The Parliament of the Commonwealth of Australia

CLOSE CORPORATIONS ACT 1989

JOINT STATUTORY COMMITTEE ON CORPORATIONS AND SECURITIES

DECEMBER 1992

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DUTIES OF THE COMMITTEE

Section 243 of the *Australian Securities Commission Act 1989* reads as follows:

The Parliamentary Committee's duties are:

(a) to inquire into, and report to both Houses on:

(i) activities of the Commission or the Panel, or matters connected with such activities, to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; or

(ii) the operation of any national scheme law, or of any other law of the Commonwealth, of a State or Territory or of a foreign country that appears to the Parliamentary Committee to affect significantly the operation of a national scheme law;

(b) to examine each annual report that is prepared by a body established by this Act and of which a copy has been laid before a House, and to report to both Houses on matters that appear in, or arise out of, that annual report and to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; and

(c) to inquire into any question in connection with its duties that is referred to it by a House, and to report to that House on that question.

TERMS OF REFERENCE

... [to] inquire into the creation of a new corporate form tailored to meet the needs of small business. The Committee will examine the unproclaimed **Close Corporations Act 1989.** That Act had as its object the simplification of the corporate rules for small business by reducing financial and other reporting requirements and by abandoning the company law distinction between directors and shareholders in favour of simple principles based on partnership laws. The Committee will also examine suggested amendments to that Act and other corporate structures having the same broad objectives.

CONTENTS

SUMMARY AND RECOMMENDATIONS

This report examines the *Close Corporations Act 1989* and the general question of the appropriate form of incorporation for small business in Australia.

The Close Corporations Act proposed to introduce a new form of incorporation for businesses with simple operating structures. A close corporation would be limited to a maximum of ten members and only natural persons could be members. There would be no distinction between ownership and management. It would not be able to act as a trustee or a holding company and would not be able to raise funds from the public. A close corporation would have separate legal identity and its members would have limited liability. In recognition of its essentially private nature and simple structure the close corporation would be simpler to establish and operate than a business incorporated under the Corporations Law; for example it would not be required to lodge annual accounts with the Australian Securities Commission.

Evidence received by the Committee, while supporting the general objective of providing a simplified form of incorporation for small business, gave only limited support to the close corporation. Criticisms of the proposal included:

- that the restrictions on its powers would render it unsuitable for small business;
- that limited liability could be lost relatively easily;
- that the structure and reporting requirements of the close corporation remain complex; and
- that there is no simple process for converting a close corporation in to a proprietary company.

These, and other more detailed criticisms, are dealt with in the body of the report.

There was general agreement on the desirable features of a form of incorporation for small business:

- establishment should be simple and cheap;
- reporting obligations should be kept to a minimum;
- the internal administration should be uncomplicated and a simple process for dispute resolution between members should be available;
- the corporate form should offer the normal benefits of incorporation and be readily understood both by its owners and third parties;
- transition to more complex corporate structures should be simple, to accommodate the growth of the business; and
- the structure should be tax effective.

Much of the evidence favoured reform and simplification of the existing exempt proprietary company, adopting some of the aspects of the close corporation.

The Committee believes that there is a place for both a simple corporate form for small business and the retention, for the time being of the existing exempt proprietary company for more complex corporate structures. The availability of the exempt proprietary company should be reviewed after a suitable time has elapsed to assess the use being made of the two forms.

The Committee acknowledges the force of the criticism of the close corporation. Thus the Committee favours the introduction of a new corporate form, the private company, within the existing Corporations Law. It would adopt the best features of the proposed close corporation while eliminating those that were the subject of extensive criticism. The members of a private company would attract limited liability in the same form as any other incorporated body; reporting requirements would be further reduced; provision would be made for the investor who did not wish to be involved in management; and transition between the various corporate forms would be a simple process.

The Committee recommends that:

- a new chapter be added to the Corporations Law. This chapter would provide that corporations which satisfied certain specific requirements would be relieved from compliance with many of the requirements of the Corporations Law. As a matter of convenience such companies, a category of exempt proprietary company, would be designated as 'private companies'. The use of an additional chapter will remove the need for a separate Act and for further enacting legislation in the States and the Northern Territory. (p.31)

- the new corporate form should retain the principle of the division between management and ownership contained in the Corporations Law. (p.24)

- the minimum number of members should be two. (p.23)

- the limit of ten members for small companies should be retained. (p.23)

- the requirement to keep accounts in the existing Close Corporations Act should not be applied to the private company. (p.27)

- when the new law is introduced it be accompanied by a simple guide, in plain language, for potential users explaining the corporate structure, its powers and obligations and the process of establishment. (p.31)

- the name 'Private Company' be adopted for the new corporate form. (p.22)

CHAPTER 1

THE CLOSE CORPORATIONS ACT

Background

1.1 The *Close Corporations Act 1989* had its origins in a report by the Companies and Securities Law Review Committee (CSLRC) in September 1985.[1] That Committee reflected a view in the business community that ' ... the collection of statutory rules and requirements with which entrepreneurs have to contend is considerable and growing'[2] and that these requirements should be reduced for small business. That Committee set itself the objective:

> ... to recommend a simpler and cheaper form of corporate structure for entrepreneurs, with due regard to their particular needs and without burdening them with statutory requirements which are not significant under the circumstances.[3]

1.2 The CSLRC recommended the creation of a new corporate entity '... designed primarily for owner-operated and other forms of small business'[4] to be known as a close corporation.[5] The proposed close corporation would

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[1] Companies and Securities Law Reform Commission, *Report to the Ministerial Council on Forms of Legal Organisation for Small Business Enterprises*, September 1985.

[2] ibid., p.3.

[3] ibid., p.3.

[4] ibid., p.3.

[5] The term 'close' is derived from the expression 'closely held' and refers to the limited number of members of the corporation and the closeness of their relationship. The term is used in other jurisdictions eg parts of the United States and South Africa. The use of the term 'close corporations' has been widely

combine the advantages of incorporation - a separate legal personality and limited liability - with simplicity of internal management based on rules derived from partnership law.

1.3 The Close Corporations Bill introduced into Parliament on 25 May 1988 followed the CSLRC proposal closely. In his second reading speech on the Bill, the then Attorney-General, the Hon. Lionel Bowen, described its purpose as:

> ... to provide a new simplified corporate structure for small business. Many of the current detailed rules applying to companies that are more appropriate for larger companies impose inflexible requirements and costly and unnecessary burdens on small companies. The distinctive features of the new corporate form which will enhance flexibility and reduce operating costs involve the reduction in financial and other reporting requirements and replacing the usual concept of management with simpler association rules.[6]

1.4 The *Close Corporations Act 1989* was part of the Commonwealth's scheme of national corporate law introduced in 1988. The principal piece of legislation, the *Corporations Act 1989* was successfully challenged in the High Court on the basis of limitations on the Commonwealth's constitutional power to make laws with regard to the incorporation of companies.[7] As a result of the High Court's decision, the single Corporations Act was replaced by a more complex Federal/State legislative scheme.

1.5 The Close Corporations Act was not challenged but it was subject to the same constitutional deficiencies as the Corporations Act and was never proclaimed. The Attorney-General, the Hon. Michael Duffy, approved drafting instructions in March 1992 for revised legislation which would be constitutionally valid. He also acknowledged that comments on the earlier legislation raised issues which required further consideration. The Committee agreed in June 1992 to examine the existing Act and proposals

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criticised because its meaning is not readily understood.

[6] The Hon Lionel Bowen, Attorney-General, House of Representatives Hansard 25 May 1988, p.2996.

[7] *New South Wales v The Commonwealth* (1990) 169 CLR 482.

for amendments to it.[8] In the course of that examination the Committee has also considered the more general issue of the appropriate form of incorporation for small business.

