Instructor manual

to accompany

Company law: an interactive approach

2nd edition

by

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Retrofit case study

How to teach with this case

Students are expected to treat the case study as a real-world business scenario, and Julian Harris and his Retrofit 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 themself with the client as the case study develops.

The first appearance of the Retrofit case in each chapter presents relevant background information, events that have occurred since the previous chapter, and an overview of the issues that will be raised in the current chapter. The list of issues at the end of the first case box in the chapter includes the key considerations/questions to be analysed in order to advise Julian. By working through the chapter and, in particular the Retrofit Activities and Insights that appear in most of the learning objective sections of the chapter, 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.

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Chapter 2: Companies and incorporation

Students should watch part 2 of the case study and/or read the case study in the printed text. At this stage, students will also benefit from reviewing part 1 of the case study, along with the analysis and decisions made in chapter 1, which together provide additional details on issues relevant to the decisions to be made in this chapter.

Issues

- What type of company should Retrofit be?
- What are the consequences for Julian and Retrofit arising from the choice of company type?
- What is actually involved in creating the company?
- What are the consequences of being a shareholder and director?
- Should Julian be the shareholder?
- What are the legal implications of the separate legal entity principle for Julian and the company?
- What is Julian's liability for the company?

At this stage, before studying the chapter, 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:

- There are different types of companies. Julian wants control and asset protection. He does not think the business will need to seek funds from the general public in the short or medium term. Julian wants to minimise the costs involved in meeting regulatory requirements. Julian is also thinking about succession. These considerations point to a proprietary company.
- The choice of company type will have consequences for the client and the business because different types of companies have different characteristics. By incorporating Retrofit, Julian and Retrofit Pty Ltd will be legally separate entities. They will not share obligations, responsibilities, debts or property. By structuring Retrofit as a proprietary company, regulatory oversight is minimised, but the company is limited in its options to seek funds.
- Creating a company requires a specific, formal process: choosing a company structure, choosing a company name, deciding how to operate the company, understanding the legal obligations, obtaining consent from officers, members and occupiers, formally registering the company with ASIC and meeting legal obligations regarding company name, ACN and ABN. The company comes into existence as a separate legal entity when it is registered by ASIC under the Corporations Act.
- The owners of a company have particular rights and responsibilities. The managers of a company have particular rights and responsibilities. A shareholder in a limited liability company has liability only up to the value of their investment (their shares). Julian's liability as the sole shareholder is the $1000 he invested to buy 1000 shares. He has already paid this amount. If he instead only partly paid the shares, the company can call on him to pay the amount owing, but his total liability remains $1000. Directors are responsible for the management of the company. They have considerable power to make virtually all decisions about the running of the company, but must comply with various legal obligations (directors' duties). Failure to comply with the directors' duties can expose them to personal liability to compensate the company. .
- There are advantages and disadvantages of combining/separating ownership and management. The answer to this question depends mainly on income management and tax issues. Shareholders do not, as shareholders, manage the company operations.

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- A company is a separate legal entity from its owners. They will not share obligations, responsibilities, debts or property. Neither can be held responsible for the actions or debts of the others, with a number of exceptions.
- Owners and managers have various degrees of liability for a company's actions. Provided Julian complies with his directors' duties under the Corporations Act, he is not, as director, liable for the company's debts. As a shareholder, Julian's liability is limited to his total investment in the company (i.e. for fully paid shares, the amount he paid for his shares; for partly paid shares, the amount he paid plus any amount outstanding).

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Learning objective 2.2: Describe the various classes of companies that can be registered.

Consider the suitability of a single director/shareholder structure for Julian's business.

