# Twenty-Year Snapshot of the Developments in the Regulation of Small Corporations

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## Abstract

*This paper explored the history of the regulation of corporate bodies through State and Commonwealth systems beginning in 1989 that resulted in the development of the legislation impacting on small proprietary company for over 20 years. The introduction of the Corporate Governance Principles for listed companies by the Australian Securities Exchange added another layer of regulation intended to promote transparency and accountability. Research into corporate governance in small companies showed that, in contrast to opinions about the US Legislation, very few Australian companies expressed negative views about corporate governance regulation. The most recent addition to corporate governance regulation has been the expectation that companies have a responsibility for corporate social responsibility. This was illustrated by the James Hardy Industries case.*

## Keywords

*Regulation, small corporations, close corporations, James Hardy Industries*

## Introduction

When the Australian Constitution was enacted the country's leaders envisaged that company law would be left to the States and it was not a matter for the newly established Commonwealth of Australia to be concerned with at all. In the following years, the various State *Companies Code* statutes worked reasonably well with state corporate affairs departments and a basic national regulator known as the National Companies & Securities Commission. However, by the late 1980s companies were moving across local and state boundaries to national distribution of goods and services. The expansion across state borders meant that companies found the need to register and comply with regulations in each state a source of annoyance and increasing cost. In this environment it was mooted to move to a federal law to govern all companies across Australia. However, the introduction of a federal scheme did not happen smoothly. The history of its development and adoption is described below. Of particular interest is the 'close corporation" model of regulation which could be relevant to small corporations.

## Early schemes

Administrative recognition of the need for a uniform law and practice for the regulation of corporations in Australia dates back to the late 1950s. Uniform companies legislation was passed throughout Australia from 1961 to 1963, a result of a cooperative drafting effort using the Companies Act of 1958 (Vic) as a model. Similar, though not identical, Marketable Securities Acts were passed in the states and territories from 1966 to 1971.

Attempts to establish a National Companies Act and Corporations and Exchange Commission, in response to the

1974 Report of the Senate Select Committee on Securities and Exchange, were frustrated by the prorogation of Commonwealth Parliament on 11 November 1975. However, in 1976 Victoria, New South Wales and Queensland formed the Interstate Corporate Affairs Commission for the uniform administration of corporate legislation. In response to this and other initiatives, a Formal Agreement between the Commonwealth and all states was made on 22 December 1978, whereby Commonwealth legislation would be applied in each of the states and the National Companies and Securities Commission would be empowered to regulate the states' application of the Commonwealth's laws.

Pursuant to the Formal Agreement, the Commonwealth Parliament passed the National Companies and Securities Commission Act 1979 , and the following co-operative scheme Acts:

- Securities Industry Act 1980 , operative 1 July 1981;
- Companies (Acquisition of Shares) Act 1980 , operative 1 July 1981;
- Companies and Securities (Interpretation and Miscellaneous Provisions) Act 1980 ,
- operative 1 July 1981;
- Companies Act 1981 , operative 1 July 1982; and
- Futures Industry Act 1986 , operative 1 July 1986.

Each state and the Northern Territory passed legislation applying the co-operative scheme Acts "to the exclusion of" the existing state legislation. The Acts applied directly to the Australian Capital Territory. The co-operative scheme was thus instituted. Its key features were:

- substantially uniform legislation applied to all jurisdictions;
- a Ministerial Council, comprising federal and state ministers, to review the laws, supervise their administration and request amendments;
- the National Companies and Securities Commission (NCSC), accountable to the Ministerial Council, to administer the laws and review the regulation of the corporations and securities industry;
- the state Corporate Affairs Commissions, continuing as the state delegates of the NCSC, to administer the laws "having regard to the principle of maximum development of a decentralised capacity to interpret and promulgate the uniform policy and administration of the co-operative scheme";
- the Companies and Securities Law Review Committee to research and report on aspects of companies and securities regulation at the request of the Ministerial Council;
- the Accounting Standards Review Board to develop approved accounting standards for use by persons regulated by the scheme;
- the Ministerial Council could request the Commonwealth Parliament to pass amendments to the laws, failing which the states had the power to individually implement the agreed amendments; neither the Commonwealth nor any state could unilaterally introduce amendments.

By 1986, the introduction to the successor to the co-operative system was in train. A timeline of the events that led to the creation of a national corporate law system based on a federal system is provided in table 1.

The legislative package to introduce a national corporations law was first presented to the House of Representatives on 25 May 1988. It was commissioned as a response to many perceived weaknesses in the co-operative scheme, to achieve "for the first time in the nation's history a single and truly national regulatory regime that can guarantee a sound and well-regulated environment for corporate activity": the Attorney-General in parliament on 8 November 1990. The primary difficulties with the co-operative scheme were the inconsistencies and duplications which arose in the provincial administration of laws regulating corporations with national dealings.

However, the States were reluctant to relinquish their ownership of their companies and the revenue derived from registration and three states challenged the power of the Commonwealth to regulate business activities. In response, the High Court in *New South Wales v Commonwealth (Incorporation Case)* (1990) 169 CLR 482 held the provisions for the formation of new companies to be constitutionally invalid. The Commonwealth's ability to legislate for the regulation of corporations is limited by enumerated heads of power bestowed on it by the Constitution.

