COMPANIES AND SECURITIES LAW REVIEW COMMITTEE

REPORT TO THE MINISTERIAL COUNCIL

ON

FORMS OF LEGAL ORGANISATION

FOR SMALL BUSINESS ENTERPRISES

September, 1985.

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The Corporate Form Reference

[1] The Committee was given a general reference from the Ministerial Council to inquire into and review the question of the use of the corporate form. As part of that reference the Committee was directed to have regard to the following matters:

(i) Issues relating to proprietary companies including:

(a) whether the existing classification of proprietary companies is appropriate and, if so, whether there should be any criteria for the incorporation of proprietary companies in Australia;

(b) the suitability of the provisions of the Companies Act 1981 in relation to the regulation of proprietary companies;

(c) the obligations of proprietary companies to make public disclosure, particularly in the light of their limited liability; and

(d) the desirability of abolishing the distinction between exempt and non-exempt proprietary companies.

(ii) The desirability and extent of a requirement for a minimum paid up capital or authorised minimum capital.

(iii) The various forms of company organisation and incorporation of businesses that should be made available to intending entrepreneurs and the categorisation of users of corporate forms.

(iv) Any related matters.

[2] The Committee decided at its inaugural meeting in February 1984 to consider first under this term of reference the various forms of organisation that should be available to intending entrepreneurs with particular reference to the structure of small business.

[3] An enquiry of this nature would also encompass many of the matters in the above-mentioned term of reference.

[4] A Discussion Paper was prepared and issued in August 1984. Some 1,000 copies were circulated and submissions were called for by November 1984. A list of respondents is found in Appendix I.

[5] The Committee now sets forth its views and recommendations in this report.

SECTION I

Overview of the Report

[6] The Committee takes the view that with the increasing complexity of company law, the collection of statutory rules and requirements with which entrepreneurs have to contend is considerable and growing. The Committee believes that it is appropriate to reconsider these requirements in the context of owner-operated and similar enterprises, with a view to streamlining and where appropriate simplifying the legislative and administrative provisions. The Committee's objective is 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. It is the intention of the Committee to achieve this end without sacrificing the interests and security of creditors.

[7] In this Report the Committee recommends that a new form of corporate entity, to be known as a close corporation, be established by separate legislation. This entity would be designed primarily for owner-operated and other forms of small business. The close corporation would be a full juristic person offering to its members all the advantages of separate legal personality including:

* perpetual succession and consequent ability to:

** purchase, hold, convey or otherwise deal with property in its own name;

** employ members, and thereby provide them with certain benefits, including superannuation entitlements; and

** continue in existence, subject to liquidation, irrespective of changes in its members;

* the right to sue and be sued in the corporate name;

* the ability to create floating charges.

[8] The emphasis throughout the Report is on simplifying the legal obligations involved in the establishment and operation of a close corporation, and this is reflected in such measures as:

* elimination of the formal director-shareholder distinction;

* regulation of the corporation's internal affairs by rules appropriate to a partnership rather than those traditionally associated with a company; and

* a minimum of reporting requirements, with civil rather than criminal consequences for non-compliance.

[9] The Report recommends adoption of the principle of limited liability for close corporations, though the interests of creditors and the general public would be protected by the imposition of unlimited personal liability on members of an insolvent close corporation in certain instances.

[10] The Committee further recommends that in the event of introduction of close corporation legislation, the category of exempt proprietary company be dispensed with for future incorporations.

[11] The Committee believes it is premature in this Report to set forward any final recommendations on the liquidation aspects of the new entity, as this forms part of the current Australian Law Reform Commission reference into insolvency law and practice. Rather the Committee prefers at this stage to adopt the relevant Companies Code provisions and set out its observations on a number of issues that impinge on insolvency, recognising that they may be in need of further modification, depending upon the outcome of the ALRC inquiry. The Committee will continue to consult with the ALRC in this area of law reform.

Work Arising from the Report

[12] In this Report, the Committee has sought to identify the general parameters of possible legislation for the formation and administration of close corporations. The Committee recognises the need for further detailed work to prepare this legislation, and requests the Ministerial Council to provide resources for the drafting of a Model Bill based on the Committee's recommendations.

SECTION II

Legislative Framework

[13] The Committee envisages that legislation regulating close corporations would fall within the ambit of the current legislative framework for companies and securities industry law. However within that context the Committee favours enactment of a separate Close Corporation Act (and Codes), rather than proceeding by way of amendment and supplementation to the Companies Act and Codes, for the following reasons:

* The abbreviated size and self-contained nature of a Close Corporation Act would enhance its utility for incorporators and their advisers. By contrast, proceeding under the Companies Act and Codes may require many possibly complex amendments in order to achieve a satisfactory statutory framework.

* A separate Act would emphasise that close corporations operate in ways distinct from companies regulated under the Companies Act and Codes.

[14] Recommendation 1

The Committee recommends that close corporations be regulated by way of separate legislation established pursuant to the procedures and practices created by the Formal Agreement of December 1978.

Administrative Framework

[15] Administration of close corporations would also fall within the scope of the Formal Agreement under which the Ministerial Council, the National Companies and Securities Commission and the various State and Territorial Corporate Affairs Authorities operate. It is envisaged that these bodies would regulate and administer the Close Corporation legislation.

[16] The proposals contained in this Report are intended to minimise external regulation and avoid imposing on Commissions any administrative duties which are not meaningful or which are not regarded as essential, taking into consideration the characteristics of this form of enterprise. There will be a minimum of prescribed forms, such as:

* the founding statement
* amendments to the founding statement
* application for conversion from a company to a close corporation
* charges forms
* winding up forms

[17] Recommendation 2

The Committee recommends that the Close Corporation legislation be administered by the Ministerial Council, the NCSC and the various State and Territorial Corporate Affairs Authorities, pursuant to the administrative arrangements under the Formal Agreement of December, 1978.

Name of the Organisation

[18] The Committee considered a number of possible descriptions and favours the term "Close Corporation" with the abbreviation CC. This term has a number of benefits:

* It is a widely accepted and well-known concept at the international level, in respect of the types of entities dealt with in the Report. There is some advantage in maintaining this uniformity of nomenclature.

* The term indicates the close or intimate nature of the legal relationship which may exist between the members in such corporations.

* It is sufficiently removed from other terms currently used in Australia and so avoids any possibility of confusion. This problem arises with terms originally suggested in the Discussion Paper, such as limited partnership companies or incorporated partnerships, which could too easily be confused with (unincorporated) limited partnerships, (unincorporated) unlimited partnerships, or companies incorporated under the Companies Code.

* It has a short and simple abbreviation - CC.

This term will be used henceforth throughout the Report.

[19] Recommendation 3

The Committee recommends adoption of the term "Close Corporation" with the CC abbreviation.

Eligibility for the New Form of Incorporation

[20] A number of important threshold requirements must be considered in determining the availability of this new form of incorporation.

Maximum Membership

[21] The Committee's Discussion Paper suggested that a close corporation have a maximum membership of 20 persons. This figure was arrived at by reference to the rule that, in general, a partnership could have no more than 20 members unless incorporated.

[22] The majority of submissions favoured a reduction of this maximum. An allowance of 20 members was considered too large, as it could include businesses of a very substantial economic size. A high maximum could also undermine the principle that, subject to any agreement to the contrary, all members may take part in the management of the corporation. This principle would be encouraged with a lower maximum.

[23] The Committee recognises the force in these representations and accordingly favours a maximum less than the original proposed 20 members. The majority of submissions suggested a maximum of 10 members and this seems an appropriate figure. Members would include both those referred to in the founding statement and other persons acting as members (see further para [98] - [104]).

[24] A close corporation which sought to increase its membership beyond 10 members would be required to convert to a company regulated under the Companies Code (see [207] -[211]). Failure to convert in these circumstances would be grounds for winding up the close corporation.

[25] Recommendation 4

The Committee recommends that the maximum membership be set at 10 persons. In determining the membership of a close corporation joint members should be counted as separate members.
The Committee further recommends inclusion of a provision that any increase in membership of a close corporation above the maximum shall constitute grounds for winding up.

Small Business Requirement

[26] A number of submissions favoured inclusion of a definition of small business as a necessary eligibility criterion. The Committee examined the task of describing small business conceptually and concluded that it was not possible to develop a suitable and workable definition. The Committee noted that in a recent instance where a definition of small business appeared in legislation (Small Business Guarantee Act No. 80 1984 (West Australia)), its application rested on the discretion of the Minister. This would not be a suitable precedent for close corporation legislation.

[27] Accordingly the Committee does not support inclusion of a small business definition in the proposed legislation.

Financial Criterion

[28] The Committee recognises that it would be possible for a corporation with substantial assets and employing many persons to be owned by not more than 10 persons and that under the proposed criterion this business may be eligible for registration as a close corporation. The Committee considered a submission that to overcome this possible result, the legislation specify an upper limit on net assets (e.g. $500,000 or $1,000,000) as a further eligibility requirement, with the opportunity for a close corporation to convert from this status to a company regulated under the Companies Code within a certain time of reaching this upper

limit. This proposal was rejected by the Committee for a number of reasons:

* any figure is arbitrary, and would continually have to be altered in light of inflation and other economic factors;

* it would disadvantage capital intensive industries visa vis other industries;

* it would be possible to circumvent any financial ceiling by incorporating a number of close corporations for the purpose of splitting the assets of the business.

[29] The Committee therefore does not favour any financial criterion and does not recommend it.

Minimum Membership

[30] The Committee's Discussion Paper suggested that there be a minimum of two members of a close corporation, for the following reasons:

(a) the partnership basis of the proposals in the Discussion Paper;

(b) conformity with the minimum membership requirements of proprietary companies; and

(c) circumvention of the problems associated with the death of a sole member.

[31] However the Committee was aware of the large number of one person businesses and therefore invited submissions on whether it would be useful and appropriate to dispense with this minimum and allow for single member incorporation.