Students need to consider the broad suitability of a single director/shareholder proprietary company structure. They should consider/query the issues raised in this section of the chapter in relation to Retrofit's current needs:

- A proprietary company can have no more than 50 members and has limits on its fundraising activities (s 113) — Retrofit is a small business that does not intend to pursue public fundraising in the foreseeable future. Students may query the client about their long-term plans as well. What sort of fundraising might be necessary in the future?
- A proprietary company has a lower regulatory burden than a public company — Retrofit has previously operated as a sole trader with few record-keeping and reporting obligations. It is likely the relatively simple regulatory requirements for a proprietary company would be appealing to the client. Students may query whether Julian's mother, Bev, will be playing a role in meeting record-keeping/reporting requirements. They may also suggest their own firm provide these services.
- A proprietary company can have limited or unlimited liability (s 112) — students should consider the issue of asset protection, specifically in relation to Julian's assets (and those of his family), including making an assessment of the possible current and future business risks facing Retrofit.
- A proprietary company can have a single director/shareholder (ss 114 and 201A) — in reviewing the case to identify Julian's key preferences in relation to the company, they should find that one of his primary concerns is being able to maintain CONTROL of the company. He has operated Retrofit as a sole trader and views Retrofit as his business. He wants to continue to be able to make ALL the decisions about the company.

Students should consider what they learned in chapter 1 and previous studies. For example, is a single director/single shareholder structure the best tax arrangement for Julian and his family? Students should consider the difference between marginal and average tax rates and the taxation treatment of different types of income. They could use the information provided about Julian's and Samantha's incomes to run tax scenarios comparing various options, recognising that the company will pay salary, and possibly distribute dividends and achieve capital gains.

Students should also consider whether this choice of company will affect succession planning for the business.

Students should appreciate that the appropriate advice is for the current circumstances, and that over time the client's needs may, and probably will, change.

Explain the main characteristics of a small proprietary company.

Students need to apply the tests in s 45A of the Corporations Act to demonstrate why Retrofit Pty Ltd would be a SMALL proprietary company.

What type of company would you recommend?

Students should now have an understanding of the key features of different types of company. The Activity box provides guidance as to the various issues students should examine, but they should also consider whether there are additional issues that may factor into the decision of the appropriate company type for Julian/Retrofit.

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- Asset protection — as a sole trader, Julian currently owns all of Retrofit's assets; he has a half share of a stock portfolio; Samantha owns their house. Students should ask what other assets Julian and Samantha own? A limited liability company structure is appropriate.
- Limited liability — related to asset protection; students should think about which company structures will deliver limited liability; students may give some preliminary thought to the appropriate share capital.
- Raising funds — students should give thought to how the company will raise funds in the short term and longer term; Julian has mentioned he would like to expand and diversify in future. Students may conclude a public company provides most ability to raise funds.
- Tax management — drawing on their prior learning, students should examine the tax consequences of the various company structures, as well as how Julian and Samantha can best arrange their tax affairs.
- Cost management — students should look at the establishment and ongoing regulatory and reporting costs associated with the various company options. Julian has been operating as a sole trader and, while he has the assistant of his mother, a retired accountant, would prefer to keep compliance costs low.
- Flexibility — students should assess how much flexibility each company structure provides in terms of Julian's current needs and future ambitions.
- Control — above virtually all else, Julian wants to maintain complete control over decisions about the business.
- Succession planning — students should query Julian about his preferences for the long-term future of the company; for example, for his daughter to take over, to sell the company or to wind up the company.

Students should realise that choosing a company structure for Retrofit involves trade-offs. No single company type is 'best' at delivering on each of Julian's issues/preferences/needs. In addition, students should acknowledge that the current best structure may not remain the best structure into the future.

Students may conclude a small proprietary company limited by shares with a single director/single shareholder is the most suitable structure. The case is written around this being the type of company Retrofit will be when first incorporated. Students should, however, acknowledge the pros and cons of this decision. For example, Julian's preference for control may result in less flexible fund-raising opportunities; his desire to protect his assets and limit his liability for the company's debts subject the company to a higher level of regulatory oversight than he has been used to.

Company conversion?

Students should draw on their response in the previous section to examine issues that might tip the balance between small proprietary company, large proprietary company and public company status. For example:

- The business may grow to the point that it no longer satisfies at least two of the three tests to be a small proprietary company. At that point it would be a large proprietary company. Students should note the consequences (e.g. increased regulatory burden).
- The business may need to raise funds to expand or pursue further opportunities in future, requiring public fundraising, thus requiring the company to become a public company. What would be the consequences for Julian in terms of his preferences (e.g. in terms of control)?
- Julian may wish to unlock the value in the business by floating it rather than selling it. Again, what would be the consequences for Julian in terms of his preferences for the business?