1.6 Various characteristics were identified in evidence and submissions to the Committee as being desirable for the small business company:

- establishment should be simple and cheap;
- reporting obligations should be kept to a minimum;
- the internal administration should be uncomplicated and a simple process for dispute resolution between members should be available;
- the corporate form should offer the normal benefits of incorporation, e.g. limited liability, and be readily understood both by its owners and third parties;
- transition to more complex corporate structures should be simple, to accommodate the growth of the business; and
- the structure should be tax effective.[9]

1.7 A significant, and in some cases dominant consideration, underlying the demand for a simplified corporate structure was not the structure itself but the tax advantages it might offer by providing access to the corporate tax regime. In principle the Committee does not believe that reform of the corporate law should be driven by the need to provide tax benefits to small business. To the extent that small business has legitimate grievances with the taxation system, they should be dealt with through taxation policy. This issue is considered in chapter 3 of this report.

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[8] Details of the Committee's inquiry are at Appendix I.

[9] See for example, Mr Bob Gardini, *Committee Hansard*, 16 October 1992, p.272; Mr John Hassen, *Committee Hansard*, 22 October 1992, p.358; Business Council of Australia, *Submissions Received by the Committee*, p.46; Australian Institute of Company Directors, *Committee Hansard*, 9 October 1992, p.84.

The Close Corporations Act

1.8 Conceptually and legally the close corporation created by the Close Corporations Act is a mixture of company and partnership principles. It has:

- separate legal identity;
- the capacities of a company;
- share capital; and
- a naming process similar to a company.

1.9 However, unlike the traditional company, it can be established with one member and does not have directors. It is similar to a partnership in that:

- all members may participate in management;
- all members are agents of the corporation; and
- members have a fiduciary relationship with the corporation.

1.10 The close corporation structure extends limited liability to members but this is defeasible in certain circumstances and, as with a partnership, the members can be made jointly and severally liable for the debts of the corporation.

1.11 The traditional company has substantial disclosure requirements but the close corporation has few. It must keep accounting records and provide a compliance certificate each year but the Act does not require that accounts be lodged with the Australian Securities Commission (ASC).

1.12 Part 1 of the Act comprises the introductory, interpretation and definition sections.

Establishment

1.13 In Part 2 the Act covers the process for setting up a close corporation. A close corporation may be established by any natural persons up to a limit

of ten. Intending founders of a close corporation must sign a founding statement [see section 16 and also sections 60 and 61].

1.14 The corporation is created by registration of the founding statement with the ASC [s.18]. The founding statement of the corporation must be lodged with the ASC and comply with the requirements of section 19 of the Act as to its contents. The founding statement must include:

- the amount of share capital;
- the names, addresses and other details of the members; and
- the number of shares held by each member.

1.15 The share capital of a close corporation must comprise fully paid shares of equal value and rights [s.17]. Any changes to the founding statement must be notified to the ASC within fourteen days.

1.16 By section 24 of the Act any company which meets the requirements of this Act can convert to a close corporation.

1.17 Once incorporated the close corporation has the same powers as a conventional incorporated company. It:

- is capable of performing all the functions of a body corporate;
- is capable of suing and being sued;
- has perpetual succession; and
- has power to acquire, dispose of and hold property. [s.23]

Naming

1.18 Part 3 sets out a procedure for naming the close corporation which is identical to that for a company. The close corporation must include in its name "Close Corporation" or "CC".

Legal Capacity and Powers

1.19 The legal capacity and powers of close corporations are dealt with in Part 4. In general they have the same capacities as companies [s.44]. There are two significant practical differences in that a close corporation cannot be a trustee [s.46] or a holding company [s.50]. The Explanatory Memorandum states that this restriction is necessary, in the case of a trust:

> ... to ensure that CC creditors are not burdened with the legal difficulties arising from action against a corporate trustee of a trading trust.[10]

1.20 The prohibition on acting as a holding company reflects the view that '... it seems more appropriate that complex corporate structures be regulated under the Corporations Act.'[11]

Members

1.21 The relationship between members is provided for under Part 7. Members may enter into a written association agreement relating to the management of the corporation's affairs [s.67]. It is envisaged that a model agreement will be set out in the regulations [s.68]. Various general principles for the conduct of members are set out in sections 70 to 75:

- provided they are not disqualified from managing a corporation under the Corporations Act, all members may take part in management of the close corporation [s.72];
- allotment of shares requires the consent of all members [s.73];
- members are not entitled to remuneration for acting in the affairs of the corporation [s.74].

1.22 These arrangements may be varied by agreement by all the members of the close corporation [s.69].

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[10] *Close Corporations Act 1989*, Explanatory Memorandum, p.33.

[11] ibid., p.34.

1.23 Members must give true accounts and information on all matters affecting the corporation to all other members [s.77] and must not, without the consent of the other members, conduct any business which competes with the corporation [s.79]. Members are liable for any losses suffered by the corporation as a result of their failure to exercise reasonable care and diligence [s.80].

1.24 The Act imports section 260 of the Corporations Law to provide a remedy in cases of oppression or injustice.

Accounting

1.25 The accounting function is dealt with in Part 8 of the Act. The duty to keep accounts is based on similar provisions in the Corporations Law. The corporation shall keep records that will enable the preparation from time to time of true and fair accounts [s.82]. There is no requirement to lodge the accounts with the ASC but the corporation must lodge an annual certificate of compliance in respect of the accounts [s.83]. An annual activities statement is required as part of the compliance certificate by section 84 and, for constitutional reasons, it must state whether the trading activities of the corporation were the whole or a substantial part of its activities.

Transactions

1.26 Part 9 of the Act deals with transactions on behalf of the corporation. Each member is an agent of the corporation (but the association agreement could specify otherwise) and an act done by the member can bind the corporation [s.85]. Contracts entered into prior to incorporation may be ratified subsequently and the corporation is bound by them [s.86].

Shares

1.27 Part 6 of the Act provides that members of the corporation may transfer shares but need the consent of other members [s.65]. Section 66 of the Close Corporations Act applies Part 7.13 of the Corporations Law, which deals with procedural aspects of the transfer and registration of shares, to close corporations.

1.28 A close corporation may acquire its own shares or finance dealings in its own shares only in accordance the requirements of Part 10 of the Act.

1.29 Dividends are payable only if assets after paying the dividend exceed liabilities and there are reasonable grounds to believe that the corporation is, and will continue to be, solvent [s. 166].

Limited Liability

1.30 Limited liability is the subject of Part 15. The general rule of the members' limited liability for the corporation's debts is established by section 106 but limited liability can be lost in the following circumstances:

(i) where the number of members exceeds 10 and there is a deficiency at the time of winding up [s.107];

(ii) where a certificate of compliance was not lodged or the accounts were not properly kept and the corporation is unable to pay a debt incurred by it during that financial year [s.108];

(iii) the corporation became a holding company and on winding up there is a deficiency [s.109];

(iv) where the corporation becomes insolvent and fails within a reasonable time to cease business or call a meeting of creditors or raise additional capital or applies to be wound up [s.110];

(v) where the corporation has acquired its own shares and on winding up it is found that the declaration of solvency was incorrect [s.111]; and

(vi) where the corporation unlawfully acquires its own shares and as a result it is unable to pay a debt [s.112].

Winding Up

1.31 The winding up arrangements of the Corporations Law are applied, with some adjustment, to close corporations [s.114].

1.32 Part 17 provides for the establishment of a Liquidators' Recovery Trust Fund [s.123] which is to be funded by contributions from corporations at the time of registration [s.127] and additional levies if required [s.128]. The purpose of the fund is to provide, on application, financial assistance

to liquidators who are investigating the corporation or conducting litigation [s.121].

General Provisions

1.33 Part 18 of the Act sets out various general provisions:

- certain decisions by the Minister or the ASC are subject to review by the Administrative Appeals Tribunal [s.130B];
- the powers of the courts are set out in sections 131-140;
- the ASC may intervene in any legal proceedings [s.141].

1.34 Several activities of a close corporation are regulated by the Corporations Law:

. charges	s.102 applies Part 3.5 of the Corporations Law;
. arrangements and reconstructions	s.103 applies Part 5.1;
. receivers and managers	s.104 applies Part 5.2; and
. official management	s.105 applies Part 5.3.