**Table 1. Events leading to the introduction of national Corporations Law**

| | |
|---|---|
| 25 May 1988 | The Australian Securities Commission Bill, the Corporations Bill, the Close Corporations Bill introduced to the House of Representatives. |
| 1 July 1989 | Parts 2 to 9, 13 and 15 (concerning just ASC itself and court jurisdiction) of the Australian Securities Commission Act proclaimed to commence. |
| 27 June 1989 | The Australian Securities Commission Act 1989 receives Royal Assent.<br>Part 1 commenced operation. |
| 1July 1989 | Australian Securities Commission Parts 2-9, 13, 15 proclaimed |
| 14 July 1989 | Remaining legislation received Royal Assent<br>Preliminary provisions of the corporations Act and Close Corporation 1989 commence operation |
| August 1989 | 3 States challenge the constitutional validity of the corporation Act: operative provisions n postponed |
| 8 Feb 1990 | The High court in New South Wales v Commonwealth (Incorporation Case) 1990 holds provisions for formation of new companies constitutionally valid |
| 29 June 1990 | Commonwealth, state and Northern Territory ministers meet at Alice Springs to overcome the consequences of the High Court decision. Heads of agreement are reached on "Future Corporate Regulation in Australia", comprising the key elements of the national scheme -- another co-operative legislative system administered by the Australian Securities Commission. |
| 14 Nov 1990 | The Corporations Legislation Amendment Bill 1990 passed |
| 13 Dec 1990 | Senate passes legislation: Act No 110 of 1990 |
| Dec 1990 | The Corporations [State] Acts are passed. |
| 1 Jan 1991 | Operation commenced |
| 1 Feb 1993 | Amendments of the Corporate Law Reform Act set new standards in directors ' duties and civil penalties applied to breaches |
| 23 June 1993 | Rules relating to 'voluntary administration" and insolvent trading provisions applied only to directors |
| 17 Oct. 1995 | First Corporate Law Simplification Act 1995 (Cwth) receives Royal Assent |
| 9 Dec. 1995 | Repeal of the Close Corporations Act 1989 Cwth) and associated legislation |
| 1999 | Corporate Law Economic Reform program (CLERP) |
| 15 July 2001 | Corporations Act 2001 (Cth) (Corporations Act) and the Australian Securities and Investments Commission Act 2001 (Cth) (ASIC Act) |

The dissenting judgment of Deane J extended the placitum power to include the formation of trading and financial corporations on the principle that such a plenary grant of legislative power should be construed liberally to avoid an unacceptably narrow and technical construction of the words. The decision also applied by extension to the Close Corporations Act.

Following the court case the Commonwealth, State and Northern Territory ministers met at Alice Springs agreement was reach on another co-operative legislation system that was ratified in State Parliaments and administered by the Australian Securities Commission. The Corporations ([State]) Acts passed, applying the Corporations Law and ASC Law to the various states were: NSW (Act No 83 of 1990); Victoria (Act No 80 of 1990); Queensland (Act No 98 of 1990); Western Australia (Act No 105 of 1990); South Australia (Act No 66 of 1990); Tasmania (Act No 41 of 1990); Northern Territory (Act No 56 of 1990).

The Corporations Legislation Amendment Bill 1990, implementing the Alice Springs Agreements, was introduced to the House of Representatives. The bill did not deal with the Close Corporations Act, leaving that legislation in constitutional limbo. The bill is passed on 14 November 1990.

Although the new law was in operation the opportunity to revamp and streamline some of the more unwieldy provisions of the superseded Companies Codes had not been taken. This was addressed by the Corporations law Simplification Task Force established by the Commonwealth Attorney-General in 1993. Responsibility for corporate law reform moved from the Federal Attorney-General department to the Commonwealth Treasury department. The Simplification Task Force was replaced in March 1997 by the Corporate Law Economic Reform Program. In 1999 a major overhaul of the Corporations Law was completed with the passage of the Corporate Law Economic Reform Program Act 1999; and in *Re Wakim; Ex parte McNally* (1999) 198 CLR 511; [1999] HCA 27 the High Court found the cross-vesting legislation, which formed the basis of the national scheme, to be constitutionally invalid.

In response to the decision in *Wakim*, New South Wales was the first state to enact a Federal Courts (State Jurisdiction) Act 1999. Other states and territories followed suit with similar legislation. The main purpose of the legislation in each state was:

- to provide that existing ineffective judgments of a federal court in the purported exercise of state jurisdiction are taken to be judgments of the Supreme Court;
- to provide for the transfer of current proceedings before a federal court in relation to state matters to the Supreme Court; and
- to enable state courts to deal with matters that arise under applied law schemes and that would otherwise be dealt with by a federal court.

In November 1999 the Council of Chief Justices of Australia and New Zealand has announced the completion of the project to harmonise the Rules of the Supreme Courts of each state and territory and the Federal Court for proceedings under the Corporations Law. It was a project undertaken with urgency in the aftermath of the High Court's decision in *Wakim*.

Further constitutional uncertainty dogged the national scheme with the High Court decision in *R v Hughes* (2000) 202 CLR 535; [2000] HCA 22. In that case the High Court unanimously upheld the power of the Commonwealth Director of Public Prosecutions (CDPP) to prosecute a person for alleged offences against s 1064(1) of the Corporations Law of Western Australia. The DPP's power was upheld on the ground that the alleged offences fell within the ambit of the Commonwealth's external affairs power and its overseas trade and commerce power. *Hughes* has given rise to great uncertainty as to the CDPP's powers to prosecute for other kinds of offences, and also the exercise of powers and functions by ASIC, under many provisions of the state Corporations Laws.

In his judgment in *Hughes* Kirby J observed:

> *The accused's arguments thus present a challenge to the scheme adopted for the regulation of corporations in Australia, of which the Corporations Law is the centrepiece.*

> *Unless the offences provided in the Corporations Law are valid and may be the subject of prosecution in Western Australia by the CDPP the legislative and administrative scheme for the regulation of corporations in Australia would collapse.*
>
> *Without enforceability, the Corporations Law would be no more than a pious aspiration.*
>
> *This court should be the upholder and not destroyer of lawful cooperation between the organs of government in all of the constituent parts into which the Commonwealth of Australia is divided.*

In the aftermath of *Hughes*, at a special meeting of the joint Standing Committee of Attorneys-General and Ministerial Council for Corporations in Melbourne on 25 August 2000, the states unanimously agreed to make a broad referral of power to the Commonwealth to restore confidence in the national scheme of corporations law. In a joint statement to the media Federal Attorney-General Daryl Williams and Minister for Financial Services and Regulation Joe Hockey welcomed the outcome:

> *... this is an historic agreement that will provide constitutional certainty for corporations law ... this is another step towards Australia positioning itself as a centre for global finance.*

Each state passed a Corporations (Commonwealth Powers) Act 2001 to formally refer the corporations power to the Commonwealth. The federal Corporations Act 2001 (Cth) (Corporations Act) and the Australian Securities and Investments Commission Act 2001 (Cth) (ASIC Act) were both assented to on 28 June 2001. Both statutes were proclaimed to commence on 15 July 2001. The majority of section numbers referred to in the Corporations Law were given the same number and wording in the Corporations Act 2001. There have been many amending statutes since that time, which continue to refine and reform the current *Corporations Act* 2001.

