

Instructor manual

to accompany

Company law: an interactive approach

1st edition

by

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Racing parts case study

How to teach with this case

Students are expected to treat the case study as a real-world business scenario, and David Douglas and his Racing Parts business as real clients. The case study does not provide all the information needed for each decision. Students need to develop the skills to know what might not have been said or provided, and to ask their clients the right questions. It is important to regularly remind students that they will need to ask their client questions. They cannot rely on the client to know exactly what information to provide.

Students should understand that it is their job as an adviser to:

- LISTEN to their client
- UNDERSTAND the law in relation to their client's questions
- SEEK further information.

Students need to understand what is important to the client and why the client wants things a certain way. An adviser will not always remember all the information about their client and it is therefore important to regularly review and reacquaint themselves with the client as the case study develops.

The first appearance of the Racing Parts case in each module presents relevant background information, events that have occurred since the previous module, and an overview of the issues that will be raised in the current module. The list of issues at the end of the first case box in the module includes the key considerations/questions to be analysed in order to advise David. By working through the module and, in particular the Racing Parts Activities and Insights that appear in most of the learning objective sections of the module, the student should be able to formulate a response to each of these issues. The more specific questions that are sometimes included are intended to help students focus on the key information relevant to decisions.

Module 3: Company constitution

Students should watch part 3 of the case study and/or read the case study in the printed text. At this stage, students will also benefit from reviewing part 2 of the case study, along with the analysis and decisions made in module 2, which together provide additional details on issues relevant to the decisions to be made in this module.

Issues

- Why are company rules required?
- Under what circumstances might a company choose to use the default rules in the Corporations Act or alternatively choose to write its own rules, or use a combination of approaches?
- Can a company constitution constrain the company or its managers from doing what they think is in the best interests of the company?
- Can a company's rules be changed?

At this stage, before studying the module, the student will not necessarily be able to advise a client on these questions, but should be able to think about the issues in more general terms:

- Students should discuss the purpose of rules and identify the two groups (shareholders and directors being the internal parties) the rules are aimed at.
- The replaceable rules may be suitable when a company requires only basic rules to govern the major areas of the company's operations in order to meet regulatory obligations. A company constitution may be suitable when a company will be better served by rules that are tailored to the company's specific size, nature, circumstances, goals and activities. A company may choose to use a combination of the replaceable rules and a company constitution if the replaceable rules are suitable to the circumstances of the company, but the company nevertheless has specific needs that are additional to the matters covered by the replaceable rules.
- Students should acknowledge that the affirmative answer is appropriate. They should draw on LO3.1 to relate this back to the reasons that company rules are required (regulatory obligations; to provide certainty to all parties internal and external; to balance managers' and owners' interests). Students may also draw on the discussion of directors' liability, described in module 2. Students should be able to explain that the company constitution can determine how much control different parties have. Students should discuss the advantages and disadvantages of a company constitution in relation to David's desire to maintain control of Racing Parts Pty Ltd.
- Students should discuss why a company may want or need to change its rules. In relation to Racing Parts Pty Ltd, they should refer to David's goals for the company and his future plans (particularly in relation to adding other shareholders and directors in future, along with this plans to diversify into other areas of business).

Learning objective 3.1: Explain why companies need a set of rules and procedures to govern their operations.

Is the need for rules important for Racing Parts if David is the only director and shareholder? What if Helen and/or Lisa become directors?

This activity draws attention to the relative importance of company rules in a company with multiple shareholders and/or directors compared with a sole shareholder/director proprietary company.

Drawing on LO3.1 and LO3.2, students should identify that single shareholder/director proprietary companies (as Racing Parts Pty Ltd currently is) are treated differently under the Corporations Act (refer to Corporations Act ss 198E, 201F and 202C) and do not need to adopt a company constitution or the replaceable rules. Students should identify that adding another shareholder or another director (which David has foreshadowed) will change this situation and require the company to adopt a set of rules — relating this back to each of the 3 points in s 134.

Learning objective 3.2: Describe the application of the replaceable rules contained in the Corporations Act 2001 (Cth).

Does David want to limit the powers of future directors — how would you word such a provision?

This activity draws attention to various issues David should consider when deciding which option Racing Parts Pty Ltd should pursue.

Students should discuss which of the replaceable rules would and would not suit David. They should relate David's ability to maintain control of the company to s 198A (replaceable rule — powers of directors) of the Corporations Act. Students could suggest rules to limit Helen to dealing with finance issues and not operational issues.

Learning objective 3.3: Describe the purpose of a company constitution.

Why does a pre-emption clause exist in proprietary companies?

Students should discuss the purpose of a pre-emption clause and why it only applies to proprietary companies. If a proprietary company adopts the replaceable rules, then such a clause, as relates to a new issue of shares, exists in the company rules (see s 254D). If a proprietary company writes its own constitution, then the constitution will need to include the pre-emption clause.