[32] The submissions received were strongly in favour of allowing single member incorporation. The Committee was also conscious that many small incorporated businesses are actually controlled and conducted by one person. Therefore there seems to be a need to contemplate a legislative structure which attaches corporate identity protection to sole traders. The Committee has reached the view that to deny the protection of incorporation to a sole trader may result either in an unreasonable discrimination against that individual or require, for the purpose of obtaining the benefits of close incorporation status, the forced inclusion of some other person who may have no knowledge, expertise or real interest in the business. To require a minimum of two members may perpetuate the artificiality that currently surrounds many small proprietary companies where the second shareholding is only a formality and that shareholder merely holds shares on trust for the real owner and controller.

[33] On this basis the Committee favours a minimum of one member for close corporations, despite the analogies with partnership law in the Discussion Paper and its divergence from the two member minimum for proprietary companies.

[34] Difficulties arising from the death of a sole or last surviving member could be overcome by statutory provisions whereby the executor or trustee of that member may act on behalf of a corporation until such time as a new member or members is appointed.

[35] The executor or trustee would attract personal liability if, in his capacity as a member, he acted in a manner which lead to the corporation' s insolvency and the lifting of the corporate veil (see [141] - [146]).

[36] Introduction of single member incorporation would obviate the need for any provision imposing personal liability for debts incurred during any period that membership fell below the statutory minimum (cc Companies Code s82).

[37] Recommendation 5

The Committee recommends that the minimum membership of a close corporation be one person.

Natural Persons

[38] The Committee's Discussion Paper suggested that in the interests of simplicity and further to the objective of responding to the needs of owner operated businesses, membership of close corporations should be confined to natural persons. Juristic persons, including other close corporations, would be excluded from membership, except where this was necessary by operation of the law e.g. trustee in bankruptcy. In addition, natural persons would be prohibited from holding any interest in a close corporation as nominee or trustee of a body corporate or in any trust arrangement in which a body corporate was a beneficiary. However, a member could hold his interest in a nominee or trustee arrangement involving natural persons only.

[39] The exclusion of direct and indirect corporate membership of close corporations may also be justified by concern that large companies might otherwise convert their subsidiaries into such corporations. The proposed restriction means that these corporate group formations and the complications to which they give rise, such as the introduction of provisions for consolidation of accounts, do not have to be provided for in the Close Corporation legislation.

[40] The Committee proposes that a natural person may be a member of more than one close corporation and that a close corporation may be a shareholder of a company. However, a close corporation may not be a holding company, in the sense that this term is understood under the Companies Code, see [45] - [50].

[41] Another consequence of confining membership to natural persons is that while a close corporation could enter into partnership with other bodies corporate, the resulting association could not itself be registered as a close corporation.

[42] The Committee recognises that these restrictions on membership would deny to close corporations recourse to corporate equity venture capital as a source of funds for growth and expansion. It would be possible to overcome this possible detriment by providing for the issue to corporate persons of participating non-voting shares in close corporations. However, the Committee believes that if the ideal of simplicity and simplified self regulation is to be observed, no departure should be made from the principle of confining membership to natural persons. This ideal may be in jeopardy by allowing for corporate equity capital, even on a non-voting basis.

[43] These restrictions on membership would not necessarily close off all avenues of participation finance, as it would still be possible for a close corporation and the corporate venture capital provider to form a partnership for the purposes of conducting a business. Moreover if the enterprise expands to a level where the possibility of corporate finance by way of equity involvement arises, or if for some other reason corporate shareholding is desired or required, it would be possible and more appropriate to convert to a company regulated by the Companies Act and Codes.

[44] Recommendation 6

The Committee recommends that membership be confined to natural persons. Juristic persons shall be excluded from membership except where this is necessary by operation of law. No juristic person shall indirectly hold a member's interest in a corporation, whether through the instrumentality of a natural person as its nominee, trustee or, otherwise.

Prohibition on a Close Corporation as a Holding Company

[45] The Committee considered whether a close corporation should be entitled to be a holding company, within the meaning of that term in the Companies Code. The Committee recognised that to permit this practice, free of further regulation, may encourage the evolution of corporate structures headed by close corporations, which would in turn avail themselves of the benefits of internal flexibility and freedom of administrative and accounting requirements that close corporations will enjoy, see [157] - [164]. It would, therefore, be necessary to modify those requirements in respect of close corporations acting as holding companies.

[46] It would also be necessary to introduce provisions relating to various consequential matters, such as:

(i) whether a subsidiary company of a close corporation should be entitled to provide financial assistance to a natural person to enable that person to acquire an interest in a close corporation (cf. Companies Code s129); and

(ii) whether a subsidiary company should be entitled to make a loan to a holding close corporation where a director of the subsidiary company was a member of the close corporation (cf. Companies Code s230).

[47] One option is to allow close corporations to act as holding companies but to introduce safeguards to prevent abuse of that control. At a minimum such close corporations would be required to comply with all the accounting obligations of holding companies under the Companies Code. It would also be necessary to attract to the legislation the relevant provisions of s129 and s230 of the Companies Code.

[48] The second option is to prohibit close corporations from being holding companies. This prohibition would overcome the difficulties involved in establishing separate accounting obligations for those close corporations who are or become, holding companies, and would also circumvent the particular Companies Code s129 and s230 issues referred to above.

[49] The Committee believes that it would be more appropriate that these more complex corporate structures be regulated exclusively under the Companies Code. Accordingly, the Committee favours the second option.

[50] Recommendation 7

The Committee recommends that close corporations be prohibited from being holding companies, as that term is understood under the Companies Code. A close corporation that wishes to create subsidiary companies must transfer to and comply with requirements of the Companies Code. A close corporation that acts as a holding company in breach of the close corporation legislation shall be deemed as and subject to all the duties and liabilities of a holding company incorporated under the Companies Code.

Residence of Members

[51] The Committee believes that to better ensure that the close corporation's responsibilities to the community can be effectively enforced, it is appropriate that a member or members reside in Australia or an external territory. These residence requirements would also be consistent with the principle that close corporations be designed for owner operated and administered businesses.

[52] Recommendation 8

The Committee recommends the inclusion of an Australian or external territory residence requirement for at least one member of a close corporation. Failure to observe this residence requirement would constitute grounds for winding up.

Summary of Eligibility Requirements

[53] The Committee favours inclusion of the following eligibility requirements for close corporations:

* a maximum membership of 10 persons
* a minimum membership of 1 person

* all members to be natural persons
* at least one member to be resident in Australia or an external territory.

[54] The Committee rejects inclusion of any eligibility criteria involving financial considerations or satisfaction of a "small business" definition.

Other Matters Involving Membership

Employee Participation

[55] A number of submissions referred to the possibility of allowing for various employee participation and incentive schemes through membership of close corporations. This is already provided for to the extent that an employee may be a member of a close corporation or a member may hold shares on trust for those employees who are natural persons; see [32].

[56] The Committee believes that employee participation schemes of any greater complexity are not appropriate for the types of organisation to which the legislative initiative is directed, and would be better regulated under the Companies Code. Such participation schemes may also involve difficult agency questions, such as the capacity of trustees of employees, as members, to bind close corporations.

[57] For these reasons the Committee rejects the inclusion of any specific provisions dealing with employee participation in close corporations.

Disqualification from Membership

[58] The Companies Code s227; 227A and s562, disqualifies persons in certain circumstances from taking part in the management of a company. The general principles behind these provisions would appear to be appropriate and desirable for application to close corporations, with necessary adaptations to reflect the management role of members of close corporations. For instance, a disqualified person would be prohibited from membership of a close corporation, except where the Association Agreement expressly excluded that person from participation in management.

[59] It would also be appropriate to provide for the winding up of a close corporation where, as a result of the operation of these provisions, the close corporation had no members.

[60] Recommendation 9

The Committee recommends that management disqualification provisions based on s227, 227A and s562 of the Companies Code be adopted, with a further provision that the close corporation be wound up in the event that the corporation has no members.

Interests that may be created in the Close Corporation

[61] The Committee was attracted to the principle that, rather than dividing the capital into shares, each member would hold an interest expressed as a percentage of the total equity interest in the close corporation. The combined interests of members must at all times constitute 100%. The Committee favours this approach as it gives a clearer and more direct indication of each member's interest than is possible under the criteria of authorised, issued and paid up capital that apply to companies.

[62] The Committee also favours a prohibition on the issue of partly paid interests. This would avoid the necessity of including provisions relating to the forfeiture or suspension of interests, or charges on uncalled capital.

[63] A prohibition on offers of the corporation's interests or debentures to the public, or any section of the public, would also be necessary.

[64] Recommendation 10

The Committee recommends that the interests of each member shall be expressed as a percentage of the capital interest of the close corporation. The combined interests of all members must at all times total 100%. All interests must be fully paid. A close corporation would be prohibited from offering its interests or debentures to the public or a section thereof.

Founding Statement

[65] The Committee's Discussion Paper suggested that a close corporation be required to lodge an initial and triennial return with the Commission containing various particulars.

[66] The Committee has since considered various terms to describe the document to be lodged upon registration, including the phrase "founding statement". The Committee is drawn to this phrase because of its self-explanatory nature and the manner in which it clearly differentiates this registration document from all documents lodged with the Commission pursuant to the incorporation and operation of companies regulated under the Companies Act and Codes.

[67] Recommendation 11

The Committee recommends adoption of the term "founding statement" to describe the document lodged with the Commission pursuant to registration of a close corporation.

Contents of the Founding Statement

[68] The Committee is of the view that in the interests of simplified administration, the contents of the founding statement should be confined to the necessary minimum.
Accordingly, the Committee has examined various possible particulars from the perspective of whether their inclusion in the founding statement is essential for the effective operation of the Close Corporation legislation.

(i) The full name of the corporation.

The Committee believes this to be a necessary requirement. The Committee also favours allowing close corporations to register as a number, and provided the corporation is not described otherwise than by reference to its number and/or some or all of the names of its members, it would be relieved of any obligation to register under the Business Names Act.

(ii) A description of the corporation's business.

The Committee believes that this requirement would be unnecessary, in view of the recommendation that the doctrine of ultra vires be excluded (see [89] - [94]). The Committee has considered whether to require close corporations to include in the founding statement a business description based on the Australian Bureau of Statistics classification, but believes, on balance, that this should not be a mandatory requirement.