CHAPTER 2

THE CASE FOR A NEW CORPORATE FORM

2.1 In Australia at present the conventional company limited by shares can be formed as either a public or a proprietary company. There is also a variant of the proprietary company in the form of the exempt proprietary company. Regulatory requirements on exempt proprietary companies are reduced - they are exempt from certain disclosure and other obligations - and it is the form of incorporation currently best suited to the small business or family company.

2.2 The Committee also considered the limited partnership, which has had a resurgence in popularity in recent years, being seen by some as a simple 'half-way house' offering some of the advantages of incorporation without the legal burdens. It is not an incorporated body but a variation of the partnership offering limited liability to some, but not all, members of the partnership. Limited partnerships are not new, they have existed in some Australian jurisdictions since the nineteenth century.

2.3 Evidence to the Committee referred to limited partnerships only in passing, if at all. It appears that their popularity has waned because of proposed changes to taxation arrangements which will prevent the partnership from distributing its losses among the members. They will be quarantined and offset against future profits. It is doubtful whether the limited partnership is an appropriate vehicle for a small business such as a corner store. A limited partnership, while attractive to the investor, offers no special advantage to the business's operators who are ultimately liable for the partnership's debts or losses. In this respect it offers little advantage over the conventional partnership.

2.4 The threshold issue to be considered is whether there is a requirement for a new corporate form. The Committee's view is that corporate regulation

should facilitate the organisation and management of all Australian businesses. The Corporations Law, as it currently exists, has been developed primarily to meet the requirements for the regulation of large companies with complex structures. For example, Mr John Hassen of Price Waterhouse stated that:

> I think the disappointing thing is that there is minimal distinction between the types of businesses covered by the legal framework. As a result, small business is required to comply with a number of corporate law requirements that have been developed and directed towards controlling large corporations with diverse shareholdings.[12]

2.5 There are many provisions in the Corporations Law which are inapplicable to or unsuitable for smaller businesses:

> These requirements are often inappropriate for the smaller private business. As a result, where a private business wishes to operate under a corporate structure, this business is forced to comply with administratively and financially onerous requirements and reporting responsibilities which provide no benefit to the small business or to the other business entities with which this small business interacts.[13]

2.6 In its submission the Attorney-General's Department identified '... the need for small business to have a tailor made vehicle rather than having to adapt structures more suitable to larger enterprises'[14] as a principal policy objective of the close corporations proposal.

2.7 The regulation of the exempt proprietary company was generally criticised as being excessive and irrelevant to the needs of small business. Mr Ian Langfield-Smith, representing the Australian Accounting Research Foundation, put the view that:

> The real problem is that the vast majority of our exempt

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[12] Mr John Hassen, *Committee Hansard,* 22 October 1992, p.357.

[13] Price Waterhouse, *Submissions Received by the Committee*, p.198.

[14] Attorney-General's Department, Submission, *Committee Hansard,* 16 October 1992, p.294.

> proprietary companies are still over-regulated in being required as a matter of law, as distinct from what is actually done in practice, to prepare financial statements to give a true and fair view. ... This does result, in many cases, in financial information being prepared that is of no use to the people who are involved in the business.[15]

2.8 This was supported by Mr Hassen who stated that:

> ... the adherence by the small exempt proprietary company to accounting standards and guidelines imposed in the corporations legislation, in my view, imposes upon it an onerous financial burden.[16]

2.9 A number of witnesses made the distinction between companies where management and shareholders were separate and the company's financial documents are a matter of public record and those businesses where there is no distinction between management and ownership.[17] In the latter case it is argued that there should be no requirement to produce balance sheets and accounts that comply with the Corporations Law. Compliance for these companies serves no significant public interest and imposes on the business costs which add nothing to its operations. In practice the requirements of the law are frequently ignored.

2.10 The Committee agrees that it is incongruous that a company that operates a corner store business should be regulated, by and large, in the same detail that applies to substantial publicly listed companies that conduct nationally significant enterprises.

2.11 The Committee also agrees with the widely held view that the Corporations Law is complex and that, as a result, small businesses run the risk of inadvertent non-compliance with its many requirements. The Committee also doubts the utility of the filing requirements which small companies must observe. The returns are rarely referred to and are of dubious value to creditors or others interested in the company.

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[15] Mr Ian Langfield-Smith, *Committee Hansard,* 16 October 1992, p.220.

[16] Mr John Hassen, *op cit,* p.359.

[17] For example, Mr Ian Govey, Commonwealth Attorney-General's Department, *Committee Hansard,* 16 October 1992, p.322; John Hassen, op cit, pp.359-63.

2.12 A significant level of formality attaches to a company - even an exempt proprietary company. The formalised management style leads to artificiality and, as recent cases have shown, to notional directors being fixed with liability that, while technically correct, might appear to be unrealistic. At the same time there is something to be said for imposing some legal discipline to the management of the affairs of a company. The Committee does not support the more extreme proposals for incorporation with virtually no formal requirements or reporting obligations.

2.13 There is general support for the view that there should be a simplified form of incorporation available to small business and that the existing range of laws governing small business structures need to be improved. This is indicated in the submissions received by the Committee. In addition, the large number of businesses already operating through exempt proprietary companies gives some indication of the importance of small business structures and the possible utility of a new corporate form.

2.14 **The Committee has therefore concluded that there is a requirement for a significant reform of the law affecting small business companies. This could be by way of the introduction of a new corporate form, either through separate legislation, such as the Close Corporations Act, or through amendment to the existing Corporations Law. Alternatively, an existing corporate form could be modified or simplified.**

2.15 Much of the discussion before the Committee concerned the desirable features of a simplified form and the best way of implementing it. This discussion resolved itself into two positions:

- that an amended Close Corporations Act be proceeded with; or
- that the existing exempt proprietary company be reformed to simplify its regulatory and other requirements, perhaps by adopting some of the features of a close corporation.

2.16 Many submissions argued that rather than setting up a new legislative scheme an alternative, or better, course of action would be to reform the existing exempt proprietary company to cater for the needs of small business:

> In our opinion a preferable approach to meeting the needs of small business would be for existing corporate law to be reviewed and simplified.[18]
>
> ... some of the more desirable deregulatory reforms in the Bill could be better made by modifying the laws in relation to exempt proprietary companies.[19]

2.17 The availability of the exempt proprietary company and unincorporated partnerships is regarded by some as sufficient reason not to proceed with the close corporation legislation. The accounting bodies said in their submission that:

> The main reason cited by advocates of close corporations is the regulatory burden, including financial reporting overload, of the Corporations Law. In light of present and proposed reforms to the Corporations Law it is believed that this contention cannot be supported.[20]

2.18 The accounting bodies' submission argued particularly that if the reporting entity concept was applied through the Corporations Law then very small businesses would not be classified as reporting entities and would not have to meet the reporting requirements of the Law.[21]

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[18] Price Waterhouse, *Submissions Received by the Committee*, p.193.

[19] Premier of Western Australia, *Submissions Received by the Committee*, p.53.

[20] Australian Society of Certified Practicing Accountants and The Institute of Chartered Accountants in Australia, Submission, *Committee Hansard*, 16 October 1992, p.204.

[21] A reporting entity is defined as a body:

> ... in respect of which it is reasonable to expect the existence of users dependent on general purpose financial reports for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources.

Statement of Accounting Concepts, SAC 1.

2.19 At the same time, concern was expressed that the focus on the regulatory burden imposed by the Corporations Law exaggerates its importance:

> ... the burdens imposed through the intricacies of company law are not the prime cause of the regulatory overload faced by small business; other factors that contribute to regulatory burden include State and Federal taxation requirements and, to a certain extent, data collection agencies such as the Australian Bureau of Statistics.[22]

2.20 To those requirements can be added Commonwealth, State and local government regulation in areas such as planning, environmental law and occupational health and safety. Thus any suggestion that a new simplified corporate form would eliminate the regulatory burdens placed on small business is unwarranted.