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Students might also make a preliminary assessment of the likelihood Retrofit will need to change structure in the future. Would that affect the choice of structure, or other aspects of the business, now? Note, there are limits on the types of conversions that can take place — see the table in s 162 and note also the process to be followed in ss 163 and 164 involving a special resolution by the company's members.

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Learning objective 2.3: Outline the steps involved in starting a company.

Company name?

The response to this question involves applying the legal requirements for elements of company names. Students should conclude that Julian cannot use the exact name 'Retrofit' for the company name as a limited company requires 'Limited' or 'Ltd' after the name and a proprietary company requires 'Proprietary' or 'Pty' after the name (ss 148–149). Students may conclude 'Retrofit Pty Ltd' is the appropriate name for the company. In doing so (or not), they should consider the reasons Julian might want to or not want to keep 'Retrofit' as part of the business name. What are the pros and cons? Could anything prevent this choice of name (e.g. a different company already exists with that name)?

Note the *Business Names Registration Act 2010* covers the legal obligation to register business names and the availability of business and company names. See chapter 1.

How would you create the company?

During this activity, students should read s 117 and complete ASIC's Form 201 'Application for registration as an Australian company' to register Retrofit Pty Ltd for Julian Harris. First, students should run through the first five steps of the company registration process to ensure they are in a position to apply to register the company with ASIC. See figure 2.3.

Students should also have answered the specific questions posed in the activity:

- When should the company commence its activities? Why? (The timing of when the company commences operations depends on the financial circumstances of the business. See LO4.4.)Students could prepare a spreadsheet showing the impact of starting now or later. Students should also consider reporting considerations, tax matters, existing arrangements with suppliers and clients, other steps required to prepare the company to start undertaking business.
- Who will be the shareholder(s)? Why? (E.g. consider liability, tax matters.)
- What bank accounts will the company need? (The company is a separate legal entity so must have its own bank accounts. Julian should be advised that the company's bank accounts are not his bank accounts.) Students should consider how a company opens its own bank accounts.
- Students should consider if/how the assets and liabilities of the sole trader should be transferred to the company. What assets should be owned by the company or by Julian (e.g. the van). (If assets are to be owned by the company, students could explore the appropriate accounting treatment for the transaction to transfer ownership.) Can the company pay for the running of Samantha's car? What are the consequences?

The case materials do not provide the information to complete every section of ASIC's form (downloadable from: http://asic.gov.au/regulatory-resources/forms/forms-folder/201-application-for-registration-as-an-australian-company/), so students should draw on their prior learning, ask questions of the client, and in some cases may need help from their instructor, particularly in relation to the share structure of the company (Julian will take 1000 shares at $1 each).

Learning objective 2.5: Describe the main features of a corporate group as relates to the concept of separate legal entity.

The creation of other companies?

Students should explore some of the reasons different business activities could be best conducted in separate companies rather than all as part of Retrofit Pty Ltd. For example, they might consider different business needs, different management, different members, quarantining risks, tax management, branding and so on. They would need to learn more about Julian's ambitions, plans and priorities in order to properly consider this issue.

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Learning objective 2.6: Explain what is meant by the 'corporate veil'.

Why is this concept important?

Students should define the corporate veil and explain what it means for Julian in relation to Retrofit Pty Ltd — that the company's obligations, liabilities, rights and property are legally separate from Julian's (as shareholder) and vice versa. Students should relate this to the concept of limited liability.

Students should note that there are exceptions and think about what these might be and why they might exist.

Finally, to address the activity, students should explain that as professional adviser, they need to fully understand the corporate veil so they can explain it to Julian, and so that they understand who their client is — are they advising Julian personally or Julian on behalf of the company?

Relate the case study to Salomon's case.