(iii) Postal address and any other address to which all communications and notices of the corporation may be sent.

The postal address of the close corporation stipulated in the current founding statement would serve the function of a registered office for the keeping of records and service of documents. Lodgment of any document at the postal or any other address referred to in the founding statement would constitute conclusive proof of service. The Committee would also favour retention of the right of a party to serve documents on any person named as a member in the current founding statement, or acting as a member (cf Partnership Act (NSW) s16). Failure to notify a change of address would result in civil penalties only, such as a judgment being entered on the basis of service at the last notified postal or other address of the corporation.

(iv) The full name of each member and date and place of birth.

The Committee favours inclusion of all these requirements.

(v) The size, expressed as a percentage, of each member's interest in the corporation.

The Committee does not believe that this information need be disclosed, being of concern only to the members themselves. The legislation will not provide for prima facie proportional liability in the event of the corporate veil being lifted. Instead each defaulting member shall be personally liable jointly and severally, regardless of his interest in the corporation. Accordingly there appears to be necessary reason for supplying this information.

(vi) Particulars of the contribution of each member.

The Committee believes that while this information may be of importance to the members, it is of little relevance to outsiders, for the same reasons as in (v). The Committee does not support inclusion of this requirement in the founding statement.

(vii) Particulars of the Accounting Officer.

The Committee supports the identification of the person or persons who would be responsible for maintaining the accounts of the corporation in the manner required by the legislation. This information should therefore be supplied.

[69] In summary the following information only should be required in the founding statement:

* the full name of the corporation
* the address of the corporation
* the full name and date and place of birth of each member
* particulars of the accounting officer.

[70] The members of the corporation would be under an obligation to notify changes in these particulars within a specified time and failure to do so would result in civil rather than criminal consequences (see [120] - [125]).

[71] The Discussion Paper had corporations be required to lodge return. This return would serve ensure the continuing accuracy of suggested that close an annual or triennial primarily as a check to the founding statement. However the requirement of an initial founding statement with notifications of changes when necessary, accompanied by civil consequences for failure to so notify, would appear to remove the need to require any periodic return.

[72] The Committee recognises that there may be revenue implications arising from the abolition of a requirement to lodge an annual or triennial return.

[73] Recommendation 12

The Committee recommends that incorporation of a close corporation would entail the registration of a single document, known as the founding statement. This statement must set out four particulars, namely

* the full name of the corporation
* the address of the corporation
* the full name and date and place of birth of each member
* particulars of the accounting officer.

A close corporation may register as a number.

The founding statement would be updated by submitting an amendment of particulars. There would be no provision for lodging a periodic return.

Founding Statement and Constructive Notice

[74] The Committee notes the trend in company law away from the common law constructive notice doctrine and would not favour operation of the doctrine in a wide form in any Close Corporation legislation. Adoption of the doctrine, would also be inconsistent with the Committee's recommendations concerning the agency powers of members (see [95] - [104]). The Committee therefore favours express abolition of this common law doctrine (except as regards registrable charges: see [175]).

[75] Rather, the founding statement would serve the following functions:

* to inform the Commission and liquidators as to who were some or all of the members of a close corporation at a particular time (membership would not necessarily be confined to those persons identified in the founding statement - see [98] - [104]);

* to provide a mechanism whereby persons may effect their withdrawal from membership without further obligations to notify outsiders (see [114] - [119]);

* to provide an irrebuttable presumption that a person was a member during the period that his name appeared in the founding statement.

[76] Recommendation 13

The Committee recommends that the legislation should provide, in terms analogous to s68C of the Companies Code, that no person shall be deemed to have knowledge of any particulars merely because they are stated or referred to in any founding or other lodged statement.

Rights of Members inter se

[77] The Committee is of the view that given the limitation on the maximum membership of close corporations, it is appropriate to take the provisions in the partnership legislation as a guide for the internal government of this new form of organisation. This would result in the vesting of management powers and functions in the members alone, without the need for a separate board of directors.

[78] The Committee proposes, therefore, that rather than adopt Table A articles or formulate a new set of standard rules for the internal affairs of close corporations, it would be preferable to write into the new legislation provisions on management which closely follow the partnership model. These provisions would be subject to any contrary agreement by the members, thus providing them with the capacity to retain maximum flexibility in their internal arrangements. The legislation would provide that the rights and duties of the members to each other shall be determined by rules drawn from partnership legislation. These rules on internal management would dispense with the notion of directors and state that:

Subject to any contrary agreement:

(a) all members are entitled to share equally in the capital and profits of the business;

(b) the corporation shall indemnify every member in respect of payments made and personal liabilities incurred by him:

(i) in the ordinary and proper conduct of the business of the corporation; or

(ii) in or about anything necessarily done for the preservation of the business or property of the corporation;

(c) a member making, for the purpose of the corporation, any actual payment or advance beyond the amount of capital which he has agreed to subscribe, is entitled to interest at a prescribed rate from the date of the payment or advance but the claim to interest shall not rank in priority over the claims of external creditors;

(d) a member is not entitled before the ascertainment of profits to interest on the capital subscribed by him;

(e) every member may take part in the management of the corporation's business;

(f) no person may be introduced as a member without the consent of all existing members;

(g) any differences arising as to the ordinary matters connected with the corporation's business shall be decided by a majority of the members, but no change may be made as to the nature of the corporation's business without the consent of all existing members; and

(h) every member may, when he thinks fit, have access to the corporation's books and may inspect any of them.

[79] Members may vary these rules by contrary agreement in order to suit their particular circumstances. It is envisaged that the most suitable variation mechanism would be a written association agreement which could be entered into and amended at any time. This written agreement would not be a registrable document or required to be submitted to

the Commission. The association agreement would constitute a means by which members of a close corporation could introduce various provisions suitable to their needs, such as specific regulations governing meetings, the particular division of powers, or the manner in which voting rights of members were to be determined. Members could, in an association agreement, exclude one or more members from management (e.g. minors) or even allocate all management powers to a single member. However an association agreement would not be a public document nor be subject to the common law doctrine of constructive notice. Accordingly, the agreement could not, of itself, alter the agency rules applicable to close corporations, namely that each member may bind the close corporation unless the outsider has actual notice of any limitations on this power (see [95] - [97]).

[80] The Committee considered whether to confine the means by which these internal rules could be varied to a written association agreement. The Committee noted that under Partnership law, these rules are subject to any agreement 'express or implied' between the partners. The same principle would appear suitable for close corporations. Accordingly, members may vary their internal arrangements by any written or unwritten agreement, express or implied, provided it is not inconsistent with any provision of a written association agreement.

[81] Recommendation 14

The Committee recommends that the relevant principles found in the Partnership Act, as adapted for close corporations, should regulate the rights of members inter se. These provisions may be altered or extended by means of a written association agreement or any other agreement, express or implied, between the members which is not inconsistent with the association agreement. The common law doctrine of constructive notice shall not apply to any association or other agreement.

Model Association Agreement

[82] A number of submissions referred to the possibility of including in the legislation a model set of rules or an association agreement based on what is now found in Table A or Table B of the Companies Code.

[83] The Committee does not favour this approach. The model rules dealing with the internal affairs of the corporation should be regulated by the set of legislative principles outlined in [77] - [81], subject to any association agreement or other agreement to the contrary. The terms of any express agreement would be for the member to determine in consultation with their own advisers.

Annual Meeting

[84] A related question is whether there should be provision for a mandatory annual meeting. The Committee prefers to omit any requirement of this nature and proceed on the partnership law basis of informal meetings. Members who prefer a more formal arrangement could so provide in their association agreement.

Fiduciary Relationships within the Close Corporation

[85] The partnership legislation provides clear rules which appear suitable to regulate the duties of corporation members. These rules, as modified for the purpose of close corporations, would take the following form:

* Members are bound to render true accounts and full information of all things affecting the corporation to any member or his legal representatives.

* Every member must account to the corporation for any benefit derived by him without the consent of the other members, from any transaction concerning the corporation, or from any use by him of the corporation's property, name or business connections.

* If a member, without the consent of the other members, carries on any business of the same nature as and competing with that of the corporation, he must account for and pay over to the corporation all profits made by him in that business.

[86] The Committee would also support inclusion of a provision imposing an obligation on members to compensate the close corporation in the event of their negligence. Under this proposal a member would be liable to the corporation for any loss caused by his failure to act, in the carrying out of the business of the corporation, with a degree of care and diligence that may reasonably be expected from a person of his knowledge and experience (cf Companies Code s229(2)). This would help protect the interests of other members, and to some extent creditors. Liability would not arise if the relevant conduct was approved by all the corporation's members either prospectively or retrospectively, provided that the members were then cognisant of all the material facts.

[87] A member would also be liable to the corporation for any dishonesty, or improper use of his position with or the information of, the close corporation (cf Companies Code s229(1)(3)(4)(6)). Such conduct should not be open to ratification by members. However a power should be given to the court to excuse irregularities in certain instances (cf Companies Code s539).

[88] Recommendation 15

The Committee recommends that members of a close corporation be subject to a series of fiduciary duties and obligations drawn from relevant partnership law principles and the fiduciary duty provisions of the Companies Code.

Capacity of the Company: Ultra Vires

[89] The Committee is of the view that in the interests of simplicity and certainty, it is necessary to exclude completely the application of the common law ultra vires doctrine. The Committee would not favour a provision such as found in the Companies Code s68 which entitles companies to place restrictions on their objects and powers and which allows for a residual assertion of the common law doctrine.
Instead the close corporation and its members would be protected, in some degree, by application of the agency rules: see [95] - [97]. The Committee believes that if promoters wish to place limitations on the objects and powers of the corporate entity, it would be more appropriate to do so by incorporation pursuant to the Companies Code.

[90] The Committee also considers it useful to provide in the legislation that the corporation shall have the same powers as a natural person and, in addition, have power to

undertake certain things which are appropriate for corporate bodies, such as issuing debentures, granting floating charges, allotting membership interests and making distributions of property in kind.

