Law Council
OF AUSTRALIA

Dr Kathleen Dermody
Committee Secretary
Parliamentary Joint Committee on Corporations
and Financial Services
Senate
Parliament House
CANBERRA ACT 2600

By facsimile: 6277 5719

By email

Dear Dr Dermody

Issues raised by the Boral constitutional amendments

During the Parliamentary Joint Committee hearing on the CLERP 9 Bill on 16 March 2004, Senator Conroy raised the issue of the relationship between the capacity to entrench clauses in a company's constitution provided by section 136 of the *Corporations Act* in the context of section 249N(1) of the *Corporations Act*. His comments were specifically directed to the adoption in 2003 of an entrenchment provision by the general meeting of Boral Ltd (**Boral**). Senator Conroy invited the Corporations Committee of the Business Law Section of the Law Council of Australia ("the **Corporations Committee**") to provide some commentary in relation to this issue.

Summary of Corporations Committee position

Common uses of entrenchment provisions

Entrenchment provisions of constitutions offer protections to investors in some circumstances without which it may be harder to aggregate "start up" capital or facilitate initial public offerings.

- A capacity to entrench particular provisions of a constitution is vital to the structuring of many incorporated joint ventures, a common and important mechanism in attracting capital for research and "start up" projects and in allowing incorporated "partnerships".
- While companies employing entrenchment provisions are most commonly found in the non-listed company arena, entrenchment provisions have also been employed by some listed companies. Examples include TAB Limited and Qantas Limited – in each case to support limitations on shareholding prescribed by government. Without the capacity to entrench ownership restrictions, governments may have been less willing to permit these companies to float.

Special meetings – amend section 249D(1)(b)

The Corporations Committee supports amendment to the Corporations Act to ensure that, for companies with a share capital, shareholders representing at least 5% of the voting capital should be empowered to requisition a special general meeting of the company. The "100 shareholder" limb of section 249D(1)(b) should be deleted.

The Corporations Committee regards this as establishing a proper balance between the need for efficiency of companies as economic entities and the principles of shareholder democracy.

Agenda items for annual general meetings – amend s249N to require "100 shareholder" rule to mean 100 shareholders with marketable parcels

The Corporations Committee supports the CASAC (now CAMAC) position that, in the context of a company with a share capital, shareholders representing at least 5% of the voting capital or at least 100 shareholders with a meaningful economic holding (usually a marketable parcel), should be able to request an item to be included on the agenda for an annual general meeting.

The Corporations Committee counsels caution

While the Corporations Committee supports an amendment to section 249N as suggested by CASAC, we direct your attention to the following:

- The Corporations Committee would have no objection to an amendment to section 249N, in the context of *listed public companies only*, to provide that shareholders representing at least 5% of the share capital or at least 100 shareholders (each with at least a marketable parcel) can require an item to be placed on the agenda of annual general meeting, *notwithstanding any further requirement in the company's constitution for the purpose of subsection 136(3)*. This would deal with the narrow issue raised by the Boral amendment referred to below, and could be effected without changing the words of section 136, which we think is desirable.
- The Corporations Committee would not support an amendment to section 136 to prohibit a requirement for a greater majority, or the consent of a particular person, or the fulfilment of a particular condition, before particular amendments to a constitution could be effective.

Background

What is the effect of the 2003 change to the Boral?

Resolution 3 of Boral's Notice of Meeting 2003 proposed an amendment to the company's Constitution (**the Boral amendment**), to insert requirements for altering the constitution (see Attachment A for the general format of the resolution). In essence, it proposed that any special resolution to modify or repeal the Constitution must, prior to notice of the relevant general meeting, either be approved by Board resolution or be included in a resolution proposed by members holding at least 5% of voting shares in the company.

Resolution 3 was passed by Boral shareholders. This arguably effectively entrenched all of the provisions of the constitution, unless the directors, or members holding 5% of the company's voting shares, are in favour of putting a special resolution to a general meeting vote.

What is entrenchment and when is it permitted – section 136 of the *Corporations Act*

To what extent does the law permit this kind of entrenchment of provisions in the corporation's Constitution? It may be helpful to set out the historical context of section 136:

- Traditionally, there was a sharp distinction between a company's Memorandum and Articles (as they were known before 1998). Early case law suggested that it was not possible to make it more difficult to alter the Articles by inserting an entrenching provision into the Articles (*Punt* v. *Symons & Co. Ltd* [1903] 2 Ch. 506; *Russell v Northern Bank Development Corporation Ltd* [1992] 1WLR 588). It was, however, possible to entrench the Articles by inserting the entrenching provision into the company's Memorandum. The legislation gave as examples of the types of entrenchment conditions that might be used: a requirement for a higher majority, the approval of a particular person, or the fulfilment of a particular condition (*Corporations Law*, section 176(3)).
- Following the introduction of the Replaceable Rules regime in the *Company Law Review Act* 1998, the Memorandum and Articles were replaced by a single constitutional document, which may include the replaceable rules in the *Corporations Act* (section 135).
- A corporation's constitution may be modified or repealed, according to section 136(2) of the *Corporations Act*, by special resolution. The *Corporations Act* also itself, however, recognises that there may be limits placed on a company's power to alter its Constitution. The Boral Amendment explicitly relies on section 136(3), which permits a company's constitution to provide that "a further requirement" must be satisfied before the special resolution is effective.
- Section 136(3) therefore itself envisages the possibility of effective entrenchment of some constitutional provisions. Unlike the predecessor legislation, the *Corporations Act* gives no examples of the types of further requirements that are contemplated by the section. However, typical "further requirements" in this context would be those referred to in the predecessor legislation, such as a supermajority voting requirement (ie requiring more than the 75% majority vote normally required for a special resolution), or that a particular person must approve the amendment to the constitution.