Section 51(xxxvii) of the Federal Constitution is the head of power enabling state governments to refer their power to regulate companies to the Commonwealth. Where amendments to the Law and ASIC Act are necessary, the meeting agreed that the referral should permit amendments relating to the formation of corporations, corporate regulation and the regulation of financial products or services.

The process of amendment is subject to provisions of the Corporations agreement. It was further agreed that the referral should be subject to a sunset clause. It was reviewed and renewed for a further five years, but could be terminated after the additional five years. "The referral can be extended by agreement", said the joint statement. "The cooperative approach at today's meeting is evidence that all the states and territories recognise the importance of long term certainty for corporations law in Australia."

The most observable feature of the new scheme was the operation of the Corporations Act and its national implementation of the Corporations Law. Equally important was the replacement of the National Companies and Securities Commission and its state delegates, the Corporate Affairs Commissions, with the sole entity of the Australian Securities Commission (ASC), now the ASIC. Nevertheless, interpretation of the Commonwealth Constitution prevented the scheme being implemented at a federal level without state collaboration.

The incorporation of a variety of Acts into the Corporations Law was designed to simplify the interpretation and implementation of the substantive law. Also, some significant changes were made to Australia's corporations and securities legislation. However, the opportunity to revamp and streamline some of the more unwieldy provisions of the superseded Companies Codes had not been taken. Most provisions were transcribed straight from the former legislation. This was being addressed by the Corporations Law Simplification Task Force established by the Commonwealth Attorney-General in 1993.

The referral of power under the Australian Constitution from the states/territory to the Commonwealth was fully effective from 15 July 2001, with the royal assent of both the Corporations Act 2001 (Cth) and the Australian Securities and Investments Commission Act 2001 (Cth). However, there have been a few cases which have challenged the constitutional basis of the corporate statutes and, in particular, the transitional provisions. The saving provisions between the Corporations Law and the Corporations Act have been tested a number of times. In particular when actual events straddle the operation of the corporations Law (in the first half of 2001) and the technical breaches occurred after 15 July 2001. An example is *ASIC v Macdonald (No 11)* [2009] NSWSC 287 where the James Hardie Industries Limited converted to James Hardie Industries NV during this period. Justice Gzell stated that equivalent law was to be applied for the event in February 2001 (the ASX announcement as to the fully funding the trust fund for asbestos victims) as to the events later in the year when the company transferred to a Netherlands based company.

In the period described above where the corporations Law has emerged from a cooperative agreement between the States to a national law supported by a fully funded regulating authority the numbers of corporations in Australia and the number of cases has grown substantially.

## Australian Registered Corporations and the Corporations Law

Over the last 19 years, Australian registered companies have grown from 892,749 to the current figure of 1,700,891. The *Australian Current Law Reporter* produced by LexisNexis classifies case law into discipline categories, of which category 120 is dedicated to "Corporations". In Table 2 it can be seen that all superior court decisions in Australia are recorded and that any matters relating to corporate law are separately recorded. As you would expect only a few corporate law cases make it all the way to the High Court of Australia.2. Over the 19 year period, 46 HCA cases have been dealt with and mostly relate to Constitutional matters. The Federal Court has grown its corporate jurisdiction but the dominate case load is carried by the various State/Territory4 supreme courts.

The majority of cases which have been recorded (5,852 corporate law cases up until September 2009 since the commencement of the federal corporations law) would relate to private companies rather than public companies. Approximately 90% of the cases are in respect of private companies and two-thirds of all litigation relate to companies in financial trouble (in liquidation or formal administration).

**Table 2. LexisNexis Australian Current law Reporter 1991-2009 (Sept).**

| Year | No. Co's | All Cases | Total | HC | %Total | FC | %Total | SSC | %Total |
|---|---|---|---|---|---|---|---|---|---|
| 1991 | 892749 | 4797 | 275 | 0 | 0.36 | 47 | 17.09 | 227 | 82.55 |
| 1992 | 859678 | 5019 | 260 | 3 | 1.15 | 51 | 19.62 | 206 | 79.23 |
| 1993 | 839593 | 5406 | 260 | 3 | 1.15 | 67 | 25.77 | 190 | 73.08 |
| 1994 | 885118 | 5939 | 290 | 3 | 1.03 | 72 | 24.83 | 215 | 74.14 |
| 1995 | 933652 | 7835 | 238 | 6 | 2.52 | 68 | 28.57 | 164 | 68.91 |
| 1996 | 965461 | 6918 | 286 | 1 | 0.35 | 92 | 32.17 | 193 | 67.48 |
| 1997 | 1,026206 | 7544 | 239 | 1 | 0.42 | 93 | 38.91 | 145 | 60.67 |
| 1998 | 1,088192 | 7510 | 295 | 4 | 1.36 | 87 | 29.49 | 204 | 69.15 |
| 1999 | 1,149297 | 6718 | 312 | 4 | 1.28 | 69 | 22.12 | 239 | 76.60 |
| 2000 | 1,195851 | 7397 | 250 | 5 | 2.00 | 10 | 4.00 | 235 | 94.00 |
| 2001 | 1,224207 | 8002 | 341 | 4 | 1.17 | 21 | 6.16 | 316 | 92.67 |
| 2002 | 1,251237 | 8071 | 351 | 1 | 0.28 | 49 | 13.96 | 301 | 85.75 |
| 2003 | 1,299985 | 8109 | 399 | 0 | 0.00 | 116 | 29.07 | 283 | 70.93 |
| 2004 | 1,359305 | 7949 | 375 | 0 | 0.00 | 122 | 32.53 | 253 | 67.47 |
| 2005 | 1,427573 | 6554 | 386 | 1 | 0.26 | 96 | 24.87 | 289 | 74.87 |
| 2006 | 1,411421 | 4504 | 441 | 2 | 0.45 | 173 | 39.23 | 266 | 60.32 |
| 2007 | 1,572054 | 4493 | 324 | 3 | 0.93 | 124 | 38.27 | 197 | 60.80 |
| 2008 | 1,645805 | n/a | 207 | 4 | 1.93 | 89 | 43.00 | 114 | 55.07 |
| 2009 | 1,700891 | n/a | 323 | 1 | 0.31 | 107 | 33.13 | 215 | 66.56 |
| **TOTAL** | | | **5852** | **46** | **0.67** | **1553** | **21.07** | **4252** | **63.67** |