[91] There is one important exception to the general principle that a close corporation have the same powers as a natural person. The Committee suggested in the Discussion Paper that a close corporation be denied the power to act as a trustee under any express trust except where the corporation was required to so act by operation of law. This means that a close corporation would be unable to act as the trustee of a unit trust or a superannuation fund. The limitation was seen as necessary in order to provide for a new form of organisation which was not complex and with which creditors could deal with a minimum of investigation. This limitation would ensure that creditors of close corporations were not involved in the legal difficulties arising from actions against a corporate trustee of a trading trust.

[92] The Committee also suggested in the Discussion Paper the inclusion of a provision that if a person purporting to act on behalf of a close corporation acted so as to lead innocent persons to believe that the close corporation had become a trustee under an express trust, the person so acting, and not the close corporation, shall be the trustee. The result would be that personal liability for any debts incurred would attach to the person so acting.

[93] The majority of submissions were in favour of these proposals. The Committee recommends inclusion of these provisions in the legislation.

[94] Recommendation 16

The Committee recommends exclusion of the common law ultra vires doctrine and that a close corporation shall have the same capacity and powers as a natural person, except that it may not act as a trustee under an express trust, other than where it is required to do so by operation of law.
Personal liability shall attach to any person who purports to act on behalf of a trustee close corporation.

External Relations of the Close Corporation: Agency

[95] The Committee's Discussion Paper suggested that given the possible limitations on the membership of close corporations, and the resulting analogy with partnerships, it would be appropriate to adopt for this new corporate entity the agency rules of partnership. These rules, as drafted for close corporations, would take the following form:

"Every member is an agent of the close corporation for the purposes of the business of the corporation and the acts of every member who does any act for carrying on in the usual way business of the kind carried on by the corporation of which he is a member shall bind the corporation, unless the member so acting has in fact no authority to act for the corporation in the particular matter and the person with whom he is dealing either knows that he has no authority or does not know or believe him to be a member".

[96] Any member may appoint a third party as the agent of the close corporation, or hold out that person as the agent of the corporation, in which case the common law rules of actual and ostensible authority would apply.

[97] Recommendation 17

The Committee recommends that the external relations of close corporations be regulated by common law agency rules, as adapted from the partnership legislation.

Definition of Members

[98] It is necessary to determine who are the members of a close corporation for various purposes, including exercise of the agency powers. The Committee favours a provision that all persons referred to in the founding statement shall automatically be members regardless of their degree of involvement in the corporation's affairs. Each of these members is entitled to bind the corporation, pursuant to the terms of the provision outlined in para [95].

[99] It is also necessary to consider the case where the personnel of a close corporation changes, but this change is not notified in the founding statement. In these circumstances a number of policy choices are available:

(i) to confine corporation membership to the persons referred to in the founding statement. Under this option only those persons referred to in the founding statement would be recognised as members and be entitled in their own right to bind the close corporation;

(ii) to confine corporation membership to those persons actually involved in the conduct of the close corporation notwithstanding that the founding statement is inaccurate. Under this option changes in personnel would affect the agency power of individuals, regardless of whether they were named as members in the founding statement;

(iii) to extend membership both to the persons referred to in the founding statement and the incoming personnel. This is a combination of (i) and (ii) above.

[100] The Committee believes that the option (i) would be unworkable in a practical sense, as in many instances the incoming persons would seek to exercise the agency powers of the close corporation, notwithstanding the inaccuracy of the founding statement. This may result in uncertainty as to the status of any contract entered into by them on behalf of the corporation. It would be unsatisfactory if these matters had to be resolved ultimately by reference to the agency rules of ostensible authority and holding out.

[101] Option (ii) overcomes the agency problems arising from option (i) and it would be attractive from that perspective. Its shortcomings are that it would conflict with the principle that the founding statement constitutes conclusive evidence that those persons named therein are members (see [98]) and furthermore it would not act as an incentive to ensure the accuracy of the founding statement. For these reasons the Committee rejects the second option.

[102] Option (iii) would allow the new personnel to contract on behalf of the corporation notwithstanding that they are not identified as members in the founding statement. However, outgoing members would retain their capacity to bind the corporation during such time as their names remained on the founding statement. This option would be consistent with the principle that persons named in the founding statement shall be members; it would allow incoming but unregistered members to exercise the agency powers; and it would go some way towards creating an incentive for continuing members to maintain the accuracy of the founding statement. This approach would also be consistent with the policy adopted in respect of the retirement of members (see [114] - [119]).

[103] The most appropriate way to achieve this third option would be in the statutory definition of member of a close corporation. A member would be:

(a) anyone referred to as such in the current founding statement; and

(b) any natural person occupying or acting in the position of member of the corporation, notwithstanding that the person's name is not recorded in the current founding statement.

[104] Recommendation 18

The Committee recommends that a member shall be defined in the legislation as:

* anyone identified as such in the current founding statement, and

* any natural person occupying or acting in the position of a member of a close corporation, independently of whether that person is recorded as a member in the founding statement.

Pre Incorporation Contracts

[105] The Committee favours inclusion of a provision based on the Companies Code s81 to cover those instances where a person attempts to act on behalf of a close corporation prior to its incorporation. The same rules concerning ratification as found in s81 should apply.

[106] Recommendation 19

The Committee recommends that provisions analogous to s81 of the Companies Code be adopted to regulate pre incorporation contracts.

Name of the Close Corporation on Official Documents

[107] The Committee considers it both useful and appropriate that outsiders be aware that they are dealing with a close corporation. This end may be achieved by requiring that the name and status of the entity as a close corporation appear on all relevant documents. It would not be mandatory for close corporations to include the names of their members on their stationery, though they may do so at their discretion.

[108] Recommendation 20

The Committee recommends inclusion of the provision, drawn from s218 of the Companies Code, that the corporate name followed by the phrase "close corporation" or the abbreviation "CC" appear on all official documents.

Transfer of Membership

[109] Establishing the circumstances in which members shall be entitled to transfer their interests involves the resolution of potentially conflicting policy considerations. If permitted restrictions are minimal, members may be able to sell or transfer their interests to persons who may be unacceptable to the remaining members. On the other hand if restrictions are severe, members may find themselves imprisoned in the corporation and unable to sell their interests because of their fellow members' refusal to accept the transfer.

[110] The Committee noted that in partnership law, no person may be introduced as a member without the consent of all existing members, though this may be varied by agreement amongst the partners. The Committee believes that the same restriction should apply to close corporations, while allowing members to relax these restrictions on transfer by agreement if they so desire. However, taking into account the policy considerations referred to in para [109], it may be appropriate to include a remedial provision similar to s186 of the Companies Code.

[111] The Committee posed the question in the Discussion Paper whether there should be statutory provision to resolve disputes concerning the amount to be paid for a transfer of interests. The consensus of submissions on this point was that this would best be resolved by members at their own discretion, and should not be the subject of statutory control. The Committee agrees with these comments.

[112] The Committee also raised the matter whether there should be provision for having the corporation wound up if transfer disputes, which were left to settlement by agreement, are not resolved within a reasonable time. The Committee believes that unresolved disputes of this nature could constitute a basis for an oppression action or a "just and equitable" application for winding up, and accordingly there appears to be no reason for including particular provisions to cover these matters.

[113] Recommendation 21

The Committee recommends that the legislation adopt the partnership rules applicable to changes of membership supplemented by a provision equivalent to s186 of the Companies Code.

Method of Relinquishing Membership

[114] The Committee perceives a need to determine a simple and clear procedure by which a person may relinquish membership. This has important consequences concerning the agency powers of that person to bind the corporation; the position of third parties who may otherwise be misled as to the membership of the corporation; and the potential liability of the retiring member for the future debts of the close corporation.

[115] Under the Partnership Act, the onus is on the member to ensure that outsiders are made aware of his retirement. Failure to do so may result in a continuing liability to persons dealing with the firm (Partnership Act (NSW) s14; s36). It may be more appropriate in the context of close corporations, to place the onus on the corporation, rather than the retiring member, to ensure that the retiree's name is no longer associated with the corporation and that outsiders are not misled.

[116] On this basis it would suffice to withdraw from a close corporation that the retiree:

* provided satisfactory notice to the corporation of his decision to retire;

* ensured that his name was removed from the founding statement (this would be done by lodging an amendment with the relevant Commission); and

* acted no longer in the capacity of a member.

[117] The retiree would be under no further obligation to establish that his name was omitted from any corporation letterhead etc. Should the corporation fail to alter the letterhead or act in any other way such that an outsider was misled as to the membership of the corporation, the outsider's common law remedies would be confined to the corporation and its current members. Conversely, if a member's name was withdrawn from the founding statement but that person continued to act as a member, he would retain the capacity to bind the company and the powers and obligations consistent with membership.

[118] The attraction of this approach is that it creates greater certainty for the relevant parties. The retiring member need comply only with the stipulated requirements, free of the further and legally imprecise task of taking "reasonable steps" to ensure that he is no longer held out as a member. The corporation and its remaining members are under an obligation to ensure that outsiders are correctly informed as to who are its current members, with potential liability in common law misrepresentation if an outsider is misled. It would not suffice as a defence, in these circumstances, merely to point to the omission of the retiree's name from the founding statement, as that statement is not deemed to be the subject of constructive notice and the statement does not necessarily stipulate all persons who are members of the close corporation.

[119] Recommendation 22

The Committee recommends that a member may relinquish his membership by:

* providing satisfactory notice to the corporation of his decision to retire;

* lodging with the Commission an appropriate amendment to the founding statement; and

* no longer acting in the capacity of a member.

Creating an Incentive for Incoming Members to File an Amendment to the Founding Statement

[120] The Report so far has identified a number of incentives for retiring members to remove their names from the founding statement, namely:

* to terminate their agency powers, and

* to ensure that they are no longer liable in the event of their being held out by others as members of the corporation.

[121] The Committee believes however that consideration must be given to creating an incentive for incoming members to have their names entered in the founding statement. This is important in that, as a matter of policy, a periodic return system, such as an annual or triennial return, should only be abandoned if some means of effective self-enforcement can be devised to protect the integrity of the founding statement.