This activity refers to *Salomon v Salomon & Co Ltd* [1987] AC 22. The student should explain similarities and differences (if any) between Aron Salomon as sole trader incorporating his company and the incorporation of Retrofit Pty Ltd. Specifically, as sole shareholder, what are Julian's liabilities should the company be unable to meet its debts? As sole director, what are Julian's liabilities should the company be unable to meet its debts?

Students should identify the matter of Mr Broaderip's secured loan and Aron Salomon's secured loan and discuss this in relation to Julian and Retrofit. Students should consider any consequences for how the company raises funds (e.g. in terms of debt versus equity and in terms of whether any funds loaned by Julian should be secured).

Students should identify that external parties dealing with companies need to assess whether the company has the resources to service any agreements entered.

Is the corporate veil fair?

Students should examine the doctrine of separate legal entity, but also explore circumstances in which it could be seen as 'fair' (drawing on the separate legal entity concept) and 'unfair' (where innocent outsiders unfairly bear the risk of a company's failure) that the directors and owners of a company can quarantine their personal assets from the company's liabilities.

Can Julian still be personally liable?

Students should identify the three broad ways the corporate veil may be lifted and acknowledge those that could apply to Julian and Retrofit Pty Ltd:

- under the Corporations Act, in those circumstances in which directors may be held personally liable for the company's debts (insolvent trading, employee entitlements, a security interest granted to an officer prior to insolvency, uncommercial transactions) — these could all theoretically apply to Julian and Retrofit Pty Ltd
- under other legislation (failing to report PAYG withholding tax under the Taxation Administration Act) — this could apply to Julian and Retrofit Pty Ltd
- under common law (fraudulent motives behind establishing a company, establishing a company to avoid an existing obligation, in certain agency relationships, in certain corporate group

relationships) — the student would need to query their client to make a decision about whether the common law exceptions might apply to Julian and Retrofit Pty Ltd.

Students should explain the rationale for these avenues of lifting the corporate veil and perhaps assess the ‘fairness’.

Students should also consider how they would explain to Julian how he can avoid becoming subject to one of the exceptions.

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Learning objective 2.7: Describe how the principle of limited liability applies to the members of a company.

Share capital requirements?

Students need to consider the question from both Julian's perspective as a shareholder and the company's perspective:

- Julian is the sole shareholder — why would he pay any substantial sum for shares given he will own 100% of the issued shares? (To provide funds to the company.)
- Who makes the decision that the company should issue more shares? Does this affect existing shareholders?
- What happens to the money the shareholder pays the company for shares when issued? (The company has it to use for business and investment purposes.) How might this affect the number of shares and/or the price of shares being issued? (The company will aim to raise sufficient funds for its needs.)
- How does the company determine the price of shares being issued? How might this differ between a proprietary company and a public company? How might this differ between a new company just starting in business and new shares issued in an established company? (Look briefly at publicly traded shares and applications for shares in a new issue.)
- What is the relevance of the share capital to creditors? Why would creditors be interested in the number of fully paid versus partly paid shares? (Look at sources of funds to meet company debts should the company fail.)
- How can a company raise more money? What are the consequences for Julian of issuing more shares (that he buys and/or that others buy)? (Look at issues outside of company law such as of capital gains and dividends.)

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APPLIED PROBLEMS

2.8 Nils and Caoimhe are the sole directors and shareholders of a small proprietary company called Flint Pty Ltd, and have approached their bank for a loan of $100 000 in the name of the company. In addition to the security for the loan that the company has already provided to the bank, the bank manager requests that Nils and Caoimhe sign personal guarantees in their individual names for the company's debts, including the $100 000 loan amount plus any outstanding interest.

(a) Do Nils and Caoimhe need to sign the guarantee documents?
(b) If they decide to sign the guarantee documents, explain the effect on the concept of limited liability.
(c) If they decide to sign the guarantee documents, is this an example of 'lifting the corporate veil'?