It has been possible to access ASIC data of companies registered in Australia under three classifications: public companies by shares (including ASX listed entities); other public companies, such as by guarantee and proprietary companies (private). Unfortunately, it is not possible to sub-divide proprietary companies into small and large, but they represent consistently over 98% of all registered companies.

## Complexity of Corporate Regulation

This has imposed greater duties and responsibilities of officers and directors than ever before in the courts. The complexity of the modern corporate legislation and ever-growing case law, can be quite imposing upon directors with little legal training or education. Before 1991, Australia had a state-based corporate law scheme, as the Australian Constitution provided that commercial law and in particular the regulation of companies was a state-matter. When the Commonwealth of Australia (Federal Government) proposed to shift corporate law to a single act of parliament in 1989, it became law in 1991. Sir Anthony Mason CJ5 wrote in 1992 "Oscar Wilde described fox-hunting as 'the unspeakable in full pursuit of the uneatable'. Oscar Wilde, the supreme stylist, would have regarded our modern *Corporations Law* not only as uneatable but also as indigestible and incomprehensible."[1]

By 2009 one would have hoped that the world of corporate law and regulation would be so much simpler! Unfortunately, Justice Graham in *Ku v Song* in 2007 stated "Whoever coined the expression 'as clear as mud' " must have been slaving over the extraordinary, and unnecessarily complex provisions of the Corporations Act and the Corporations Regulations….Gaining an understanding of the relevant law on this subject [share transfers] back in 1961 involved a five minute exercise…Today, it requires hours of study, reference to numerous sections and regulations…Why the law had to be expressed in such an obscure way beggars belief.".[2]

## Close Corporations – 1988 Proposal

Today the corporations law describes companies as 'public' or proprietary' but does not distinguish between regulation of small or large corporations. In 1988, as part of the reform of corporate law from the State/Territory system to a national scheme, it was proposed to adopt a "close corporation" system. This would have created three main types of companies, public, private and close. The public companies would attract investment from the public via prospectuses and have the ability to have their shares publicly traded. Private companies (keeping the traditional Australian term "proprietary") would have up to 50 investors, but not be allowed to be listed on an exchange. The close corporation would be limited to only 20 members and would be closer to a limited partnership model.

Close corporations have been successful in South Africa (which the Australian bill was model on) and a number of States in North America. Unfortunately, the Constitutional difficulties relating to the national scheme produced meant that as a political compromise, the close corporation bill was dropped in favour of the single corporations law bill and the single regulator (the Australian Securities Commission).

## Small Proprietary Companies

Although the close corporations bill did not create a new entity, the Federal Attorney-General's Department noted the demand for an easier regulation of small to medium sized entities (SMEs). Section 112 *Corporations Act* 2001 (Cth) only provides for the registration of public or proprietary companies. The type of company is not linked to size, but to the ability of the public to make investment and the number of shareholders that a company may have. Proprietary companies are limited to a maximum of 50 shareholders and public companies are unlimited.

In 1995, as part of the *First Corporate Law Simplification Act*, it was proposed that proprietary companies would be divided into small and large. The definition of small proprietary was based on

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1 Anthony Mason, "Corporate law: The challenge of complexity" (1992) Vol 2 (1) Australian Journal of Corporate Law p.1

2 KU v Song [2007] FCA 1189 @[175]. Quoted from Harris, Hargovan & Adams, Australian Corporate Law LexisNexis 2008 p.vii.

satisfying a two-out-of-three criteria in a financial year. The criteria related to consolidated gross revenue of $10 million; the value of consolidated gross assets of $5 million and fewer than 50 full-time employees. If the company was greater than these amounts it was deemed a large proprietary company.

By June 2007 the criteria in s 45A (2) *Corporations Act* 2001 (Cth) for a small proprietary company was increased to:

- consolidated gross revenue of less than $25 million;
- value of consolidated gross assets less than $12.5 million; and
- fewer than 50 full-time equivalent employees.

A large proprietary company is defined in s 45A (3) as greater than the specified amounts for a financial year. It is important to note that a company is not actually registered as small or large; it is a definition that is applied by the regulator, ASIC, based on the information supplied by the extract of particulars (the old annual returns) each year, with the annual renewal fee.

The importance of the distinction relates to disclosure purposes of a company and the requirement to produce formal accounts and auditing. Thus, a large proprietary company has the same reporting requirements of annual accounts (balance sheet, profit & loss etc) and audit requirements as a public company. A small proprietary company under s 292(2) generally does not have to provide a financial report nor a directors' report unless there is a direction (request) from the shareholders (s 293) or ASIC (s 294). However, all companies, including small proprietary companies have an obligation to keep financial records under s 286 *Corporations Act* 2001 (Cth). The financial records must correctly record and explain all transactions and the financial position of the company and **would** enable a true and fair financial statement to be prepared. The records must be kept for seven years and it is a strict liability criminal offence to fail to keep such records. This obligation is in addition to any tax law provisions.