[122] To create this incentive, the Committee proposes that while a non-registered member may be subject to all the liabilities arising from membership, he would not be entitled to enforce any of the powers or rights of membership involving any act or omission that occurred during any period that he acted in the capacity of a member but was not registered as such in the founding statement. This would mean that no membership claim on the corporation would be recognised by any person claiming to be a member, whose membership had not been notified at the relevant time.

[123] The only general exception to this principle would be as regards the agency powers of non registered members: see [95] - [104].

[124] A possible drawback with this proposal is that a non-registered member may be defeated in an attempt to establish that he was being oppressed or that his fellow members were acting contrary to the interests of himself or the corporation as a whole. It may therefore be appropriate to provide as an exception to the above general rule, that a member, whether registered or not, is entitled to commence an oppression or winding up action, notwithstanding that all or some of the relevant events relied upon in the application, occurred during such time as the applicant was a non-registered member of the close corporation.

[125] Recommendation 23

The Committee recommends that a person shall not be entitled to enforce membership rights if at the relevant time his name did not appear as a member in the founding statement. However a non-registered member is not barred from commencing an oppression or winding up action.

A Close Corporation Acquiring the Interests of a Member

[126] The Committee posed the question in the Discussion Paper whether close corporations should be empowered to pay out a member's interest, in lieu of that member selling or transferring all or some of his interests to a fellow or incoming member.

[127] The benefit of such a power would be to make investment and participation in close corporations more attractive, by providing members with a further means of disposing of their interests, while permitting the remaining members to maintain control and ownership of the business. When, for instance, an investor or a family member with a

significant interest retires or dies, the other members may not have the capital or credit capacity to acquire this interest. There may be cases where the only option, apart from liquidation, is to sell the interest to a third party, and this may result in a change of control. This could sometimes be avoided by utilising the corporation's funds to buy the interest.

[128] It may also contribute to the efficient management of a close corporation if dissident or apathetic members can be bought out by the corporation. There may be no ready market for the interest in question, and the other members may not have sufficient funds to acquire the interest.

[129] While for the reasons outlined the Committee favours granting close corporations the power to acquire a member's interest, it is also concerned that proper regard be given to the continuing financial obligations of the corporation and the rights of creditors.

[130] The Committee originally suggested that any amount paid by the corporation by way of repurchase of an interest be recovered under a court order in liquidation proceedings if, in the ensuing 12 months, the close corporation was unable to pay its debts as they fell due. The former member would be obliged to surrender the amount received and his right of recovery would rank below that of secured and unsecured creditors, but in advance of the rights of other members.

[131] A number of submissions strongly criticised this suggestion. The 12 month period was seen as arbitrary and the rights of various parties could turn too much on this. The Law Council of Australia pointed out that the fortunes of a small business are often particularly dependent on the personality of its members and may undergo dramatic reversals within a short period of a member departing, particularly if

the withdrawing member was the driving force. The proposed provision would place the withdrawing member at the mercy of the remaining members over whom he had no control. The Law Council believed that the effects of the proposal would be to encourage retiring members to have the corporation wound up and the surplus assets distributed, however undesirable this may be from a commercial perspective, rather than face the risk that funds received from the close corporation may be subject to recovery by the liquidator in the event of a subsequent insolvency.

[132] The Committee recognises the force in these submissions but is also conscious that it is possible for an entity which is in fact insolvent on a liabilities over assets basis to remain in operation for a considerable period by utilising existing cashflows and credit facilities. These funds may suffice to pay off the debts that exist at the date of retirement. It is therefore necessary to guard against the possibility of a member receiving corporation funds in payment of his interests, notwithstanding that it is subsequently established that the corporation was at that time insolvent.

[133] The Committee now proposes that rather than persevere with the 12 month or any other time period, a preferable approach would be to empower a liquidator to recover any funds paid by a close corporation in a repurchase where it appears that at the time of payment (and taking into account the payment) the corporation could not satisfy solvency and liquidity criteria. These criteria would concentrate on whether the close corporation is and would remain solvent and liquid after having acquired these interests. Any such payment by a corporation may validly be made only if:

* after any such payment is made, the corporation's assets, fairly valued, exceed all its liabilities; and

* the corporation is then able to pay all its existing debts as they will become due in the ordinary course of its business.

[134] All members would be required to complete a declaration of solvency and liquidity as a prerequisite to the repurchase. This would serve to focus the minds of the members on the corporation's financial position and act as a point of reference or relation back for a liquidator in any subsequent insolvency. It would be no bar to recovery that the members honestly believed the close corporation to be solvent if the liquidator establishes that the corporation was then insolvent.

[135] The effect of this provision would be to encourage members to obtain an accurate determination of the state of solvency of the corporation before entering into any agreement to sell their interests to the corporation.

[136] The close corporation would be prohibited from holding any interest that it acquired. This interest would be added proportionally to the interests of remaining members so that their combined interests, at all times, constituted 100%.

[137] Recommendation 24

The Committee recommends that a close corporation be entitled to acquire the interests of members, subject to satisfaction of a solvency and liquidity test. The liquidator would be entitled to recover any amounts paid by the corporation where it is established that at the time of payment the company was not both solvent and liquid.

Protection of Creditors: Limited or Unlimited Liability

[138] The Committee considered a range of creditor protection options involving the liability of members for the outstanding debts of a close corporation:

(i) to dispense with the notion of limited liability altogether and impose unlimited personal liability on all members of the corporation (cf. partnerships);

(ii) to introduce a more restricted form of unlimited liability in that each member would be under a legal obligation to meet any outstanding liabilities of the close corporation, but only up to a prescribed amount, being a fixed amount per member, a fixed amount per proportionate interest, or a total fixed amount for the corporation with each member jointly and severally liable (the proposal of Professor Gower);

(iii) to impose a statutory requirement that at least two persons called controllers assume personal responsibility for the debts of the close corporation, in the same manner as sole traders and partners (the proposal of Mr. A. Yeoman's);

(iv) to retain the principle of limited liability subject to a number of qualifications in the event of insolvency.

[139] The Committee has major reservations about the first, second and third options, as they represent strong, if not compelling, disincentives to the use by entrepreneurs of the close corporation entity, in comparison with limited liability proprietary companies. The Committee is of the belief that entrepreneurs contemplating incorporation place great store on the principle of limited liability, notwithstanding that its protection is, in practice,

significantly eroded and it may be defeasible through a finding by a court of fraud, recklessness or negligence in management.

[140] Recommendation 25

The Committee recommends that the Companies Code model of defeasible limited liability be retained for close corporations, with the grounds of defeasibility determined in accordance with Recommendation 26.

Protection of Creditors: Lifting the Corporate Veil

[141] The Committee proposes three legislative grounds of recourse against members personally in the event of the corporation's insolvency.

(i) A provision adopting the principle underlying s556 (1) and s557 of the Companies Code making the limitation of liability defeasible upon showing that the debt was incurred recklessly. The Committee considers that this principle, as drawn from the Companies legislation, is suitable for application to the members of close corporations.

(ii) Compensation for assets improperly disposed of. In the liquidation of an insolvent close corporation, power would be given to the court to order that persons who were members of the corporation at the time of a misapplication of its assets should be liable to pay the corporation the value of what was misapplied, together with the value of any goodwill, profits or gain that might have been made

from the assets. This is based on the principle that underlies s453 of the Companies Code. Liability would be extended to persons who were members within 12 months before the misapplication. Such former members and persons who were members at the time of the misapplication could avoid liability by showing that it occurred without their authority and, where they had reason to suspect a misapplication, they made reasonable efforts to enable the company to recover the assets or obtain compensation. A general power would reside in the court to relieve from liability persons who had acted honestly and reasonably and ought fairly to be excused.

To the extent that such a clause would not cover all circumstances within s453 of the Companies Code, a provision specifically adapting this section to close corporations would also seem desirable.

(iii) Imposition of unlimited liability on members where there has been undue delay in bringing the corporation's activities to an end. Under this provision members of an insolvent close corporation would be liable without limit where they had either failed within a reasonable time to cause the cessation of the corporation's business, to call a meeting of members and creditors, or to arrange for adequate capital to be put into the corporation.

[142] These provisions would place an onus on members of a close corporation to take reasonable steps to monitor the corporation's financial position.

[143] A member refers to any person whose name appears, at the relevant time, in the founding statement and any person who at that time occupies or acts in the capacity of a member, notwithstanding that his name is omitted from the founding statement: see [98] - [104].

[144] The Committee considered a submission from the Law Council of Australia that these provisions were oppressive in that they would impose the burden of proof on members to satisfy the court of certain particulars, rather than the onus being on those who sought to remove the corporate veil. The Committee believes that in the circumstances of an insolvency there should be some obligation on members to establish that they have acted appropriately. The Committee also considers that the proposed grounds of liability contain balancing elements. For instance the right of recovery of misapplied assets arises only where it is established that they have been improperly disposed of, and the court may dismiss the recovery action where it is satisfied that the defendant members acted honestly and reasonably and ought fairly to be excused. Many of these matters would be peculiarly within the knowledge of defendants and it is reasonable to place an evidential obligation upon them. Defendant members would also be entitled to refer to the terms of any relevant association agreement which impinged on their capacity to control the corporation.

[145] For these reasons, the Committee considers that these clauses represent an appropriate balance between the interests of members and creditors and ought to be retained in that form.

[146] Recommendation 26

The Committee recommends three legislative grounds of recourse against members personally in the event of the insolvency of a close corporation:

* a provision adopting the principle underlying s556 (1) and s557 of the Companies Code;

* compensation to the corporation for assets improperly disposed of; and

* imposition of unlimited liability on members who unduly delayed terminating the activities of an insolvent close corporation.

Minimum Paid Up Capital

[147] The Committee raised the question in the Discussion Paper whether it was appropriate to prescribe a minimum paid up capital for close corporations. Relevant arguments pertaining to a minimum capital requirement may be summarised as follows:

Arguments favouring a mandatory minimum paid up capital:

(i) It may discourage frivolous incorporation and so constitute a partial response to the perceived abuses associated with some $2 companies.