2.21 In submissions and evidence to this Committee there was only limited specific support for the introduction of close corporations as set out in the current Act. There was, however, general support for a simplified corporate form tailored to the needs of small business. It is argued that close corporations, with suitable modifications, would be a much less complicated structure for small business. They would be free from the regulatory burdens imposed on exempt proprietary companies by the Corporations Law. The close corporation is seen as having some desirable features. Equally it has a number of significant drawbacks which make it unattractive to many businesses, particularly the inability to act as a trustee or a holding company and the range of circumstances in which the limited liability of members can be lost.

2.22 The appropriate legislative mechanism for introducing reforms to the regulation of small business is discussed in chapter 4 of this report.

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[22] Australian Society of Certified Practicing Accountants and The Institute of Chartered Accountants in Australia, Submission, *Committee Hansard*, 16 October 1992, p.206.

CHAPTER 3

FEATURES OF THE NEW CORPORATE FORM

3.1 The Committee has assessed the close corporation created by the *Close Corporations Act 1989* against the desirable features of a small business corporation put to it in evidence and summarised in chapter 1. It has also considered a number of other specific issues raised before the Committee during its inquiry.

Simplicity of Establishment

3.2 Leaving aside the constitutional requirement for an activities statement, the present Act requires only two steps for the formation of a close corporation:

- subscription to a founding statement; and
- registration of the founding statement with the ASC.

An associated step is that of reserving and registering the name if the subscribers do not wish to trade under the corporation's registration number.

3.3 Mr Athol Yeomans advocated in his submission to the Committee a form of incorporation which eliminates the requirement for initial registration.[23] The view of the Committee is that incorporation is a serious matter conferring important legal privileges and that the public interest requires, at least, some formalities associated with it. **The Committee does not consider that the procedure for setting up the proposed close corporation is onerous nor that it needs to be made any more simple.**

Establishment Costs

3.4 There is at present no indication of the likely cost of establishment of a close corporation. It currently costs $550 to register an exempt proprietary company with a $152 annual fee. The current cost of establishing a company

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[23] Mr Athol Yeomans, *Committee Hansard,* 9 October 1992, pp.41-45.

has been widely criticised as being a revenue raising exercise rather than a fee for service.

> I think that it is now reasonably simple to form a company. The major cost is the registration fee and this is, I suspect, in some way merely a monopoly tax rather than a fee for service. It may be worthwhile looking at decreasing the formation costs and perhaps redistributing them to the larger corporations that get the greater benefit from them.[24]

3.5 The Business Council of Australia suggested an initial registration fee of $50. The simplicity of the incorporation process should result in lower setting up costs and, if there is a model association agreement, the overall costs might be further lowered. While the level of the registration fee is a matter for the government, the Committee's view is that it should be kept as low as possible.[25]

Minimal Reporting

3.6 The Act requires changes to the founding statement and membership details to be reported and, in its present form, the close corporation must lodge an annual certificate of compliance which provides an activity statement and certifies that accounts have been kept.

3.7 The Committee acknowledges that reporting is important as a method of providing information to creditors, members and the regulator. It accepts, however, that the process can impose costly burdens on small business and it regards reporting merely for compliance with the law as a waste of time. There must be some doubt as to the value of filing information when it is almost certainly not assessed, is very often out of date and provides no real information for those who need it. Major creditors would be more likely to require information directly from the company rather than consult the ASC data base.

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[24] Mr Ian Langfield-Smith, *Committee Hansard,* 16 October 1992, p.226.

[25] Precise information on the cost to the Australian Securities Commission to register a corporation is not available. The ASC has estimated that, excluding the costs of support, compliance, information and enquiry services, the cost to incorporate an exempt proprietary company is in the vicinity of $40.00 to $50.00.

3.8 The activities statement is a constitutional requirement which the Committee understands would no longer be necessary if the constitutional underpinning used in the Corporations Law is applied to the Close Corporations Act. If the duty to keep accounts is abolished the annual certificate of compliance will become otiose. The requirement to report on changes to the particulars of the founding statement is appropriate and should be maintained. However, **the Committee recommends that the annual filing of returns should not be required.**

Easily Understood Structure

3.9 The Committee sympathises with the desire of the business community that corporate structures should be easily understood both by those involved in the company and by those dealing with it. The structure of the company and the rights and responsibilities of members and management should be clear. The Committee is, however, mindful that where legal issues are involved it is not always possible to reduce them to such a level of simplicity that the need for professional advice can be eliminated.

3.10 Conceptually the close corporation is as easily understood as any other incorporated body. However, many of the concepts which it introduces will be unfamiliar both to members of the corporation and to creditors. Nor do these concepts fit into the normal corporate structure with which Australians are familiar. The Committee is concerned that the existing Close Corporations Act may not provide the easily understood structure sought by the business community.

Flexibility for Growth

3.11 The Close Corporations Act makes provision for a company incorporated under the Corporations Law to convert to a close corporation while retaining its legal identity. However there is no provision for a close corporation which has expanded and outgrown the close corporations structure to do the reverse. The need for such flexibility was repeatedly emphasised during the Committee's inquiry.[26]

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[26] Mr Bryce Hardman, *Committee Hansard,* 9 October, 1992, pp.47-48.
Mr Ian Govey, *Committee Hansard,* 16 October, 1992, p.318.
Mr John Hassen, *Committee Hansard,* 22 October 1992, p.358.

3.12 Where the proposed close corporation has outgrown its original owner-operated scale it should be able to convert simply into a company without undergoing the incorporation procedures of the Corporations Law.

Limited Liability

3.13 As with the traditional style of company, the members of a close corporation have limited liability in respect of the corporation's debts. In fact, because the shares of a close corporation are fully paid, they would not be required to contribute at all. Similarly, because of the separate existence of the corporation, its members are not liable for other contractual obligations or in relation to any tort committed by the corporation.

3.14 Evidence to the Committee on the question of limited liability was inconclusive. It was put to the Committee that the limited liability available through a close corporation was only of secondary importance, its main benefit being with regard to tortious liability.[27] Several witnesses pointed out that personal guarantees are routinely required from directors of small business companies as 'security' for loans, trade credit or even leases.[28] A small business could have a legitimate interest in seeking protection from tortious liability. However, witnesses generally viewed the concept of limited liability as of restricted practical utility with regard to debts and other financial obligations.

3.15 The Close Corporations Act in section 106 upholds the principle of limited liability but it includes provisions under which limited liability is defeasible:

- if the number of members exceeds ten [s.107];
- where proper accounting records are not kept [s.108];
- if the corporation becomes a holding company [s.109];
- in circumstances where the corporation was insolvent [s.110/111/112].

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[27] Mr Bruce Watson, *Committee Hansard,* 9 October 1992, p.4, p.10.

[28] *Committee Hansard,* general discussion pp.380-381.

3.16 Despite the low priority given to limited liability by some witnesses, it was stated by others, and in several submissions, that it would be too easy to lose limited liability under the Close Corporations Act. Indeed, this was offered by several practitioners as the major reason for not recommending close corporations to clients.[29] However it was also stated that currently unincorporated businesses are already accustomed to unlimited personal liability and that the limited protection that incorporation would offer is not a decisive matter for them.

3.17 The Committee sees no advantage in establishing a new corporate form without limited liability. Although, in practice, the protection offered by limited liability is less than complete there are no good policy grounds for applying it to close corporations on different terms from those applying to other forms of incorporation.

Tax Effectiveness

3.18 It is apparent from the submissions that taxation is an important consideration for small business and it might even be the most important. Indeed, the results of an informal survey undertaken by the Committee with the assistance of trade associations confirms that.

3.19 In its crudest form, the taxation issue is about provisional tax. A company does not pay provisional tax whereas an unincorporated business does. It appears that the rate of tax is not as significant a consideration. A sole trader or partner would need to earn a taxable income in excess of $100,000 before the corporate rate of taxation is advantageous.

3.20 The view of the Small Business Coalition is that the introduction of an instalment system for the collection of provisional taxation has created cash flow problems for small business.[30] The Institute of Company Directors advocated a 'tax effective' regime. It argued that it:

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[29] Business Council of Australia, *Submissions Received by the Committee*, p.46.
Institute of Company Directors, Submission, *Committee Hansard*, 9 October 1992, p.84.
Australian Society of Certified Practicing Accountants and The Institute of Chartered Accountants in Australia, Submission, *Committee Hansard*, 16 October 1992, p.205.