One of the other benefits to come out of the *First Corporate Law Simplification Act* 1995 (Cth) was s 111J (Part 1.5 Small business guide) of the *Corporations Act* 2001 (Cth). This was an attempt to summarise in plain English the main provisions of the corporate law statute into a few pages to cover SME corporations. The structure of the *Small business guide* is 12 simple headings with a brief explanation of the law, with cross-references to the exact sections in the *Corporations Act* 2001 (Cth). The headings included:

1. what registration means
2. the company structure for small business
3. setting up a new company
4. continuing obligations after the company is set up
5. company directors and company secretary
6. shares and shareholders
7. signing company documents
8. funding the company's operations
9. returns to shareholders
10. annual financial reports and audit
11. disagreements within the company
12. companies in financial trouble

One of the most useful tables in the *Small business guide* is a list of the notifications required to be sent to the regulator. It is a series of eight statements which start "If..." a company issues shares or changes director etc and then states how many days before the regulator must be notified (28 days or 7 days or whatever) and what is the key section in the *Corporations Act* 2001 (Cth). This particular table is useful to all companies, even large proprietary as well as public companies.

## Australian Corporate Governance Research

So as to address the question of corporate governance a research team based at the Centre for Corporate Governance of the University of Technology Sydney, spent three years (2005-2007) examining the extent to which the Australian corporate governance reforms have caused changes at a practical level within companies. The study, entitled *The Changing Roles and Responsibilities of Company Boards and Directors*, was focused on qualitative changes in thinking and behaviour rather than on quantitative measures of compliance. It can be distinguished from the ASX's annual surveys of corporate governance reporting and provides evidence to support some of the findings of those surveys (ASX, 2007). The research also offers qualitative support for recent corporate governance surveys conducted by Chartered Secretaries Australia (2007) and the BDO *Mid-Cap Corporate Governance Report 2007* which looked at 150 annual reports to determine a "tick a box approach" to governance.

Some of the points relevant to SME corporations are picked up in the research. In light of the changes made by companies, it considers whether Australia has found the right balance in its corporate governance regime. On the basis that both the costs and benefits are difficult to precisely pin down, it is not an easy balancing act to achieve. Nevertheless, Australia appears to be on the right track in terms of developing a useful and well-balanced corporate governance system.

## Summary of Australian Research Findings

For most companies, implementation of corporate governance regulation proved a gradual process of formalisation and improvement rather than an outright transformation. Across all sectors of Australian business surveyed there was evidence of intelligent engagement in corporate governance and professionalism in its implementation. To a degree this may have been a reflection of the interest in corporate governance of the companies and interviewees, the majority of whom demonstrated themselves to be highly informed directors, company secretaries and legal counsel.

Engagement with the ASX Principles has proved a positive process in this sample of companies and to a large extent they have tailored their corporate governance structures to fit the needs of the organisation. Risk management systems had an obvious value in improving information flow and promoting better decision-making.

The research clearly revealed that the corporate governance practices appropriate for a company change as the business grows and develops. The governance needs of start-ups and small enterprises are very different from those of mature ASX 100 companies. The role of the board and directors changes over time and board composition ought to reflect the needs of the company rather than conforming to any particular formula.

## Rules-Based and Principles-Based Approaches to Reform

The ASX Corporate Governance Principles set out the requirements for best practices in governance expected of Australian listed companies. The Principles and their Guidelines are not mandatory, enshrining the *'if not, why not'* or *'comply or explain'* principle by which companies that do not wish to comply with particular guidelines can explain their reasons for non-compliance to the market. This was first applied in the UK 1992 *Cadbury Report*. This kind of market regulation can be less costly to comply with than prescriptive legislation because it acknowledges that one size does not always fit all. In contrast to black letter law, the ASX Principles are more adaptable to changes in best practice and easier to keep up to date and relevant. Additional advantages include the fact that the Principles were able to be produced relatively quickly and were designed by experts with relevant industry knowledge, who together represented every part of the investment and corporate value chain.

The alternative regulatory approach of using prescriptive law has been adopted historically by the United States. Continuing this legal tradition the *Sarbanes-Oxley Act* of 2002 (SOX) prescribes governance practices that must be followed and which can be enforced by way of penalties for non-compliance.[3] SOX was a direct response to the collapses of Enron and WorldCom and has been

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3 See e.g. McDonnell B. (2004) 'Sarbanes-Oxley, Fiduciary Duties and the Conduct of Officers and Directors' *University of Minnesota Law School, Legal Studies Research Paper Series*, Research Paper No.04-13

widely criticised as a knee-jerk reaction that imposes unreasonable costs on business. A concern of the rules based approach of SOX is that it has encouraged, both internally and externally, a heavily bureaucratised technical approach to auditing, that makes for inflexible processes and involves significant costs.[4]

In contrast principles-based approaches are not as rigid in implementation, and improvements in standards of practice can be encouraged over time. Principles work to influence a broad set of practices meeting the expectations of the stakeholder community at large.

## The Debate on Regulation in Australia

The debate, about the need for regulation on the one hand and on the other hand the burden that regulation imposes is a long running one in Australia and other countries. However, most criticisms of over-regulation encountered in this research were not about corporate governance regulation *per se*. Participants complained about regulation in the areas of occupational health and safety, financial services, food and drug safety, local government planning, accounting standards and money laundering. Indicative of the views about Australian corporate governance regulation was:

> *In Australia, my view is that where we are now is about where we want to be. If we take it a few steps further companies will no longer be in control of themselves – their destiny would be in the regulators' hands, which is not where it should be"*

Interviewees regarded the United States corporate governance regulation as a different matter. All participants who had been affected by SOX, particularly because of a U.S. listing, said that it was out of proportion and very costly. Perhaps the favourable view of the Australian regime is a consequence of the belief that the alternative could be a lot worse. As one respondent said:

> *I don't think Australia's reforms are too bad. SOX is a great overcompensation – the cost has been extraordinary. Certainly its cost us half a million and the ongoing things – internal and external auditors etc.*

The prime reason why SOX is disliked is because companies feel that the costs outweigh the benefits. It is this cost-benefit equation that determines whether regulation is seen as good or bad; whether the company feels regulated or over-regulated. The fact that there was little complaint about the ASX Principles suggests that they have, for the most part, succeeded in finding the right cost-benefit ratio.