(ii) It may, in effect, require proprietors to put some of their own funds at risk and therefore constitute a form of obligatory good faith on their part.

(iii) Under-capitalisation has been identified as a major cause of small business failure and a minimum paid up capital requirement may provide some protection to creditors upon incorporation, instead of after the event.

Arguments against a mandatory minimum paid up capital:

(i) Substantial or total loss of paid up capital in the course of normal trading may occur even where a corporation is adequately capitalized upon its formation.

(ii) Paid up capital is no true indication of the current worth of the corporation or its ability to meet its debts.

(iii) Any minimum capital figure would be arbitrary and therefore inappropriate in particular instances (being either excessive or insufficient), given the broad range of activities that may be undertaken by close corporations.

(iv) Difficulties may arise in valuing capital provided in non cash form.

(v) The requirement would constitute a burden on all corporations for the sake of giving some comfort for creditors of those close corporations which abused limited liability.

[148] The Committee believes, on balance, that the disadvantages of a minimum paid up capital requirement clearly outweigh any benefits that may be derived and that in many instances the requirement would not offer any real protection for creditors. The majority of submissions were in agreement.

[149] Recommendation 27

The Committee recommends that there be no requirement that close corporations have a minimum paid up capital.

Publicity as to Paid Up Capital

[150] The Committee raised as a possible addition or alternative to the adoption of a minimum paid up capital

requirement, that corporations be obliged to disclose on their letterhead etc. their actual paid up capital. There was little support in the submissions for imposing this obligation and the Committee believes it would be an unworkable requirement, open to substantial misrepresentation, and potentially misleading to outsiders.

[151] Recommendation 28

The Committee recommends that there be no requirement that close corporations disclose their actual paid up capital.

Maintenance of Share Capital

[152] In broad outline, this concept has traditionally been interpreted as meaning that the share capital of a limited liability company constitutes a fund to which creditors of the company may look for the satisfaction of their claims. From this common law concept certain rules have emanated:

(a) a prohibition on the purchase by a company of its own shares;

(b) a prohibition on the rendering of financial assistance by a company to any person for the purchase by that person of the company's shares; and

(c) a prohibition on the payment of dividends to shareholders otherwise than out of profits (i.e. a prohibition on payment of dividends out of share capital).

[153] The Committee has already indicated that it intends to relax the first prohibition for close corporations (see [126] - [137]).

[154] As regards (b) the Committee believes that similar rules should apply to close corporations and proprietary companies and therefore favours introduction of validation procedures modelled on s129(10) - (15) of the Companies Code for these financial assistance transactions by close corporations (subject to the limitations found in [45] - [50]).

[155] As regards (c) the Committee is of opinion that little would be gained in subjecting close corporations to the complex and often unsatisfactory common law rules on dividends. Instead the Committee proposes that close corporations be empowered to make payments to members, subject to a solvency and liquidity test identical to that pertaining where a company acquires its own interests. Accordingly any payment by a close corporation to any member by reason of his membership may be made only if:

* after any such payment is made, the corporation's assets, fairly valued, exceed all its liabilities; and

* the corporation is then able to pay its existing debts as they will become due in the ordinary course of its business.

Payments in breach of this provision would be recoverable by the corporation in a subsequent liquidation.

[156] Recommendation 29

The Committee recommends that the Close Corporation legislation include specific provisions allowing corporations to:

* acquire their own interests;

* provide financial assistance for the purchase of their interests; and

* distribute funds otherwise than pursuant to the law of dividends.

The interests of creditors would be protected by solvency and liquidity requirements.

Accounting Records and Books

[157] It is axiomatic that the maintenance of adequate accounting records is essential to ensure a proper continuing financial evaluation of any business. In the context of companies legislation the desire to protect creditors of limited liability companies has prompted requirements for audited accounts or public disclosure of key financial data.

The Committee believes that these requirements can be burdensome for small enterprises. The Committee suggested that it may be possible to abandon these requirements for close corporations and to require no more than that such corporations keep accounting records in a manner as would enable a profit and loss account and a balance sheet to be readily prepared and capable of being conveniently audited.

This would enable members to monitor the financial situation of the close corporation and also provide essential information in the event of the liquidation or investigation of the corporation. The interests of creditors would be protected in other ways (see [133 - [137]; [141] - [146]).

[158] The obligation to maintain the accounts would rest, in the first instance, with the accounting officer identified in the founding statement.

[159] The majority of representations agreed with the Committee's approach. Furthermore, a number of submissions questioned the costs and effectiveness of any move to require an auditor for small business and so favoured the minimising of accounting obligations. It was also pointed out that the lodging of annual accounts with the Corporate Affairs Commission gave no real protection to ordinary trade creditors who must rely primarily on references, personal guarantees and good credit control. In practical terms, it

often made no difference to ordinary creditors whether historical accounts were filed or not; information in them could be so outdated and unrevealing as to be of no real value.

[160] The Law Council commented that in the absence of any external enforcement mechanism, it may be difficult to ensure compliance with the requirement that the accounts and balance sheet be kept in a form capable of being conveniently audited. The Committee recognises the importance of maintaining accurate accounting records and books and believes that self enforcement would be encouraged by the various provisions imposing personal liability on members in the event of the corporation's insolvency, see [141] -[146]. It would be more difficult for members to establish a defence to such an action if, at the relevant time, the accounting records were not in a satisfactory form.

[161] Members may also be criminally liable for various offences arising from breach of these accounting requirements: see [205].

[162] The Committee believes that the accounting records should be available, as of right, only to members of the close corporation, the Corporate Affairs Commission and the liquidator. There should be no statutory entitlement on the part of the general public or creditors to inspect the accounting records; this should be left to the discretion of the close corporation or pursuant to the terms of security instruments. The location of the accounting records and any computerised records would be regulated by provisions similar to those contained in the Companies Code (e.g. s267; s546).

[163] The proposed legislation would lay down only the minimum accounting requirements. The accounting records of a close corporation may be made the subject of a formal audit,

if members wished this to be done for their own requirements or where a prospective creditor required that this be undertaken for the purpose of a transaction.

[164] Recommendation 30

The Committee recommends that a close corporation shall be required to keep its accounting records in such a manner as would enable a profit and loss account and balance sheet to be readily prepared in a manner capable of being conveniently audited. A close corporation shall not be required to have the accounts audited or file an annual return.

Legal Proceedings

[165] There will need to be provisions about service of documents on close corporations. It is proposed that a document may be served on a close corporation either by:

(a) personal delivery to any member (cf Partnership Act (NSW) s16), or

(b) delivery at the postal address stipulated in the current founding statement.

[166] A provision requiring the close corporation to give security for costs in circumstances where the Companies Code requires it from a company would also be needed (cf Companies Code s533).

[167] A certificate of incorporation of a close corporation given by the Commission shall be conclusive evidence that all the registration requirements of the legislation have been complied with and that the close corporation referred to in the certificate is duly incorporated (cf Companies Code s549).

[168] The Committee believes that it is beneficial to make explicit which persons have the authority to make admissions on behalf of a close corporation. There is no statutory provision dealing with this matter under the Companies Code but the Partnership Act (NSW) (s15) provides that an admission or representation made by any partner concerning the partnership affairs, and in the ordinary course of its business, is evidence against the firm. The Committee notes that this provision does not make statements by a partner conclusive, but merely renders them admissable in evidence. A provision of this nature, substituting the term member for partner, would appear appropriate for close corporations.

[169] It would also be appropriate to include provisions dealing with the evidentiary and admissibility aspects of corporation documents: cf Companies Code s544; s550.

[170] Recommendation 31

The Committee recommends the inclusion of provisions that:

* service of documents be effected either by personal delivery to one or more members or delivery at the address of the close corporation stated in the founding statement;

* courts be empowered to require close corporations to give security for costs.

* a certificate of incorporation be conclusive evidence of such incorporation;

* any admission or representation made by a member concerning the affairs of a close corporation and in the ordinary course of its business be evidence against the close corporation; and

* books of a close corporation have the same evidentiary value and be admissible in the same manner as books of a company incorporated under the Companies Code.

Remuneration for Acting in the Business of the Organisation

[171] The Partnership Legislation provides that subject to any agreement between the partners, no partner shall be entitled to renumeration for acting in the partnership business. This would appear to be an appropriate starting position for close corporations. It would be open to members to make provision in an association agreement for their acting as paid employees of the corporation.

[172] Recommendation 32

The Committee recommends adoption of the partnership principle that subject to any contrary agreement, no member shall be entitled to renumeration for acting in the close corporation business.

Oppression of Members

[173] The oppression remedies provided in Part IX of the Companies Code are appropriate for application to the new organisation. Any member, whether or not registered, shall be entitled to seek an oppression remedy (see also [120] -[125]). The provision in the Partnership Legislation that no majority of partners can expel any partner unless the power to do so has been conferred by express agreement should also be adopted.

[174] Recommendation 33

The Committee recommends that the Close Corporation legislation include oppression provisions based on s320 of the Companies Code. An oppression action may be commenced by any member, whether or not registered. The legislation should also provide that no majority of members may expel a fellow member unless a power to do so has been conferred by express agreement between all the members.

Registration of Charges

[175] It is envisaged that close corporations shall be entitled to grant charges over their assets. Accordingly it would be appropriate to include provisions based on S68C and Part IV Division 9 of the Companies Code regulating the registration of such charges and application of the doctrine of constructive notice to registered charges.

[176] Recommendation 34

The Committee recommends that provisions equivalent to s68C and Part IV Division 9 of the Companies Code regulating the registration of charges granted by close corporations be included in the legislation.

Powers of Inspection and Special Investigation

[177] Close corporations will enjoy the benefits of limited liability for members and minimal reporting requirements. It is therefore necessary to provide, in the public interest, that in appropriate circumstances their affairs be open to scrutiny. The powers given to the Commissions to investigate the affairs of companies, as found principally in Part II Division 1 and in s541; 542, 545, 551, 573 and 574 of the Companies Code should be made applicable to close corporations.