Answer:

Shareholders of a company limited by shares have limited liability. The creditors cannot have access to the personal property and assets of the shareholder unless the shareholder has provided a personal guarantee or the courts 'look through the corporate veil'. The ability of large creditors to secure corporate debts through personal guarantees provided by the company's shareholders or directors is a matter that is often overlooked in discussions around limited liability. Effectively, a company's shareholders and directors can voluntarily give up the benefits of limited liability by offering to sign personal guarantees in favour of creditors. A **personal guarantee** is a promise made by one party to cover the debts of another party. Enforcing personal guarantees provided to the company's creditors by its shareholders or directors is a matter of contract law and is generally not regulated under the Corporations Act.

(a) Directors and shareholders are not legal obliged to sign personal guarantees. It is a matter that is negotiated by the creditor (in this case, the bank) and the company's participants.
(b) Effectively, a personal guarantee is a voluntary agreement by directors and shareholders of the company to give up the benefits of limited liability for the company's debts.
(c) This is not conceptually speaking the same as lifting the corporate veil, which refers to the courts providing a policy reason to ignore the corporate veil and limited liability. Lift the corporate veil occurs as company participants need to become responsible for some wrongdoing, such as using the company structure for fraud or to avoid legal obligations.

[LO 2.7]

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2.9 For the past several years, Rawiri has been working on a new design for the manufacture of surfboards. While Rawiri believes that the sale of his inventive surfboard will make a lot of money, considerable additional research and development is needed to perfect the design. Indeed, the first few prototype surfboards that were manufactured snapped and one had fins that were too sharp and injured the person using it. Rawiri believes that if the design is successful, many thousands of people will want to invest in his company.

(a) Advise Rawiri about the most suitable type of company for his surfboard design project.

Answer:

The purpose of this question is to have students discuss various potential company types for the entity and the pros and cons of each.

Companies are distinguished by being a separate legal entity. They can be classified into various types based on the liability of the members, whether they are proprietary or public, and their listing status. Categorised by liability, companies may be as follows.

- Companies limited by shares — such a company is formed on the basis that the liability of members is limited to any unpaid amount on the shares they hold.
- Companies limited by guarantee — a company limited by guarantee involves the members of the company undertaking to contribute specific amounts to the company in the event the company is wound up. This structure is often used for clubs and charities.
- Unlimited companies — a company in which members are liable for all debts of the company if it is wound up. In this way, the liability of members is similar to that of partners in a partnership. While not providing access to limited liability, the unlimited company form can still offer the other advantages of the company structure.
- No liability (NL) companies — these companies only operate for mining purposes (s 112(3) of the Corporations Act). They are distinguished from companies limited by shares in that the company can not force shareholders to pay outstanding amounts of unpaid or partly paid shares (the shareholder will simply forfeit the shares).

Companies may be proprietary or public.

- Proprietary companies — these are not public companies. They are limited to 50 members and have limits on their fundraising activities.
- Public companies — any company that is not a proprietary company is a public company.

Public companies may be listed or unlisted:

- Listed companies — a listed company is a public company that has listed its securities for trading on a public securities exchange such as the Australian Securities Exchange (ASX).
- Unlisted companies — these are public companies that have not listed on a securities exchange.

The ideal structure would be a proprietary company because:

- Limited Liability: The structure (like all companies) provides limited liability for the members.
- One person: Rawri can be the sole director and sole shareholder.
- No loss of control.
- Maintain confidentiality.
- Can convert to a public company if investors are needed at a later point.
- Administrative costs are low.
- Relatively easy and inexpensive to create.

[LO 1.6, 2.2]

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2.10 What type of company would be best suited for the following organisations?

(a) a charity raising funds for cancer research
(b) a major domestic soccer federation
(c) three friends who wish to start a fashion business
(d) a group of 75 people who have agreed to pool money and invest in the stock market
(e) a mining company that wants to invest in a speculative gold mining venture with its own funds and funds raised from the public
(f) a start-up telecommunications company that needs $1 billion for its infrastructure and intends to raise the funds from the public.

Answer:

This chapter focuses on companies registered under the Corporations Act 2001 (Cth). Recall that chapter 1 also looked at other types of incorporated business entities.
Companies are distinguished by being a separate legal entity. They can be classified into various types based on the liability of the members, whether they are proprietary or public, and their listing status. Categorised by liability, companies may be as follows.