[30] Small Business Coalition, Submission, *Committee Hansard*, 16 October 1992, p.246.

> ... is pointless to simplify general accounting and reporting requirements if close corporations are equated with companies for taxation purposes.[31]

It advocated taxation reforms that will recognise the partnership-like status of close corporations. The Committee understands this to mean that the tax losses of the close corporation should be capable of distribution to individual members.

3.21 The accounting bodies considered the taxation system generally and concluded that the close corporation offers no specific tax advantages over existing structures.[32] They acknowledged that the way in which taxable income is derived can depend on the structure of the business. Thus a business operator can earn a salary from the company and be free of provisional tax obligations whereas partners or sole traders cannot employ themselves and are therefore liable to provisional tax.

3.22 The taxation issue was very prominent in the Bedall report[33] which suggested that the Close Corporations Act should have a role in changing the taxation scheme. It recommended that the operation of the Act be reviewed annually:

> ... to assess the extent to which the objectives of the legislation are being achieved viz: ...
>
> - reduce the taxation, superannuation and other disadvantages currently experienced by small businesses which are not incorporated.[34]

3.23 It is possible that through a corporate form a small business has a better opportunity to reduce the income tax burden. The close corporation could reduce its income by paying salaries to the working members. They,

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[31] Institute of Company Directors, Submission, *Committee Hansard*, 9 October 1992, p.96.

[32] *Committee Hansard,* 16 October, 1992, p.207.

[33] *Small Business in Australia, Challenges, Problems and Opportunities,* Report by the House of Representatives Standing Committee on Industry, Science and Technology (Canberra 1990).

[34] ibid., p.240.

in turn, would pay tax at rates which might be lower than 39 per cent (the corporate rate). By taking the income in that form they would not be required to pay provisional tax.

3.24 There is no doubt that concern about taxation - the rates, the collection process and administration generally - is legitimate. It is legitimate even under anti-avoidance laws such as Part IVA of the Income Tax Assessment Act for businesses to be incorporated in order to generate what they perceive to be a tax advantage.

3.25 The real issue to consider is whether the relative taxation treatment of incorporated and unincorporated businesses is one which should be dealt with under the rubric of corporate law. No matter how persuasive the arguments for taxation relief, the appropriate forum for examining them is in the development of taxation policy. **The Committee does not believe that it is appropriate to pursue taxation reform through the indirect method of corporate law reform.**

Name of the New Corporate Form

3.26 The Committee believes that the name 'Close Corporation' is unsuitable. This name is not clearly descriptive of the nature of the corporation and its significance will not be readily discernible to either small businesses or to those who deal with them. The Committee's view on this issue was supported in the submissions it received and during its public hearings. In fact, nobody spoke in favour of retaining the name. A variety of alternative names were put forward by different organisations.[35] **The Committee recommends that the name 'Private Company' be adopted for any new corporate form and that it be identified by the abbreviation 'PC Ltd'.**

Number of Members

3.27 An issue which was frequently raised before the Committee was the maximum number of members a close corporation should be allowed to

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[35] Mr Laurie Eakin, *Committee Hansard,* 16 October, 1992, p.283.
Mr Bob Gardini, *Committee Hansard,* 16 October, 1992, p.284.
Attorney-General's Department, Submission, *Committee Hansard,* 16 October 1992, pp.314-315.
Small Business Coalition, Submission, *Committee Hansard,* 16 October 1992, p.253.

have. In evidence to the Committee it was suggested that a maximum of 10 members was a purely nominal figure, was too restrictive and did not allow the corporation to grow as its business expanded. It was put to the Committee that even small family businesses might commonly involve more than ten family members. Various maximum numbers were suggested to the Committee. Mr Jooste suggested that 15 members was more appropriate; the Small Business Coalition and the Institute of Corporate Managers Secretaries and Administrators suggested 20; and the Australian Institute of Company Directors recommended that the number be increased to 50.

3.28 Given that the close corporation was intended to be a form of organisation specifically for the smallest of incorporated businesses these suggestions to increase the number of members seemed inappropriate to the Committee. The Committee therefore sought information from the ASC on the number of shareholders in existing exempt proprietary companies. The data supplied by the ASC indicated that 94.0 per cent of these companies have five members or less and that 99.1 per cent have ten members or less. These figures would suggest that the limit of 10 members in the Close Corporations Act is appropriate, if not too large.

3.29 **The Committee recommends that the limit of ten members for small companies should be retained.** Those few businesses which require a corporate form which would allow a more diverse shareholding will still have the option of becoming an exempt proprietary company.

3.30 The Close Corporations Act currently allows a Close Corporation to operate with only one member. While the Committee considers that there may be benefits in retaining that provision, for example removing the need for a token director, it would not facilitate the easy transition between a private company and an exempt proprietary company. **The Committee therefore recommends that the minimum number of members should be two.**

Passive Investors

3.31 A major deficiency of the Close Corporations Act approach is that it does not accommodate the passive investor. The existing Act has absorbed the partnership principle that allows all members to be involved in the management of the company. Section 85 of the Act makes each member of the corporation an agent capable of binding the corporation and appointing other agents. Given the recent findings of the courts in cases involving passive directors the Act could place a passive investor at a considerable risk

of personal liability. Ian Govey, representing the Commonwealth Attorney-General's Department, observed that the current Close Corporations Act:

> ... does involve an absence of any distinction between ownership and management and, quite clearly, it will not be an appropriate vehicle for a husband and wife to operate unless both are taking part in the management of the enterprise.[36]

3.32 The need to recognise the possible role of passive investors was emphasised by Professor Austin:

> It is the principle upon which company law has been founded since Salomon's case, that investors essentially are investors. There is a distinction between investment and management. Investors should be allowed to put their money in, hoping for a return, but not having any involvement in the decisions which lead to the continuing management of the company, ...[37]

3.33 The Committee considers that an important function of any corporate form is to allow passive investors to become involved in providing capital for incorporated businesses. **It recommends that the new corporate form should retain the principle of the division between management and ownership contained in the Corporations Law.**

Compatibility with the Corporations Law

3.34 The Close Corporations Act also suffers by not being generally compatible with the Corporations Law. To apply different principles or different rules for directors' duties, insolvency provisions and the defeasibility of limited liability from either the existing partnership law or the corporations law imposes an additional regulatory burden on administrators, professional advisers and company managers. Differences between the close corporations regime and the Corporations Law would also create difficulties during the process of conversion from the status of a close corporation to another corporate form.

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[36] Mr Ian Govey, *Committee Hansard,* 16 October 1992, p.322.

[37] Professor Bob Austin, *Committee Hansard,* 9 October 1992. p.39.

Constitutional Difficulties

3.35 In its present form the Close Corporations Act suffers the same constitutional defects as the original Corporations Act. To overcome these defects would involve:

> ... the drafting of the substantive provisions of the Close Corporations Act as a separate law in a similar way to the creation of the Corporations Law. It would require separate complex underpinning legislation, both Commonwealth and State/Northern Territory, similar to Parts 2 to 9 of the Corporations Act and the State Application Acts ...[38]

Ability to Act as Holding Company or Trustee

3.36 The Close Corporations Act currently prohibits a close corporation from acting as a trustee (s 46) or a holding company (s 50). These restrictions have been criticised on the grounds that they greatly restrict the usefulness of the close corporation to small businesses which want to use more complex corporate structures. The submission of the Attorney-General's Department responded to these views by concluding:

> In particular, the argument that the Act should be amended because a number of existing exempt proprietary companies would not be eligible to become close corporations (e.g. because they currently act as trustees or holding companies) overlooks the policy behind the development of the Act.
>
> It was always intended that the Close Corporations Act would assist small business which needed a simple entity. Such businesses would be able to use a simpler management structure and have fewer accounting and reporting obligations. In return for these concessions, close corporations were to be limited in their capacity and functions and their members were to assume a degree of personal liability for the corporation's debts.

