so that Laurie now holds 60% and Ted 40% of the equity in the company. Upon Ted’s retirement, Laurie’s daughter, Lizzie, was employed to take over the management of the Waverley store. Laurie thinks that she has done an excellent job and brought in a new clientele of independent women interested in home renovation.

During the 1980s Laurie persuaded Ted to let the company expand into importing and distributing building products for the plumbing trade. (Egan’s Hardware has a good reputation in the plumbing trade and plumbing supply represents a major part of its trade business.) Laurie then established reliable overseas sources of supply and distributed these products through a range of outlets including their two shops. The supply business proved profitable for a while but Ted was never comfortable with it and they abandoned it a few years later.

Laurie now proposes to Lizzie that a new company be formed to resume the supply business, using some of the overseas supply contacts that he had developed earlier and distributing products through the old supply outlets he had developed. He wants to encourage his daughter so he contributes \$20,000 of his personal savings to assist with start

up costs. No documentation is provided in relation to the funds. Laurie suggests to Lizzie that she form and run a company to import and distribute plumbing products through any hardware outlets in NSW that will take them, including the Waverley and Randwick stores where they will not receive any favoured treatment. Lizzie will continue to work half time as manager of the Waverley store and the rest of her time will be devoted to developing her own business. Lizzie agrees and Lizzie's Plumbing Supplies Pty Ltd is soon incorporated. Lizzie relies upon the old supply and distribution contacts in developing her business.

Laurie tells Ted that Lizzie will now work half time only for the company but does not tell him anything more about Lizzie's new venture. Laurie tells the third director, the solicitor Vaughan, what is to happen and Vaughan thinks that it is a clever solution to the problem of keeping Lizzie involved in the company's business while also developing her own skills and financial base.

Advise Laurie and Lizzie whether there are any legal problems raised by this proposal. The constitution of Egan's Hardware Pty Ltd provides:

- The quorum for a meeting of directors shall be two directors.
- No director shall be disqualified from being a director or being counted in a quorum, or shall otherwise be accountable to the company, because of their dealings or transactions with the company if they disclose those dealings or transactions to the company.

Exercise 12.3 Discussion Question

To what extent may a conflict of interest constitute "impropriety" for the purposes of the Corporations Act 2001 (Cth)? What can a director do to make acting under a conflict of interest not "improper"? Should the business judgment rule extend to cover situations involving a conflict of interest (as advocated by the AICD)?

TUTORIAL NO 13 “Corporate Governance”

TUTORIAL OBJECTIVES

After completing the required reading for this class and working through the assigned exercises, students should be able to:

- Discuss why minority shareholders need remedies
- Identify the differing remedies available to minority shareholders
- Differentiate between the derivative suit as a representative action and other remedies brought in a personal capacity
- Assess the elements of each remedy and apply these elements to a given factual situation

Exercise 13.1 *Short Problem Question*

John holds 20 per cent of the equity in a private company which carries on business as franchisor of real estate agencies. Robert and his wife hold 60 per cent of the equity and the balance is distributed among company employees. John and Robert are both directors, Robert being managing director. The constitution gives Robert power to nominate a majority of the board. Personal relations between John and Robert have seriously deteriorated and John now resents Robert’s dominance of board proceedings. Specifically, John complains that:

- board meetings have been conducted without regard to the views of directors other than Robert;
- meetings of Robert and his board appointees are held before full directors’ meetings to formulate a position and strategy with respect to items arising at board meetings;
- Robert arbitrarily restricts the speaking time available to John; and
- often calls a board meeting upon shorter notice than required by the constitution at a time when it was known to be inconvenient to John.

John and Robert do not speak to each other save for absolutely necessary communications. John would like to terminate the relationship. **Advise him of his possible remedies.**

Exercise 13.2 *Long Problem Question*

Acme Ltd is an ASX listed agricultural company that supplies major supermarkets with fresh produce daily. Acme’s main competitor is Beta Ltd, which is controlled by the feisty New Zealand corporate tycoon Mick Doonan. Mick has been keen to takeover Acme since he moved into the Australian domestic market 6 years ago and he formulates a plan to obtain a strategic stake in the company to contain his competitor and ultimately secure control via a hostile takeover. Mick convinces a number of institutional shareholders to sell their stakes to him slightly above market price, which gives him a 16% share of the company. This makes Mick the only foreign national shareholder in Acme with a shareholding of than 5%.

Over the next 2 years Mick secures a position on the board and begins to cause trouble by secretly leaking information to the press in order to embarrass the company and keep the share price low. The company’s shares are currently trading at \$2.20 per share but have dropped as low as \$1.80 per share in recent months. Mick also votes against every proposal put forward by the board at the members’ meetings and is generally disruptive and uncooperative.

Acme's board is keen to remove Mick from the board and the share register so they devise a plan (codename "Project Rainbow") to alter the company's constitution to totally remove Mick from the company. They do not inform Mick of these plans and hold secret board meetings that exclude Mick.

The company proposes to hold an extraordinary members' meeting on 1 February 2009 to vote on the following resolution:

Proposition 1-that the company's constitution be amended so as to provide that any shareholder who is not, as of 1 January 2009, an Australian citizen or (if a corporation) whose main residence is in Australia must not own more than 5% of the issued ordinary shares in Acme Ltd. Any foreign shareholder holding in excess of 5% must sell their shares to the company at \$2 per share.

Proposition 2-if proposition 1 is not carried, then the company's constitution is amended by providing that any shares held by persons other than Australian citizens on 1 January 2007, will be stripped of their voting rights immediately.

Advise on what remedies Mick may have in this situation. Include in your response an assessment of how Mick's own conduct is relevant for determining whether he should have a remedy.

Exercise 13.3. Discussion Question

Is the current statutory derivative action too narrow? Given the fact that it has not been used more than the previous exceptions to *Foss v Harbottle* is the SDA a failure?