The benefits of entrenchment clauses

Entrenchment clauses have a long history in corporate law, and have on many occasions been upheld by the courts, even where they conflict with a mandatory provision of corporate legislation (*Bushell v Faith* [1970] AC 1099). Entrenchment clauses generally can be vitally important, particularly in closely held corporations and incorporated joint ventures, where they can be used as a self-governance technique to protect the parties involved from oppression. Without the availability of these protections, investors would often not be willing to commit capital to "start up" ventures. They are also often used as a regulatory tool by governments in the context of privatizations.

Thus, in many cases, entrenchment clauses are an important and legitimate aspect of corporate law and a reflection of shareholder democracy. Any legislative attempt to interfere with or prohibit them could have undesirable and unintended consequences.

The Corporations Committee therefore would oppose any proposal to amend section 136 to restrict the capacity for companies to include entrenchment provisions in their constitution.

The underlying problem

It has been suggested that one of the factors influencing listed companies to introduce an entrenchment clause of the nature of the Boral amendment is the ease with which shareholders can request the directors to call a general meeting. The practical effect of the Boral amendment is to bypass the 100 member test in favour of a 5% of voting shares test, both in circumstances where members wish to *convene* a general meeting for the purposes of modifying or repealing

the constitution as well as where they wish to *add an agenda item dealing with the constitutional amendment* to an already scheduled general.

Section 249D

Section 249D of the *Corporations Act* states that the directors of a company must *convene* a general meeting on the request of (a) members holding at least 5% of the company's voting shares; or (b) at least 100 members entitled to vote.

The numerical 100 member test under section 249D(1)(b) has been controversial since its inception. CASAC (now CAMAC) criticised the test as unsatisfactory, on the basis that it provided too low a threshold and was prone to abuse by a small number of shareholders in a listed public company, who may use the power to disrupt business and pursue a social agenda at the company's expense. CASAC recommended that the 100 member test should be jettisoned. (CASAC, *Shareholder Participation in the Modern Listed Public Company*, Final Report, July 2000, recommendation 2, p 15).

The Corporations Committee supports this view.

Section 249N

CASAC suggested that there is a distinction between placing restrictions on the ability of shareholders to *convene* a general meeting, and *limiting the ability of shareholders to propose a resolution* at general meeting that has already been validly convened. CASAC recommended retaining the ability for shareholders to have matters discussed at meetings whilst at the same time limiting the ability for a very small number of shareholders to put a company to the expense of calling a meeting.

CASAC recommended retaining the ability (in section 249N of the *Corporations Act*) for 100 shareholders (or holders of 5% of total issued shares) to place shareholder resolutions on the agenda for the next shareholder meeting. CASAC did, however qualify this, by recommending that each of the 100 shareholders should hold shares of a meaningful economic value (recommendation 5, pp 29-30).

The Corporations Committee also supports this view.

The Corporations Committee is also concerned to ensure that the common law capacity of companies not to put a proposed resolution to shareholders where it would be legally futile be retained.

Is the Boral amendment problematic?

The Boral amendment circumvents what many regard as an unsatisfactory rule (section 249D(1)(b)) but only in very limited circumstances – the amendment of the constitution. It has no effect in relation to any other resolutions that might be proposed by members. However, in doing so, it also restricts the ability of shareholders to propose amendments to the constitution at forthcoming scheduled meetings, which may be viewed as problematic, particularly for retail shareholders, who are much less likely than institutional shareholders to hold 5% of the issued shares.

The Corporations Committee does query how big a problem this is, given that a resolution to amend a constitution requires the support of at least 75% of the votes cast at a meeting, and if it is not possible to get 5% of the shareholders to support the proposal it is unlikely to be passed at the meeting. However from a policy perspective, the Corporations Committee would have no objection to an amendment which distinguishes the power in section 249D from that in section 249N in the manner referred to above.

If you require any further information, please contact John Keeves, Chairman of the Corporations Committee, on (08) 8239 7119.

Yours sincerely

Peter Webb
Secretary General
26 May 2004

Attachment A

(a) A special resolution to modify or repeal the Constitution of the Company, or a provision of the Constitution of the Company does not have any effect unless the requirement set out in Article [x](b) has been complied with.

(b) A special resolution to modify or repeal the Constitution of the Company, or a provision of the Constitution of the Company must, prior to notice of the meeting of Members at which the special resolution is to be considered, being given to Members, either:

(i) have been approved by a resolution of the Board; or

(ii) have been proposed by Members with at least 5% of the votes that may be cast on the resolution.