The Hon Justice Neville Owen outlined in 2008 his top five directions to lift corporate governance and professionalism, as follows:

1. Commitment to an ethical framework for decision-making;
2. Notion of compliance;
3. Need for education on fiduciary principles and instil ethical values;
4. Performance, not conformance by avoiding just the 'tick boxes' approach; and
5. Critical responsibilities of the legal and accounting professions.

One area of corporate governance over which shareholders seem to have very little control is the annual general meeting (AGM). The Federal Minister for Corporate Governance, Senator Nick Sherry, in late April 2008, stated that a review is necessary but does not expect real changes as there is no systemic problem with Australian corporate governance! However, a proposal is being considered for an overhaul to shareholders meetings to bring them into the 21st century and address the decline in attendance.[5]

Also, Chartered Secretaries Australia (CSA), the Australian Division of the Institute of Chartered Secretaries and Administrators) released a discussion paper[6] in May 2008 entitled "Rethinking the AGM" which followed a roundtable discussion with the law firm Blake Dawson in February 2008.

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4 Branson, D. M., "Too Many Bells? Too Many Whistles? Corporate Governance in the Post Enron, Post WorldCom Era" (February 26, 2006). Available at SSRN: http://ssrn.com/abstract=887176.

5 Patrick Durkim; "Pack 'em in: Plans to get investors back to AGMs" (2008) 21 May, *Australian Financial Review* p 8.

6 Download the paper at <www.CSAust.com>

The CSA issued a *Benchmarking Governance in Practice in Australia* report in April 2008 which showed the cost of a large AGM is AUD$2.08 and $3.31 for a medium size listed company. This amount is paid on top of the share registry costs of $9.32 and $7.31 per shareholder.[7] Only 11.1% of respondents had over 300 people present at their AGM and 41.3% had fewer than 100 shareholders present. This means that for large companies only 1.52% of the membership body attend AGMs in person and 0.7% of medium sized listed companies. The use of webcasting for AGMs has increased from 47% in 2001 to 73.1% for large companies and from 15% to 45% for medium sized companies. Of course, none of these are a real burden to an SME corporation!

## Case Study: James Hardie Industries (2009) – movement from corporate governance to corporate social responsibility?

All governance professionals should now be on notice that the principles and concepts on corporate governance (Klettner et al 2007) as expressed in corporate law have now moved towards including more onerous corporate social responsibility concepts. The 23rd April 2009 is not quite an ANZAC Day equivalent, but it can be interpreted as a watershed in the development of Australian corporate law. Justice Gzell handed down a 194 page judgment (broken up into 1313 individual paragraphs) to explain why the James Hardie Industries Group (JHI) of companies and its officers[8] had misled the public and investors as to the funding of future asbestos claims. JHI believed they had "ring fenced" any current or contingent liabilities that might arise out of the asbestos claims arising from their building products over the previous 75 years. [9]

It is worth noting that by 1978 JHI and its subsidiaries had overwhelming evidence of the dangers of asbestos products and as such warning labels were attached to products. The corporate body finally made a decision to stop all production in Australia in 1987. The size of the outstanding liability has been a core contentious issue and the expert actuaries have had to work hard to make accurate "estimates". But it is a fact that approximately 50% of all claims made to the NSW Dust Diseases Tribunal relate to JHI products.

**Corporate Governance to Corporate Social Responsibility**

By 2001 the management and the board of directors had decided to reorganise themselves to be a Netherlands based company named JHI NV. This was an extremely complex matter for any company to organise as there were so many subsidiary companies spread throughout the world. The only legal methodology that is available under corporate law is known as a scheme of arrangement, and this requires the court's permission as well as the shareholders consent to the changes. A variety of reasons were given for this reorganisation including taxation and business costs (savings) and that the appropriate level of funding for future asbestos victim claims would be met through a trust (Medical Research and Compensation Foundation – MRCF). The true motive behind the reorganisation has never been publicly stated and still remains quite unclear, apart from it was agreed by the board of directors on a business case, but the general community appears to be sceptical as to the corporate body's intention.

In 2001 JHI transferred the value of A$293 million to establish the MRCF and made a very clear statement that this trust was "fully funded" to meet the future Hardie asbestos claims. By the end of 2001 the actuaries estimated that MRCF would in fact need A$574 million and by 2002 liability had grown to A$752 million and by the end of 2003 the estimates sat at an amazing A$1.573 billion.[10] In February 2004, the NSW Government appoints Mr David Jackson QC to conduct a Special

7 The ASX Top 200 companies were surveyed and 36% responded. Large means greater than AUD$3 billion market capitalisation and medium means between AUD$500 million to AUD$3 billion. The survey has been conducted in 2002, 2004, 2006, 2007. The average number of shareholders per company surveyed was 104,000.

8 Officer is defined in s 9 *Corporations Act 2001* (Cth) as "a director or secretary of the corporation"

9 Mr James Hardie and Mr Andrew Reid (both from Scotland) set up a business partnership in Melbourne in 1895 and Hardie sold his share on retirement in 1911. The company developed asbestos products from the 1930s and JHI was listed on the Australian Stock Exchange in 1951

10 The figures are quoted from the David Jackson (2004) *Report of the Special Commission of Inquiry into the Medical Research Fund and Compensation Foundation* [online], <www.dpc.nsw.gov.au/publications/publications/publication_list_-_new#11330>.

Commission in the MRCF and by September 2004 he produces the *Final Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation* showing up a A$2 billion short fall and noting a public statement that "seriously misled" the Trust.

The civil action was commenced in February 2007 by the corporate regulator, the Australian Securities and Investments Commission (ASIC) against the original listed entity (JHI) and its former directors. The major focus of the case was on the media release (as an announcement) to the Australian Securities Exchange (ASX) that JHI had fully funded the MRCF. The media release, which one might call the "smoking gun" in a criminal case, was a single page drafted by a public relations firm, which passed through internal and external lawyers, the senior management and the whole board itself.