[178] The public interest would also require that where necessary close corporations be subject to a special investigation. The provisions of Part VII of the Companies Code should be adopted.

[179] Recommendation 35

The Committee recommends that the relevant inspection and special investigation provisions of the Companies Code be adopted for close Corporations.

Arrangements and Reconstructions

[180] There may be occasions when a close corporation wishes to enter into a scheme of arrangement with members or creditors. The provisions of Part VIII of the Companies Code would provide a suitable mechanism for these purposes.

[181] Recommendation 36

The Committee recommends that the scheme of arrangement provisions of Part VIII of the Companies Code be adapted to close corporations.

Receivers and Managers

[182] The Committee sees it as highly desirable that uniform provisions apply to receivers and managers of close corporations and companies incorporated under the Companies Code. Accordingly Part X of the Companies Code should be adopted for close corporations.

[183] Recommendation 37

The Committee recommends that the provisions of Part X of the Companies Code dealing with the powers and duties of receivers and managers be applied to close corporations.

Official Management

[184] The Committee is aware of the criticism that the official management procedures under the Companies Code have not been effectively utilised and should be discontinued.
However, the Committee believes that there may be instances where entry into official management would be an appropriate course of action for a close corporation that is in a poor financial state. The Committee also believes that there is

benefit in maintaining uniformity between close corporations and companies incorporated under the Companies Code in this respect, and would not favour exclusion of the official management provisions from the Close Corporation legislation while they remained in force under the Companies Code.

[185] Recommendation 38

The Committee recommends that the provisions of Part XI of the Companies Code relating to official management be adopted for close corporations.

Takeovers

[186] The Committee has elsewhere recommended that a close corporation have a maximum of ten (10) members (see [21] -[25]). This will have the effect of exempting close corporations from the Companies (Acquisition of Shares) Act as that legislation does not apply to a company whose membership does not exceed 15 persons: CASA s13(1). Accordingly there will be no need to make special provision in the Close Corporation legislation for the operation of CASA.

Winding Up

[187] The Australian Law Reform Commission is currently undertaking an overall review of insolvency laws as they pertain to both individuals and corporations. This review is continuing and therefore the Committee's comments on winding up are provisional only and may require modification or further adaptation as a result of the outcome of that review.

[188] The Committee suggested in its Discussion Paper that the provisions of the Companies Code dealing with voluntary and compulsory winding up and dissolution of the corporate entity be adopted for close corporations, with the addition of relevant winding up provisions of the Partnership Act (Partnership Act (N.S.W.) s35). The Committee maintains this basic approach, though it notes that a number of commentators have pointed to the high costs associated with normal corporate winding up and have stressed the need for a more simplified liquidation procedure.

[189] Recognition would have to be given in any winding up procedure to the flexibility inherent in the internal arrangements of close corporations. This may be achieved by a provision that the capacity of members to bring about a members' voluntary winding up should require the concurrence of such number of members as is specified in any association agreement. Short of any such agreement, any member may seek a voluntary winding up of the corporation.

[190] Recommendation 39

The Committee recommends that the provisions of Part XII of the Companies Code be adopted, pending the outcome of the ALRC Review, modified by a provision that the capacity of members to initiate a members' voluntary winding up require the concurrence of such number of members as is specified in the Association Agreement.

[191] In addition to these general principles governing winding up, a number of particular issues arise which call for separate consideration.

Deferring Debts of Members

[192] The Company Directors Association proposed that members loans to the corporation be deferred behind unsecured creditors. Inherent in this proposition is the belief that members prefer to advance necessary working capital by way of loan rather than equity. If adopted, members loans would rank for payment after all external creditors have been paid,
but before other amounts owing to members in that capacity.

[193] Recommendation 40

The Committee recommends that amounts owing to members by way of loans to the corporation will rank for payment after all external creditors have been paid in full but before other amounts owing to members in their capacity as members.

Provisional Liquidator

[194] The Discussion Paper suggested that in the case of a failing close corporation, provision be made for its members to appoint an official liquidator as a provisional or controlling liquidator of the corporation, in advance of meetings of members and creditors. The appointment would last for a specified period within which the requisite meetings would be called. That period could be extended by the NCSC but should cease upon the appointment of a liquidator in a winding up. The provisional liquidator would be eligible to be appointed as the winding up liquidator.

[195] The controlling liquidator would immediately take charge of all the affairs of the corporation and therefore supersede the powers of the members. A precedent for this procedure is found in Part X of the Bankruptcy Act. There was general support in the submissions for such an appointment.

[196] Recommendation 41

The Committee recommends that members be empowered to appoint an official liquidator as a provisional or controlling liquidator of the close corporation in advance of meetings of members and creditors.

Liquidators' Recovery Fund

[197] The Committee observed that the adequate investigation of many corporate insolvencies is hampered by lack of funds available to liquidators. The Committee's Discussion Paper suggested, as a partial solution, the establishment in each jurisdiction of a liquidators' recovery trust fund. To that fund all close corporations would be required to contribute on their being registered and they might also be required to make periodic contributions. A liquidator would be empowered to apply to the court ex parte for an order that an amount be advanced from the fund to defray the Costs of investigation and/or any civil recovery proceedings.

[198] The court would be empowered to award the provision of an amount from the fund, with or without conditions, on it being satisfied that there existed a prima facie case for a declaration. It would be provided that if proceedings in which the liquidator was so assisted resulted in recovery, a proportion of the amount recovered should be paid back into the liquidation recovery trust fund.

[199] The Committee believes that the recovery trust fund principles may have useful application to all corporate insolvencies, though in the context of this Report, discussion is confined to close corporations.

[200] There was opposition in some submissions to the introduction of a recovery fund. Some representations expressed concern with the administrative costs in running a fund, while others claimed that the large number of solvent businesses would be under an unfair burden in being required to contribute to a fund directed against insolvent operators. The West Australian Corporate Affairs Office observed that post failure investigation provisions have been found to do little for creditor protection and pose immense difficulties in regard to prosecution.

[201] A number of other submissions were strongly in favour of the establishment of a recovery fund. A submission from a firm of liquidators pointed out that in dealing with numerous liquidations of failed businesses, the firm had been unable, in many instances, to fully investigate the affairs of the insolvent company because of a lack of sufficient assets to cover expenses.

[202] The Committee believes that a recovery fund would confer a general public benefit, both in assisting creditors and increasing public perception as to the enforcement of liabilities arising from a liquidation. These would outweigh the costs and contribution objections raised in various submissions.

[203] The costs involved in liquidations might also be lessened if all examinations by liquidators were conducted in lower courts in a manner analogous to existing procedures for judgement debts. Currently such examinations of insolvent companies under the Companies Code are conducted at various

court levels, in different jurisdictions. The Committee believes that it would be unnecessary to involve higher courts in liquidators examinations of persons concerned with close corporations.

[204] Recommendation 42

The Committee recommends that provision be made for creation of a liquidators' recovery fund to assist liquidators to defray the cost of investigation and associated civil procedures arising from the insolvency of close corporations. Liquidators' examinations of persons concerned with close corporations should take place in lower courts.

Offences

[205] The Companies Code contains a range of offences associated with corporate activities. These are found mainly in Part XIV Division 2 of the Companies Code. The Committee favours their application to close corporations.

[206] Recommendation 43

The Committee recommends that the principles found in the offence provisions of the Companies Code: s553-564; 568-574; be included in the Close Corporation legislation.

Conversion

[207] It would be appropriate to include provisions whereby companies registered under the Companies legislation which satisfied the criteria for close corporations and which desired to obtain the advantages of:

* not having to appoint directors; and

* being subject to a lesser degree of external regulation

could convert to close corporations.

[208] Eligibility to convert would be limited to those companies whose membership conformed to the appropriate maximum for a close corporation, whose membership was confined to natural persons, and which had the prescribed number of members resident in Australia or an external territory. Companies with share capital would need to have all their issued shares fully paid.

[209] An equivalent provision would need to be inserted in the Companies Act and Codes to provide for the conversion of close corporations to companies.

[210] The Committee recognises that it would be necessary to examine the lodgment fees associated with conversion, and their incentive implications.

[211] Recommendation 44

The Committee recommends that provisions be included in the Close Corporation legislation entitling eligible companies to convert to close corporations, with an equivalent provision in the Companies Code for the conversion of close corporations to companies.

Elimination of the Category of Exempt Proprietary Company [212] The Committee believes that given the facility for formation of close corporations which do not have to lodge accounts or have their accounts audited, it would be appropriate, consequent upon the introduction of Close

Corporation legislation, to discontinue the category of exempt proprietory companies. The choices then available would be non-corporate status (unincorporated sole trader; partnership), close corporation, non-exempt proprietary company, or public company. The incentive for adopting the close corporation form over the other corporate entities would be the minimum external regulation associated with the former. By contrast non-exempt proprietary companies and public companies would have to comply with all the relevant provisions of the Companies Code, including the lodgment of audited annual returns.

[213] One consequence of the elimination of the status of exempt proprietary company would be that existing exempt proprietary companies which were barred from converting to close corporations, such as companies acting as trustees or companies with corporate membership, would be required to appoint an auditor and provide key financial data. This factor, and the loss of other benefits associated with the exempt proprietary company status, may place a substantial new burden on these companies.

[214] To overcome this problem the Committee proposes inclusion of a "grandfather" clause whereby after the Close Corporation legislation is enacted, no proprietary company will be accorded "exempt" status unless it held that status immediately prior to the enactment and remains continuously qualified for that status. An exempt proprietary company which subsequently converts to a close corporation or becomes ineligible to remain as exempt, for any period, shall not be entitled to revert to that exempt proprietory status. To better enforce this provision after introduction of the Close Corporation legislation, it would be appropriate to require exempt proprietary companies to file an annual declaration that they have continuously satisfied the requirements for exempt status.

[215] In this way the legislation will provide a mandate for the future without disturbing the rights of already established exempt proprietary companies.

[216] Recommendation 45

The Committee recommends that following enactment of the Close Corporation legislation, the category of exempt proprietary company be discontinued. Existing exempt proprietary companies may continue to be accorded the benefits of that status during such time as they remain continuously qualified as such companies.