- Companies limited by shares — such a company is formed on the basis that the liability of members is limited to any unpaid amount on the shares they hold.
- Companies limited by guarantee — a company limited by guarantee involves the members of the company undertaking to contribute specific amounts to the company in the event the company is wound up. This structure is often used for clubs and charities.
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Public companies may be listed or unlisted:

- Listed companies — a listed company is a public company that has listed its securities for trading on a public securities exchange such as the Australian Securities Exchange (ASX).
- Unlisted companies — these are public companies that have not listed on a securities exchange.

(a) Company limited by guarantee. This is what these types of companies are designed for.
(b) This could be any type of company depending on the nature of the organisation. If it were not for profit, it could be a company limited by guarantee. If for profit, it could be a proprietary company or a public company depending on factors such as the number of investors.
(c) A small proprietary company. A proprietary company as one in which there are no more than 50 members and no fund raising activity is undertaken that would require a disclosure document under the Corporations Act. For financial years commencing on or after 1 July 2019, the tests are:

- The consolidated revenue for the financial year of the company and any entities it controls is $50 million or more.
- The value of the consolidated gross assets at the end of the financial year of the company and any entities it controls is $25 million or more.
- The company and any entities it controls have 100 or more employees at the end of the financial year.

(d) If the individuals each wanted to be shareholders, it would need to be a public company limited by shares as a proprietary company can only have a maximum of 50 non-employee shareholders.
(e) It could be a public company limited by shares or a proprietary company, but looking at the characteristics set out in the questions it could also be a No Liability company. Indeed, no liability companies were designed for mining businesses with all the characteristics mentioned in the question. If fund raising from the public that required a disclosure document under Ch 6D was proposed a proprietary company would not be permissible.
(f) This would be a public company limited by shares and in all likelihood would be listed on a stock exchange such as the ASX.

[LO 2.2]

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2.11 CCS Pty Ltd is registered with Mira and Aaron as its directors. CCS Pty Ltd has issued five shares, with the following persons owning one each: Mira, Aaron, Ryan (Mira's son), Janice (Aaron's daughter) and Marilyn (Aaron's friend). CS Pty Ltd operates a business that manufactures and sells widgets.

For each of the following developments, explain whether the shareholders and/or directors would be personally liable to the landlord, NAB Bank, Janice or Acme Computers Pty Ltd.

(a) CCS Pty Ltd enters into a lease for new premises where the business is to be headquartered.
(b) CCS Pty Ltd borrows $100 000 from NAB Bank on an unsecured basis. Mira personally guarantees the repayment of the loan.
(c) CCS Pty Ltd purchases a block of land from Janice for $500 000 to build a new warehouse. CCS Pty Ltd grants Janice a mortgage over the land equal to the $500 000 purchase price.
(d) CCS Pty Ltd purchases several computers from Acme Computers Pty Ltd. One third of the purchase price is paid on delivery and the balance is payable in equal monthly instalments.

Answer:

(a) As a separate legal entity, the company enters into contracts in its own name. The company would be solely liable for the lease obligation as the company is a separate legal entity and was a party to the lease contract. The so-called "corporate veil" would protect the directors and members from personal liability.

(b) While the company would be primarily liable on the loan, Mira would also be liable as they have personally guaranteed the obligation. Mira has voluntarily assumed liability by entering into the guarantee agreement with the bank.

(c) As a separate legal entity, the company enters into contracts in its own name, including mortgaging its property. Janice as secured creditor with a registered security interest would have rights to enforce the contract directly against the company, including the right to foreclose pursuant to the mortgage over the land and sell the land to recover any amounts she is owed.

(d) As a separate legal entity, the company enters into contracts in its own name, including acquiring property in its own name. Assuming that ACME has no registered security interest in the computers, they belong to the company and ACME has rights in contract. ACME is s an unsecured creditor and would have to look to the company to get paid.

[LOs 2.2, 2.4 & 2.6]

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