ASIC brought the civil action against 12 defendants, being the original company, James Hardie Industries (now with a change of name called ABN 60 Pty Ltd) and the current company (James Hardie Industries NV) with the three executive directors (Peter Macdonald, Peter Shafron and Phillip Morley) and seven non-executive directors.[11] The case is actually named after the first plaintiff and defendant, *ASIC v Macdonald (No 11)* (2009).[12] [13]

At a similar time that ASIC was bringing a civil case, ASIC also made a referral to the Commonwealth Director of Public Prosecutions to bring a criminal prosecution against the company and its executive officers. In September 2008 it was determined that there was insufficient evidence to pursue a criminal prosecution, but the civil case started its 45 days of hearings in the NSW Supreme Court before Justice Gzell. The result of this case, which is explained below in summary[14], is a number of serious breaches of the *Corporations Act* for both the company (old JHI and new JHI NV) as well as all the former non-executives directors and three senior executives of JHI.

A key distinction in this current case is that the decision focuses on a specific behaviour of a corporate body that reorganised itself, using a legal mechanism (the scheme of arrangement) to avoid future liabilities. From a corporate governance perspective, the board and management followed the procedures and believed it was the right thing for the shareholders. However, there does not appear to be evidence of the wider duties and responsibilities being shown to the broader stakeholders – the employees or consumers of JHI products, which have become asbestos victims. This case, as the common law system requires, has a focus on technical aspects of the law, but provides direction to the board over its broader corporate social responsibility duties.

**What are the general themes of the case?**

There is a general principle that time is crucial in legal cases, as only the relevant law at that time of the event occurring can be applied to a particular legal action. The corporations' legislation has had a long and difficult history from the previous State/Territory versions (the old *Companies Code*) to the Commonwealth version (the 1991-2001 *Corporations Law)* and its more constitutionally stable current form, the *Corporations Act 2001* (Cth) which commenced on 15th July 2001. Thus, the events surrounding the JHI business decision to reorganise as a company based in the Netherlands and comply with a series of detailed documents, court procedures and necessary ASX announcements (the media releases) must be applied to the law at that time and not the current version.

It is also fair to state that business in Australia 2001 was going through a difficult economic period and the largest collapse in our history (HIH Insurance) and icons like One.Tel and the problems of the AMP takeover of GIO, resulted in complex legal problems. The result is a series of officer's cases have arisen, such as Mr Williams and Mr Adler of HIH Insurance, Mr Rich of One.Tel and Mr Vines of GIO, that have enabled the courts to deal with both key directors' duties (Adams, and Nehme 2009) and the transition of provisions from the former *Corporations Law* to the current *Corporations Act*. In substance the words are the same, but the section numbers are different for both the misleading

[11] Michael Brown, Michael Gillfillan, Meredith Hellicar (chair) Martin Koffel, Geoffrey O'Brien, Gregory Terry and Peter Willcox.

[12] 32 [2009] NSWSC 287 (23 April)

[13] In the August 2009 issues of *Keeping Good Companies* there will be a more detailed legal analysis of *ASIC v Macdonald (No 11)* [2009] NSWSC 287 (23 April). [2007] NSWCA 75

[14] Adams, M. & Nelme, M. 2009

conduct provision and the officers' duty of reasonable care and diligence. Justice Gzell handles this point very clearly in the judgment and follows the same line of logic as Justice Austin did in *ASIC v Vines* (2005)[15]

However, it can get confusing when the judgment discusses this former JHI Ltd being held liable for misleading conduct under s 995 *Corporations Law*, but the current JHI NV is found liable under s 1041H *Corporations Act 2001*. Similarly, JHI failed to disclosure to the market that it had a Deed of covenant and Indemnity document which should have been made known to the ASX and as such as a breach of the old s 1001A *Corporations Law* and the current JHI NV breaches s 674 *Corporations Act* for continuous disclosure of the cancellation of partly paid shares in ABN 60 Pty Ltd (the new name for JHI Ltd)!

**Table 2: Contraventions of CA2001 per defendant**

| Position/Capacity | Corporations Act | Contraventions |
|---|---|---|
| Old JHI<br>(now ANB 60 Pty Ltd) | Misleading conduct (s 995)<br>False statement to securities (s 999)<br>Continuous disclosure (s 1001A) | Three<br><br>Two<br><br>One |
| Current JHI NV company | Section 1041H (misleading conduct)<br>Section 1041E (false statement in financial products)<br>Section 674 (continuous disclosure) | One<br><br>One<br><br>One |
| CEO<br>(Peter Macdonald) | Section 180 (duty of care) | Ten |
| General counsel (Peter Shafron) | Section 180 (duty of care) | Six |
| CFO<br>(Phillip Morley) | Section 180 (duty of care) | One |
| Seven non-executive directors (including the chairperson Meredith Hellicar) | Section 180 (duty of care) | One each |
| 12 defendants | Corporations Law and Corporations Act 2001 | 33 contraventions in total |

**What are some of the key lessons?**

In *ASIC v Macdonald (No 11)* (Table 2) *there were 52 allegations of contraventions of the* Corporations Act brought against the 12 defendants. Companies, JHI (ABN 60 Pty Ltd) and the current entity, JHI NV, as well as the seven non-executive directors and three executives (CEO, general counsel and CFO) were all named. ASIC was successful in proving 33 of the contraventions covering officers' duties (24), misleading and deceptive conduct (4), false statements in relation to securities (3) and breaches of continuous disclosure rules (2).

37 [2009] NSWSC 287 (23 April)

ASIC was unsuccessful (that is not able to prove to the appropriate standard) in 19 alleged breaches of the *Corporations Act* relating to officers' duties, misleading or false statements.