There are two types of pre-emption clause. First, students should discuss the pre-emption clause from the perspective of a seller of shares (i.e. they must offer shares being sold to existing shareholders first). Second, students should examine that when a company issues more shares it will have to offer to sell them to existing shareholders first. It would be useful to discuss how accountants get involved when such a clause exists (e.g. if there is a dispute between a seller and the other shareholders as to the appropriate price of the shares). The internal rules may have a clause to settle disputes between members (s 140(1)(c)). Accountants may need to value the company as part of settling the dispute. Students should explain possible reasons for having a pre-emption clause (e.g. maintain shareholders below 50 (to remain a proprietary company); ensure the directors do not become shareholders; prevent competitors from acquiring an ownership stake).

Explain whether RPs constitution is a mixture of the replaceable rules and the company's own rules? How will David maintain control? How will he avoid disputes? What would you suggest?

Students should look at the draft constitution for Racing Parts Pty Ltd provided in the Appendix and go through some of the key clauses that are not in the replaceable rules, explaining why they have been included in the constitution.

Students will notice that the Racing Parts Pty Ltd constitution is structured and ordered very differently to the replaceable rules listed in s 141. There are many more clauses than the replaceable rules (e.g. the whole first section about purposes). Some clauses refer to provisions in the Corporations Act. We would conclude that Racing Parts Pty Ltd has its own constitution.

As referred to in the prior activities, David may wish to adopt several strategies to maintain control and avoid disputes:

- limit the power or functions of newly appointed directors
- issue different classes of shares so that new shareholders have different (lesser) rights (e.g. voting)
- include pre-emption clauses so existing members get first right of refusal over any new shares issued by the company, or any existing shares available for sale.

Different classes of shares — why would David want this in the constitution?

There are some common matters that are not contemplated by the replaceable rules:

- no provision to issue partly paid shares, permitted by s 254A
- no provision to issue shares with different rights attaching, permitted by s 254A.

Look at the Racing Parts Pty Ltd constitution in the appendix — note that clauses 6 and 7 permit different classes of shares and voting rights are different among these classes. David holding voting shares and other members holding non-voting shares is one way for David to maintain control.

Learning objective 3.4: Explain the purpose of an objects clause in a company constitution.

Is the doctrine of ultra vires redundant? Does David have to say what the objective of the company is?

This activity guides students in relation to the suitability of an objects clause for Racing Parts Pty Ltd. Suggest that students first identify and explain this concept in company law — that activities, operations and transactions not within the scope of a company's stated object clause were beyond its power and therefore void. The Act now contains provisions that fundamentally affect the operation of *ultra vires* and constructive notice:

- Section 124 companies have the same powers as a natural person.
- Section 125 companies may (but do not have to) have an objects clause that limits powers or objects; but if they do, corporate activities are not invalid merely because the activity breaches that clause.

David does not have to specify an objects clause for Racing Parts. Suggest that students read Racing Parts Pty Ltd's constitution for a very general and broad objects clause.

Learning objective 3.5: Explain who is bound by the company constitution.

David wants to be CEO for life. Would you put this in the constitution?

Students should discuss what would happen if there is a breach of contract between David and the company whereby the company removes David as the CEO. Could David take action? The question is whether the breach affects any of the statutory contracts created by the company constitution under s 140 of the Corporations Act. Students should briefly describe each of the three statutory contracts:

1. between the company and each member
2. between the company and each director and company secretary
3. between a member and each other member.

As David is both a director and shareholder, does s 140 apply? If David is a member, then perhaps s 140(1)(a) would apply. However, the courts consider whether the breach (i.e. removal of David as CEO) affects his rights as a shareholder. Does it? He has lost his job, but he would presumably still have his rights as a shareholder. Similarly does losing his job as CEO affect his rights as a director? Students should discuss what they think are the rights of a shareholder and a director and consider whether losing a job as CEO for life impacts on those rights. Students should also look at *Eley v Positive Government Security Life Assurance*.

Students should identify David's employment contract as a way he could enforce his rights.

Learning objective 3.6: Explain how a company's rules can be changed.*Changing the rules.*

This activity should prompt students to discuss what are valid reasons for changing a company constitution. They should discuss the concepts of proper purpose and fairness, and relate these requirements to how they might restrict David's ability to change the company constitution.

Students should discuss why a company may want or need to change its rules. In relation to Racing Parts Pty Ltd, they should refer to David's goals for the company and his future plans (particularly in relation to adding other shareholders and directors in future, along with this plans to diversify into other areas of business).

Students should identify that the process to change a company's rules is described in s 135(2) of the Corporations Act for a company using the replaceable rules and in the company constitution itself for a company that has adopted a constitution.

Students should discuss how David could ensure he has the power to make changes to the constitution (e.g. holding sufficient voting rights).