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[38] Commonwealth Attorney-General's Department, Submission, *Committee Hansard*, 16 October 1992, p.313. The submission went on to raise the possibility of identifying 'a simple drafting device for enacting the provisions by reference to the Commonwealth/State/Northern Territory laws'. However no such device is identified in the submission.

> Business or family arrangements which require or desire a more complex structure have the option of incorporating under the Corporations Law. For these arrangements not to be able to take advantage of close corporations legislation would not be a shortcoming of such legislation.[39]

3.37 The Committee concurs with this view of the role of close corporations. **It recommends that these restrictions be retained for any new corporate form aimed at small business.**

Compliance with Accounting Requirements

3.38 The Committee is strongly of the view that, if only for prudential reasons, any business, in whatever form it operates, should keep proper accounting records. The Committee is not convinced that enshrining such a requirement in legislation, particularly if it cannot be effectively enforced, is beneficial. Several witnesses gave evidence to the Committee on this issue.

> ... the vast majority of accounts of exempt proprietary companies have never complied with the law and will never comply with the law. It is a travesty to continue to have in place provisions in the legislation which say that they shall comply with that aspect of the law in the quality of characteristics of financial statements.[40]

> In my view, clients and small business are spending the funds allocated for accounting fees on compliance costs when they could be spending the same dollar seeking business advice or strategy, business planning etc.[41]

3.39 Witnesses put the view to the Committee that the requirement for a business to keep proper accounts and to have them audited is in any case imposed upon businesses as they become larger. Creditors, such as banks,

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[39] ibid., p.316.

[40] Mr Ian Langfield-Smith, *Committee Hansard,* 16 October 1992, p.220.

[41] Mr John Hassen, *Committee Hansard,* 22 October 1992, p.362.

will insist upon seeing properly prepared and audited accounts before lending large amounts to a business.[42]

3.40 The Committee also notes that section 262A of the Income Tax Assessment Act requires that sufficient records be kept to enable a business's assessable income and allowable deductions to be readily ascertained, and to retain those records for seven years. **The Committee therefore recommends that the requirement to keep accounts in the existing Close Corporations Act should be deleted.**

Internal Disputes

3.41 One important issue raised before the Committee is the cost of resolving internal disputes concerning small companies through the legal process. At present, remedies for oppressive conduct and other internal disputes must be sought through the courts. It was suggested to the Committee that some form of tribunal be established as an alternative to the formal court system to deal with these matters in an efficient and cost effective manner.[43]

3.42 The Committee has considerable sympathy with this viewpoint. However the jurisdiction, powers and structure of such an organisation would raise extremely complicated issues which extend beyond the scope of this inquiry.

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[42] Mr John Hassen, *Committee Hansard,* 22 October, 1992, p.372.

[43] Mr Bruce Watson, *Committee Hansard,* 9 October, 1992, pp.12-15.

CHAPTER 4

PROPOSAL FOR CHANGE

4.1 The Committee considers that the existing Close Corporations Act does not satisfy the requirements for a new corporate structure for small business. Adapting the existing legislation to overcome the shortcomings referred to in Chapter 2 would require extensive modification of the legislation; there would need to be other changes to bring the legislation to the standard the Committee regards as appropriate; and yet other changes to harmonise the Close Corporations Act with the post-1989 body of corporate law.

4.2 The Committee considers that to meet its specifications, and those of the business community, it would be necessary or appropriate to

- re-name the Act. The term 'close corporation' is not widely known amongst those who would be likely to use it.

- overcome the constitutional difficulties it currently faces. This change could be modelled on the formula currently applied in the Corporations Law. If a separate Act were to be maintained it would be necessary to enact a Close Corporations Act and Close Corporations Law and legislation in the States and the Northern Territory.

- repeal division 3 of Part 1 of the Act, which deals with dormant close corporations.

- amend the legislation to establish a minimum of 2 and a maximum of 10 members.

- provide for a simple transition to an exempt proprietary company without changing the corporation's legal identity.

- delete divisions 2 and 3 of Part 2 of the Act which deal with activities statements and the effects of a close corporation ceasing to be a trading corporation. These provisions should no longer be required if the constitutional obstacles are overcome.

- repeal section 45 of the Act, which deals with the application of State and Territory company laws and will no longer be necessary.

- delete section 64, which deals with the effect of the death of a sole member.

- amend section 80 to bring it into line with the proposed amendments to the directors' duties provisions contained in section 232 of the Corporations Law.

- delete the requirement for the keeping of accounts, the submission of an annual compliance certificate and the consequential penalty provisions for non-compliance.

- abolish the agency relationship between members and the corporation.

- replace the complicated scheme in Part 10 by a provision which enables a private company to acquire its own shares or to assist in financing their acquisition if the value of the company's assets after the transaction exceeds the total liabilities of the corporation and the corporation can make a declaration of solvency.

- make the circumstances under which limited liability is lost the same as under the Corporations Law.

- repeal the provisions for a liquidators' recovery trust fund.

- set the initial and annual registration fees at as low a level as is practicable.

- simplify the compliance requirements.

4.3 In view of the scope of these changes **the Committee recommends that the Close Corporations Act be repealed. Rather than create a new corporate entity the Committee's preferred approach is to provide an additional, simplified variant of the exempt proprietary company.** Remaining within the structure of the Corporations Law will avoid the constitutional problems which would be inherent in creating a new corporate structure through separate legislation.

4.4 The Committee is also concerned that the creation of close corporations introduces yet another business structure, one that is novel and which would create new administrative pressures on the Australian Securities Commission. There have been suggestions that exempt proprietary companies be abolished to make way for close corporations. The elimination of exempt proprietary companies could create difficulties for persons wishing to use a corporate vehicle as trustee or wishing to establish a holding company. The close corporation is unable to carry out those functions.

4.5 The Committee has considered the various options and believes that a range of corporate forms is desirable. It favours providing for the creation of a small business corporation within the Corporations Law but having a number of the characteristics of a close corporation. This may be too restrictive for many existing exempt proprietary companies, particularly the prohibition on acting as a trustee or a holding company. Thus the exempt proprietary company should be retained for more complex corporate structures. Experience over time with the new form will indicate how attractive it is to business and may lead to the further rationalisation of the various types of corporation.[44]

4.6 This approach will also facilitate transition between the different corporate forms. The Committee is conscious of the criticism that the Corporations Law is complex and that what it advocates could be seen as perpetuating that problem. However, the addition to the total volume of company law through this approach will be considerably less than if a separate Act was passed. Its proposal is to simplify the law and it hopes that the government, the Institute of Company Directors and the professions will intensify their efforts to educate small business.

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[44] It is interesting to note that in the United States there appears to be a division of opinion as to how to express the laws governing close corporations. Some States have legislated separately for close corporations while others have made provision for them in sections of their general corporations law.

4.7 The Committee recommends that a new chapter be added to the Corporations Law. This chapter would provide that corporations which satisfied certain specific requirements would be relieved from compliance with many of the requirements of the Corporations Law. As a matter of convenience such companies, a category of exempt proprietary company, would be designated as 'private companies'. The use of an additional chapter will remove the need for a separate Act and for further enacting legislation in the States and the Northern Territory.

4.8 The Committee recommends that when the new law is introduced it be accompanied by a simple guide, in plain language, for potential users explaining the corporate structure, its powers and obligations and the process of establishment.

4.9 The private company will have the attributes discussed below.

Membership

4.10 It will have a minimum of two and maximum of ten members. The Committee considers that this would make it easier for private companies to revert to proprietary company status. The close corporation allowed for a single member company and that, superficially, removed the risk to nominal directors exemplified by the decision in the *Morley v Statewide Tobacco Services* case.[45] There were, however, circumstances in the Act which made members of the close corporation liable in the same way as were nominal directors.

4.11 Only natural persons may be members. This is consistent with the concept of a owner operated business and in this respect differs from the conventional exempt proprietary company.

Shares

4.12 Private companies should have only one class of fully paid shares. As with a close corporation, there appears to be no justification for a more sophisticated capital structure for a small business corporate entity.