There are some key lessons to be learnt from this case and these are broken into simple headings:

1) Importance of minutes – the judge discusses the adequacy of minutes as evidence in a court of law and notes that it is recorded that the whole board approved the relevant misleading ASX announcement (media statement) in draft on 15 February 2001 and thus the actual ASX announcement

15 *ASIC v Vines36* (2005) 55 ACSR 617; [2005] NSWSC 171 and upheld on appeal at *Vines v ASIC* (2007) [2007] NSWCA 75

and press conference statement on 16th February. The minutes had not been entered in the official minute book within the requisite 30 days, which caused some legal issues.

2) The boards reliance on the public relations firms, professional advisers including external lawyers, actuaries, accountants, as well as the senior management. The CEO failed to advise the board of the too emphatic language in the draft announcement and the cash flow model prepared by PwC and Access Economics was limited to technical correctness and logical soundness. But ASIC did fail to make out its case for the advice that the "best estimate" in the Trowbridge actuaries report only had a 50% probability of being achieved and was too uncertain as to assessing adequacy of funding.

3) Misleading conduct – one of the most litigated provisions in commercial law is s 52 *Trade Practices Act 1974 (Cth) "A corporation shall not, in trade or commerce, engage in conduct that is misleading or deceptive or is likely to mislead or deceive."* This was very successfully used to prevent the aborted float of the NRMA from a mutual to a listed company in 1995. The famous *NRMA v Fraser*[16] (1995), where the expression "free shares" were deemed to be misleading and prevented the two billion float from proceeding by one simple provision of the TPA. After the NRMA case, financial services (including securities) were removed from the TPA[17] and placed in the *Corporations Act.* However, in the NRMA case the central issue was whether the company has misled its members and not a question of whether the board of directors was responsible. This current decision goes further in that in *ASIC v Macdonald (No 11)* (2009) states that the original company, JHI (now ABN 60 Pty Ltd) and the current company, JHI NV, engaged in misleading and deceptive conduct in respect of financial products through the media release to the ASX on 16th February 2001. More importantly, every individual director and in particular the CEO, Mr Peter Macdonald, was held to have failed to take reasonable care[18] as a corporate officer for the misleading in drafting that media release, as well as other documents.

4) False statements – the judge carefully explains that the former company, JHI, made a false statement in connection to securities for the ASX announcements under the old s 999 *Corporations Law.* As well as the new company, JHI NV, making a false statement in connection to financial services and products (including securities) under s 1041E *Corporations Act* for sending to the ASX PowerPoint slides that had been used in the UK for an investors' road show, which contained the same statements ("fully funded" for asbestos claims).

5) Continuous disclosure – the two corporate defendants managed to be caught for continuous disclosure for failing to disclose in 2001 the Deed of Covenant and Indemnity document in 2001 under s 1001A *Corporations Law* and for failing to inform of the cancellation of partly paid shares in ABN 60 Pty Ltd (the new name for the old JHI) under s 674 *Corporations Act*.[19]

6) Officers' duties – the heart of the action and the distinct feature of this case, is that all the directors and in particular the CEO is held to have breached the most basic of officer's duties. All ten directors, without exception were found to have contravened s 180(1) *Corporations Act* – this section states that a director or officer of a corporation must exercise their power and discharge their duties with the degree of care and diligence that a reasonable person would exercise in those circumstances. This is known as "statutory negligence" and the directors fail to meet the objective standard set out by Parliament in the legislation. In making the original draft ASX announcement (media release) on 15th February 2001, they did not take the necessary care that would have been expected by directors of a public listed company at that time and in those circumstances. This does follow a number of

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16 *Fraser v NRMA Holdings Ltd* (1995) FCR 452.

17 Section 51AF *Trade Practices Act 1974* (Cth).

18 40 Section 180 *Corporations Act* 2001 (Cth).

19 Nehme, M, Hyland, M, & Adams, M; "Enforcement of continuous disclosure: The use of infringement notice and alternative sanctions" (2007) 21 *Australian Journal of Corporate Law* 1.

precedents on officers duties including *ASIC v Adler* (2002)[20], *ASIC v Rich43* (2003)[21] and *ASIC v Vines44 (2005)*[22].

The companies involved can only be ordered to pay compensation (civil damages) for their misleading and deceptive conduct. The former officers of the company are in breach of a civil penalty provision and thus could face damages, a penalty (up to $200,000) and a disqualification order from being a director or senior manager of a company for five years. The CEO was required to pay $350,000 and was banned for 15 years and the non-executive directors all received $30,000 penalties and five year disqualifications. JHI NV had a small penalty of $80,000 and the original JHI was protected by statute! Meredith Hellicar has announced her resignation of all other directorships as an immediate consequence of the James Hardie case outcome. The other directors are likely to follow suit. Personal reputations have been closely focussed on throughout this litigation and once indicate a changing tide of public opinion as to corporate greed over corporate social responsibility to a wider audience.

## Conclusion

This paper began by exploring the history of the development of the Corporations Law that exists today. It reported that the number of corporations had grown exponentially since the corporations Law was introduced in the early 90s. In many respects the bias in the law towards large corporations has been addressed by a special section directed towards small corporations. The introduction of the Corporate Governance Principles for listed companies by the Australian Securities Exchange added another layer of regulation intended to promote transparency and accountability. Research into corporate governance in small companies showed that, in contrast to opinions about the US Legislation, very few Australian companies expressed negative views about corporate governance regulation.

The most recent addition to corporate governance regulation has been the expectation that companies have a responsibility for corporate social responsibility. This was illustrated by the James hardy Industries case. The broad lesson to be learnt by all governance professionals in small or large corporations is that the small details matter. It is not acceptable to delegate everything to a PR firm or rely upon lawyers and the CEO to make critical decisions. Minutes are used as key evidence in officers' duties case and great care should be taken in recording them accurately. Companies can be held accountable for substantial amounts of money if they are found to have misled investors, their shareholders and the general public. In the 2003 Royal Commission in the collapse of HIH Insurance, Commissioner Justice Neville Owen stated that the Board of Directors has the ultimate responsibility for corporate governance.45 This case probably additionally adds the broader duty of corporate social responsibility being owed to a wider group of stakeholders, including all the employees and consumers, impacted by the activities of a small or large corporation. .

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