Committee Members

H.A.J. Ford (Chairman)
R. I. Barrett
D. A. Crawford
A. B. Greenwood
K. W. Halkerston

Research Director

J. B. Kluver

September, 1985.

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APPENDIX I

LIST OF RESPONDENTS

Australian Associated Stock Exchanges
Australian Automobile Dealers Association
Australian Bankers' Association
Australian Formation Services Pty. Ltd.
Australian Institute of Credit Management
Australian Small Business Association (N.S.W. Branch)
Australian society of Accountants and the Institute of Chartered Accountants in Australia
John C. Barnes & Co.: Public Accountants
Kevin G. Bliss & Associates Pty.: Public Accountants
Chamber of Manufactures of New South Wales
Clark & Talbot: Public Accountants
Commercial Law Association of Australia: Company Law Advisory Committee
The Company Directors' Association of Australia
The Confectionery and Mixed Business Association of Australia and New Zealand
Coopers & Lybrand: Chartered Accountants
Corporate Affairs Office, Perth
Department of Industry and Commerce (Cth.)
Electronic Toy Services
Mr. K. L. Fletcher: Senior Lecturer in Law:
University of Queensland
Foodland Associated Limited
Furniture Retailers Council of Australia
Hooper & Company: Public Accountants

(ii)

Horwath & Horwath: Chartered Accountants
The Institute of Chartered Secretaries and Administrators: Victorian Branch
Mr. J. G. Jackson: Lecturer in Legal Studies: University of Wollongong
Lander & Rogers: Solicitors
Mr. P. Latimer, Senior Lecturer in Law: Monash University
Law Council of Australia: Business Law Section
The Law Society of Western Australia Mr. D. H. Price
Price Waterhouse: Chartered Accountants
Mr. T. Short: Senior Lecturer in Law: South Australian Institute of Technology
Small Business Association of Victoria
Small Business Council (Cth)
Small Business Development Corporation (Vic.)
Small Business Development Corporation (W.A.)
The Small Business Development Council of N.S.W.
Mr. I. A. Smith: Lecturer in Accounting: University of Tasmania
Sutton, Darbyshire and Smith: Public Accountants
Mr. I. A. Thomson
Victorian Chamber of Manufacturers
Mr. A. Viney
Mr. R. K. Winterton

APPENDIX 2

RECOMMENDATIONS

RECOMMENDATION 1

The Committee recommends that close corporations be regulated by way of separate legislation established pursuant to the procedures and practices created by the Formal Agreement of December 1978.

RECOMMENDATION 2

The Committee recommends that the Close Corporation legislation be administered by the Ministerial Council, the NCSC and the various State and Territorial Corporate Affairs Authorities, pursuant to the administrative arrangements under the Formal Agreement of December, 1978.

RECOMMENDATION 3

The Committee recommends adoption of the term "Close Corporation" with the CC abbreviation.

RECOMMENDATION 4

The Committee recommends that the maximum membership be set at 10 persons. In determining the membership of a close corporation joint members should be counted as separate members.

The Committee further recommends inclusion of a provision that any increase in membership of a close corporation above the maximum shall constitute grounds for winding up.

RECOMMENDATION 5

The Committee recommends that the minimum membership of a close corporation be one person.

RECOMMENDATION 6

The Committee recommends that membership be confined to natural persons. Juristic persons shall be excluded from membership except where this is necessary by operation of law. No juristic person shall indirectly hold a member's interest in a corporation, whether through the instrumentality of a natural person as its nominee, trustee or, otherwise.

RECOMMENDATION 7

The Committee recommends that close corporations be prohibited from being holding companies, as that term is understood under the Companies Code. A close corporation that wishes to create subsidiary companies must transfer to and comply with requirements of the Companies Code. A close corporation that acts as a holding company in breach of the close corporation legislation shall be deemed as and subject to all the duties and liabilities of a holding company incorporated under the Companies Code.

RECOMMENDATION 8

The Committee recommends the inclusion of an Australian or external territory residence requirement for at least one member of a close corporation. Failure to observe this residence requirement would constitute grounds for winding up.

RECOMMENDATION 9

The Committee recommends that management disqualification provisions based on s227, s227A and s562 of the Companies Code be adopted, with a further provision that the close corporation be wound up in the event that the corporation has no members.

RECOMMENDATION 10

The Committee recommends that the interests of each member shall be expressed as a percentage of the capital interest of the close corporation. The combined interests of all members must at all times total 100%. All interests must be fully paid. A close corporation would be prohibited from offering its interests or debentures to the public or a section thereof.

RECOMMENDATION 11

The Committee recommends adoption of the term "founding statement" to describe the document lodged with the Commission pursuant to registration of a close corporation.

RECOMMENDATION 12

The Committee recommends that incorporation of a close corporation would entail the registration of a single document, known as the founding statement. This statement must set out four particulars, namely:

* the full name of the corporation

* the address of the corporation

* the full name and date and place of birth of each member

* particulars of the accounting officer.

A close corporation may register as a number.

The founding statement would be updated by submitting an amendment of particulars. There would be no provision for lodging a periodic return.

RECOMMENDATION 13

The Committee recommends that the legislation should provide, in terms analogous to s68C of the Companies Code, that no person shall be deemed to have knowledge of any particulars merely because they are stated or referred to in any founding or other lodged statement.

RECOMMENDATION 14

The Committee recommends that the relevant principles found in the Partnership Act, as adapted for close corporations, should regulate the rights of members inter se. These provisions may be altered or extended by means of a written association agreement or any other agreement, express or implied, between the members which is not inconsistent with the association agreement. The common law doctrine of constructive notice shall not apply to any association or other agreement.

RECOMMENDATION 15

The Committee recommends that members of a close corporation be subject to a series of fiduciary duties and obligations drawn from relevant partnership law principles and the fiduciary duty provision of the Companies Code.

RECOMMENDATION 16

The Committee recommends exclusion of the common law ultra vires doctrine and that a close corporation shall have the same capacity and powers as a natural person, except that it may not act as a trustee under an express trust, other than where it is required to do so by operation of law.
Personal liability shall attach to any person who purports to act on behalf of a trustee close corporation.

RECOMMENDATION 17

The Committee recommends that the external relations of close corporations be regulated by common law agency rules, as adapted from the partnership legislation.

RECOMMENDATION 18

The Committee recommends that a member shall be defined in the legislation as:

* anyone identified as such in the current founding statement, and

* any natural person occupying or acting in the position of a member of a close corporation, independently of whether that person is recorded as a member in the founding statement.

RECOMMENDATION 19

The Committee recommends that provisions analogous to s81 of the Companies Code be adopted to regulate pre incorporation contracts.

RECOMMENDATION 20

The Committee recommends inclusion of the provision, drawn from s218 of the Companies Code, that the corporate name followed by the phrase "close corporation" or the abbreviation "CC" appears on all official documents.

RECOMMENDATION 21

The Committee recommends that the legislation adopt the partnership rules applicable to changes of membership supplemented by a provision equivalent to s186 of the Companies Code.

RECOMMENDATION 22

The Committee recommends that a member may relinquish his membership by:

* providing satisfactory notice to the corporation of his decision to retire;

* lodging with the Commission an appropriate amendment to the founding statement; and

* no longer acting in the capacity of a member.

RECOMMENDATION 23

The Committee recommends that a person shall not be entitled to enforce membership rights if at the relevant time his name did not appear as a member in the founding statement. However, a non-registered member would not be barred from commencing an oppression or winding up action.

RECOMMENDATION 24

The Committee recommends that a close corporation be entitled to acquire the interests of members, subject to satisfaction of a solvency and liquidity test. The liquidator would be entitled to recover any amounts paid by the corporation where it is established that at the time of payment the company was not both solvent and liquid.

RECOMMENDATION 25

The Committee recommends that the Companies Code model of defeasible limited liability be retained for close corporations, with the grounds of defeasibility determined in accordance with Recommendation 26.

RECOMMENDATION 26

The Committee recommends three legislative grounds of recourse against members personally in the event of the insolvency of a close corporation:

* a provision adopting the principle underlying s556 (1) and s557 of the Companies Code;

* compensation to the corporation for assets improperly disposed of; and

* imposition of unlimited liability on members who unduly delayed terminating the activities of an insolvent close corporation.

RECOMMENDATION 27

The Committee recommends that there be no requirement that close corporations have a minimum paid up capital.

RECOMMENDATION 28

The Committee recommends that there be no requirement that close corporations disclose their actual paid up capital.

RECOMMENDATION 29

The Committee recommends that Close Corporation legislation include specific provisions allowing corporations to:

* acquire their own interests;

* provide financial assistance for the purchase of their interests; and

* distribute funds otherwise than pursuant to the law of dividends.

The interests of creditors would be protected by solvency and liquidity requirements.

RECOMMENDATION 30

The Committee recommends that a close corporation shall be required to keep its accounting records in such a manner as would enable a profit and loss account and balance sheet to be readily prepared in a manner capable of being conveniently audited. A close corporation shall not be required to have the accounts audited or file an annual return.

RECOMMENDATION 31

The Committee recommends the inclusion of provisions that:

* service of documents be effected either by personal delivery to one or more members or delivery at the address of the close corporation stated in the founding statement;

* courts be empowered to require close corporations to give security for costs;

* a certificate of incorporation be conclusive evidence of such incorporation;

* any admission or representation made by a member concerning the affairs of a close corporation and in the ordinary course of its business be evidence against the close corporation; and

* books of a close corporation have the same evidentiary value and be admissible in the same manner as books of a company incorporated under the Companies Code.

RECOMMENDATION 32

The Committee recommends adoption of the partnership principle that subject to any contrary agreement, no member shall be entitled to renumeration for acting in the close corporation business.

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The Committee recommends that the Close Corporation legislation include oppression provisions based on s320 of the Companies Code. An oppression action may be commenced by any member, whether or not registered. The legislation should also provide that no majority of members may expel a fellow member unless a power to do so has been conferred by express agreement between all the members.

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