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[45] *Morley v Statewide Tobacco Services Ltd* (1992) 8 ACSR 305. In this case the Appeal Division of the Supreme Court of Victoria found that it was unacceptable for a director to escape liability by ignoring his or her obligations as a director and pleading ignorance of the financial position of a company.

4.13 The right to transfer shares should be restricted. This is likewise a statutory feature of a proprietary company.

Fund Raising

4.14 Private companies are to be prohibited from raising funds from the public. This is a requirement under the Corporations Law for a proprietary company and is thus appropriate for a private company.

Powers of the Company

4.15 It may not be a trustee (other than a constructive trustee). This was a feature of the close corporation and the Committee considers that for a simple owner operated entity it would not be appropriate for it to conduct itself as a trustee. A small business concern or a 'family company' wishing to do so would be able to do so as an exempt proprietary company.

4.16 It may not be a holding company. As with a close corporation it is not envisaged by the Committee that a private company would operate on the scale where it would be a holding company. Such a corporate structure would be outside the realm of an owner operated entity.

Exemptions

4.17 As a category of exempt proprietary company, the private company will enjoy the same exemptions. For as long as it maintains its status as a private company it will have extra exemptions from compliance with the Corporations Law.

4.18 There should be no requirement to maintain accounts. The Committee shares the view of the ASC that:

> ... accounts kept by [small business enterprises] are essentially management accounts to be prepared to the satisfaction of management and therefore should not be subject to any legal constraints as to preparation, nor required to be lodged with the ASC.[46]

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[46] Australian Securities Commission, *Submissions Received by the Committee*, p.292.

4.19 Private companies need not lodge an annual return. The Committee has serious reservations about the value to anyone of the requirement to lodge an annual return. It notes the comment of Mr Bryce Hardman of the Institute of Corporate Managers, Secretaries and Administrators in the context of the benefit of annual filings that:

> There are perceived benefits. They are revenue earners for the Australian Securities Commission. That is the benefit. There is no benefit to businesses.[47]

4.20 The Committee considers that money spent with accountants on complying with this requirement would be better spent on obtaining managerial advice that provides some value to the small business.

4.21 The private company should be required to keep its founding documents lodged with the ASC up to date. Thus the Committee believes that companies should be required to advise the ASC on a continuing basis of any material changes to the founding documents.

4.22 Subject to the company's articles, there should be no statutory requirement for an annual general meeting. The Committee is aware of the significance of annual general meetings for shareholders who, once a year are able to require directors to give an account of their stewardship. In a closely held corporation the distance between shareholders and directors is not as great and the annual meeting could be an expensive waste of time. Members should, however, have the option of requiring an annual general meeting and can do so through the articles.

4.23 The private company should have the capacity to deal more easily in its own shares. The Committee understands the policy considerations that lie behind the complex buy back provisions for companies. It has received evidence that, in respect of small business entities, creditors usually adopt self-help to protect their interests[48] and therefore the traditional doctrine of protecting the entity's capital base is not as critical. In keeping with its desire to simplify the regulation of small business the Committee considers that a private company dealing in its own shares should be able to do so without an elaborate authorisation process. Creditor interests would be

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[47] Mr Bryce Hardman, *Committee Hansard,* 9 October 1992, p.49.

[48] Australian Securities Commission, *Submissions Received by the Committee*, p.292. Mr John Hassen, *Committee Hansard,* 22 October 1992, p.361.

protected by a solvency requirement as set out earlier in para 4.2.

Change of Status

4.24 Should the private company lose any of its special characteristics there should be provision for it to change its status. In such circumstances it would revert to the status of proprietary company or, with the appropriate procedures, convert to a public company.

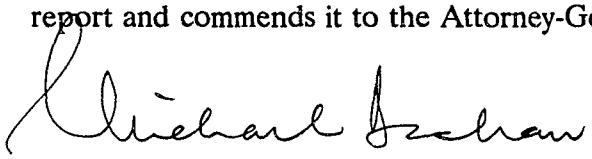
Application of the Corporations Law.

4.25 The Committee believes that while it is important to reduce the regulatory load for small business entities there are areas where they should be subject to the same standard of regulation as other companies. In particular it is important that there be standardisation in respect of insolvent trading, directors' duties and winding up. These aspects of a private company's existence would be regulated by the same law as applies to other companies.

Drafting of the Law

4.26 Throughout the Committee's inquiry it was emphasised by a wide range of witnesses that the close corporations proposal, or any alternative to it, was aimed at small business and should be readily understandable to its members and their advisers. **The Committee believes that in drafting the new chapter of the Corporations Law every effort should be made to make it as clear as is compatible with accuracy.**

4.27 At the invitation of the Committee, Professor David Kelly, the then Chairman of the Victorian Law Reform Commission, provided alternative drafts to a number of sections of the Close Corporations Act using the VLRC's 'plain English' style. The Committee has recommended that the Act be repealed thus Professor Kelly's proposals are not immediately applicable. However the Committee has included his work as Appendix III to this report and commends it to the Attorney-General's Department.



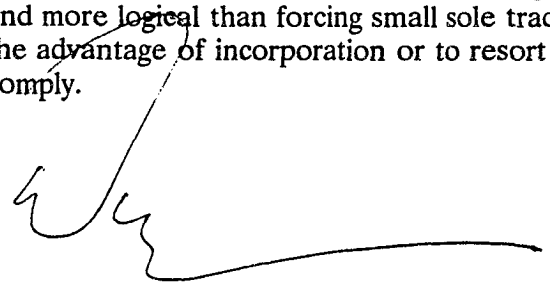
Michael Beahan
Chairman

DISSENTING REPORT

I dissent from the Committee's conclusion that the minimum number of members of a private company be increased to two. This is unjustified and denies the company's utility to many small sole traders etc.

The sensible course would be to either provide for some simple transition mechanism or even more conveniently, alter the requirement that proprietary companies must have at least 2 directors. I have never seen a convincing argument advanced for this latter requirement.

Either of the above courses would be simple to give effect to and more logical than forcing small sole traders either to forgo the advantage of incorporation or to resort to artifice so as to comply.



Duncan Kerr, MP

Appendix I

The Committee's Inquiry

The Committee adopted this reference in June 1992. Advertisements seeking submissions were placed in major newspapers on 24th June, 1992. Letters were sent directly to State and Territory governments, small business agencies and over 80 small business organisations, professional bodies and potentially interested parties. The Committee received 30 submissions and conducted three public hearings in Sydney, Melbourne and Perth, taking evidence from 20 witnesses.

Public Hearings

During the course of the inquiry, the Committee held public hearings in Sydney, Melbourne and Perth.

Friday, 9th October, 1992 - Sydney

The following people appeared as witnesses:

Australian Institute of Company Directors
Austin, Prof R.
Dunstan, Mr P.
Matheson, Mr I.

Barker Gosling Solicitors
Castle, Mr D.

Burnett, Mr K., University of Western Sydney

Gooley, Mr J., University of Western Sydney

Institute of Corporate Managers Secretaries and Administrators
Hardman, Mr B.
Pinchen, Mr M.

Watson, Mr B., Grant Samuel and Associates

Yeomans, Mr A., Institute of Company Directors

Friday, 16th October, 1992 - Melbourne

The following people appeared as witnesses:

Attorney-General's Department
Govey, Mr I.

Australian Society of Certified Practicing Accountants
Institute of Chartered Accountants in Australia
Langfield-Smith, Mr I.

Small Business Coalition
Eakin, Mr M.
Gardini, Mr B.
Spicer, Mr I.

Thursday, 22nd October, 1992 - Perth

The following people appeared as witnesses:

Ffrench, Mr H., Edith Cowan University

Hassen, Mr J., Price Waterhouse

Jooste, Mr P., Parker and Parker

Law Society of Western Australia
Shervington, Mr L.

Metcalf, Mr R., Metcalf and Spahn

Simmonds, Professor R., Murdoch University

Appendix II

List of Submissions

Submission No.	
1	Small Business Corporation of South Australia, Adelaide, SA
2	Australian Association of Ethical Investment Clubs, Chidlow, WA
3	ACT Attorney General's Department, Canberra, ACT
4	Barker Gosling Solicitors, Sydney, NSW
5	Metcalf Spahn, Subiaco, WA
6	University of New England (The), Orange, NSW
7	Small Business Development Corporation, Melbourne, VIC
8	Business Council of Australia, Canberra, ACT
9	Australian Institute of Company Directors, Sydney, NSW
10	Australian Society of Certified Practicing Accountants and The Institute of Chartered Accountants in Australia.
11	Trustee Companies Association of Australia, Melbourne, VIC
12	Institute of Corporate Managers, Secretaries and Administrators, Victoria Park, WA
13	Premier of Western Australia, Perth, WA
14	Clarke and Kann Solicitors, Brisbane, QLD
15	Home Unit Owners Association of New South Wales, Cronulla, NSW

16 Grant Samuel and Associates, Sydney, NSW

17 Small Enterprise Association of Australia, Adelaide, SA

18 Corrs Chambers Westgarth, Brisbane, QLD

19 Attorney-General's Department, Canberra, ACT

20 Australian Council of Professions, Canberra, ACT

21 Confederation of Australian Industry, Canberra, ACT

22 Premier of South Australia, Adelaide, SA

23 Law Society of Western Australia, Perth, WA

24 Government of the Northern Territory, Darwin, NT

25 Gooley, Mr J.V., Riverwood, NSW

26 Axtens, Mr J.M., Lismore, NSW

27 Price Waterhouse, Perth, WA

28 Institute of Corporate Managers Secretaries and Administrators, Sydney, NSW

29 Lessing, Assistant Professor J., Gold Coast, QLD

30 Ffrench, Mr H.L., Perth, WA

31 Australian Securities Commission, Sydney, NSW

Appendix III

Comments on the drafting of the *Close Corporations Act 1989* by Professor D StL Kelly, Chairman, Victorian Law Reform Commission.

STRUCTURE OF

THE CLOSE CORPORATIONS ACT 1989

The general structure of this Act is much the same as that of other Commonwealth Acts. It is defective because it does not present information in a coherent order. The main messages of the Act are hidden away. Basic principles are overwhelmed by a mass of detail.

1. The Act begins with a series of sections (short title, application to the Crown, Extension to external Territories, Administration) which are of peripheral interest. These sections should be put at the back of the Act. The short title section should be dropped, as it has been in Victoria.

2. The Act then contains a 'general dictionary' which, while important to the operation of the Act, cannot be read as a coherent whole. A dictionary is something one looks to for the precise meaning of a term in an operative section that one is puzzled by. Why on earth put it at the front of an Act, when it is never the first thing one wants to know about and, on its own, makes no sense at all?

3. The Act then sets out a series of definitions (holding company, subsidiary, control of a body corporates board, involvement, receiver and manager, two of which are not referred to in the general dictionary! It is, of course, all too common to discover that the 'dictionary' in an Act doesn't cover all terms and phrases that are defined, in one way or another, in that Act.

4. The Act then talks in the most pedantic manner about the way in which the Corporations Act applies to close corporations. It is largely concerned with adjustments to the meaning of terms used in the Corporations Act. Fascinating stuff, no doubt, but what on earth is it doing at the beginning of the Act?

5. The Act deals with the formation and registration of a close corporation. But there is still no clear indication of the effect of forming and registering a close corporation, or of the reasons why Parliament decided to create the new concept, or how it reduces the level of regulation and of compliance costs.

   Instead, we are told about the minute detail of the registration process, the effect of a certificate of compliance, the need to lodge an activities statement, the naming of close corporations, abbreviations, and so on. The detail is overwhelming.

6. Later sections in the Act deal with more substantial matters. But they do so in a totally obscure way. Nowhere in the Act is there a clear statement why the new concept is being created, or how a close corporation is different from another corporation or a partnership. That is simply intolerable. Not surprisingly, the Explanatory Memorandum is also deficient in the latter respect.

7. The Act, is my view, a prime example of the need for radical surgery on the structure of Commonwealth legislation and the drafting style still being used in Canberra. The overriding problem is a lack of concern about the audience of legislation. The Close Corporations should be transparent enough for company secretaries and directors - and even shareholders - to read and follow. At the moment, they would have not the slightest hope of doing so.

PART 4 - WHAT A RESTRICTED CORPORATION MAY AND MAY NOT DO ETC

43 It has the powers of an individual

A restricted corporation has, both in and outside Australia, the legal capacity of an individual. Its capacity is not affected by the doctrine of ultra vires, nor by the fact that an act done or to be done by the corporation is not, or would not be, in its best interests.

44 It has power in relation to shares etc

A restricted corporation has power, both in and outside Australia, to do any of the following things:

- Allot and issue fully paid shares in itself - but not partly paid shares or shares at a premium or discount.
- Issue debentures in itself.
- Distribute any of its property in any way among its members.
- Grant a floating charge on its property.
- Arrange for it to be registered or recognised as a body corporate outside Australia.
- Do anything it is authorised to do by any other law (including a law of a foreign country).

45 It may offer shares and invitations to members, but not to public

A restricted corporation may make a genuine offer or invitation to its members to accept subscriptions or subscribe for its shares.

However, it must not make an offer or invitation of that type to the public or any section of it. It doesn't matter how the section of the public is defined. Nor does it matter that an offer or invitation can only be accepted or acted on by a person to whom it is made.

46 It does not have power to act as express trustee

A restricted corporation does not have power to act as a trustee under an express trust. An appointment of a restricted corporation as a trustee is void.

46.1 If a person, while claiming to act on a restricted corporation's behalf, leads someone else to believe that the corporation is a trustee under an express trust, the person - not the corporation - incurs any obligation that would otherwise be incurred by the corporation.

47 It may not be a holding company

A restricted corporation may hold shares in another body corporate. However, if it becomes a holding company of another body corporate, it must, within one month, either start to be wound up, or become a company itself.

Proposed redraft

48 Assumptions which may be made about dealings with restricted corporations

A person is entitled to make the assumptions set out in 48.1 - 48.6 in connection with any dealings the person has with a restricted corporation, or with a person who has acquired or claims to have acquired property from a restricted corporation. The fact that a person or agent referred to in section 48.2 - 48.6 acts fraudulently or commits forgery is irrelevant.

48.1 Any association agreement has been complied with.

48.2 A person is a member of the corporation, if he or she appears to be so from the corporation's founding statement (as affected by any notice lodged under section 20).

48.3 A person held out by the corporation or a member to be an agent of the corporation has been properly appointed and has the authority normally possessed by an agent of that kind.

48.4 An agent of the corporation who has authority to issue a document or a certified copy on behalf of the corporation has authority to warrant that it is genuine or a true copy.

48.5 A document has been duly sealed by the corporation if:

- it shows what appears to be an impression of the corporation's official seal; and
- the seal appears to be witnessed by a person who, because of 48.2, may be assumed to be a member.

48.6 The agents of the corporation properly perform their duties to the corporation.

49 When those assumptions may not be made

A person is not entitled to make any of the assumptions referred to in section 48 that the person actually knows is wrong or, because of the person's connection with the corporation, should know is wrong.

49.1 The fact that a founding statement, document or a set of particulars has been lodged, or is referred to in another document that has been lodged, is not sufficient to infer that a person has knowledge of it or of its contents. This doesn't apply in relation to a document (or its contents) that has been lodged under Part 3.5 of the *Corporations Law* - but only to the extent that the document relates to a charge registrable under that Part.

50 Assumptions not to be contradicted

In any proceedings, neither the corporation, nor the person who has acquired or claims to have acquired property from the corporation, may contradict any assumption which the person who had the dealings was entitled to make.

51 Effect of other laws

A restricted corporation may carry on business in a State or Territory despite the law of that place relating to foreign companies (as defined by that law).

However, nothing in this Act is to be taken as impliedly limiting the application of a law of a State or Territory that is capable of applying concurrently with this Act.