

States, commonwealth put on the gloves

Challenges to Australia's federal corporate law

Australian corporate law is a sometimes clumsy mix of federal and state jurisdiction. There is hope that it can be mended. IAN RAMSAY gives an overview of the federal structure of the law, refers to the judgments which challenge this structure and examines the possibilities for reform.



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As a result of recent High Court judgments, Australia's federal structure of corporate law is under substantial challenge. The seriousness of the situation is demonstrated in an Australian Securities and Investments Commission media release of 23 March 2000 in which ASIC chairman Alan Cameron said that recent judgments "reflect the High Court's view that the complex, highly technical scheme to create, by agreement, a regime of national regulation by the commonwealth administering state laws is indeed so complex, that it falls under its own weight". Cameron is quoted as saying that the recent cases demonstrate the need to fix the basic question of company law in Australia once and for all.

AUSTRALIA'S FEDERAL STRUCTURE OF CORPORATE LAW

Although many people typically think of Australia's corporate law as being a national law, the reality is very different. Corporate law is state law but with a number of

federalising features. In other words, the Corporations Law is an act of each of the states. The reason for this lies in the High Court judgment in *New South Wales v Commonwealth* (1990) 169 CLR 482 where the High Court considered section 51(xx) of the constitution in the context of an attempt by the commonwealth parliament to enact a national Corporations Act. Section 51(xx) gives the commonwealth parliament power to legislate with respect to "foreign corporations, and trading or financial corporations formed within the limits of the Commonwealth". In this 1990 judgment, the High Court (by a majority of six to one) held that section 51(xx) did not confer on the commonwealth parliament power to deal with the incorporation of companies. Only the state parliaments have this power.

It must be recalled that the commonwealth parliament's attempt to legislate nationally for the regulation of companies (including the incorporation of companies) followed

persistent problems with the previous so-called cooperative scheme which existed from 1982 until the end of 1990. In 1987 the Senate Standing Committee on Constitutional and Legal Affairs published a report titled "The Role of Parliament in Relation to the National Companies Scheme" in which the committee identified a number of substantial problems with the cooperative scheme, including lack of uniform administration by the state Corporate Affairs Commissions, lack of accountability and duplication of functions between the state Corporate Affairs Commissions and the National Companies and Securities Commission. In addition, there were general concerns about the need for more effective national enforcement. The committee recommended that the commonwealth government should assume full responsibility for corporate regulation and this resulted in the enactment of the Corporations Act 1989 (Cth) and the Australian Securities Commission Act 1989 (Cth). However, the High Court judgment in *New South Wales v Commonwealth* meant that significant parts of the Corporations Act were unconstitutional.

Negotiations between the various state governments and the commonwealth government led to an agreement which was signed in June 1990. Each state would enact its own Corporations Act and the Commonwealth Corporations Act would apply only to the Australian Capital Territory and not to the states. However, in order to have a national structure for the regulation of companies, a number of key federalising features were added. Some of the more important were:

- The Australian Securities Commission (now the Australian Securities and Investments Commission) was established as the national regulator to assume full responsibility for the regulation of companies. It replaced the state Corporate Affairs Commissions and the National Companies and Securities Commission.
- Federal administrative bodies such as the Administrative Appeals Tribunal and the Commonwealth Ombudsman would have a role to play in corporate regulation.
- The investigation and prosecution of offences under the various state Corporations Acts would be undertaken by ASIC, the federal police and the

commonwealth director of public prosecutions (DPP).

- The Federal Court was given the power to hear matters arising under the state Corporations Acts. This was done by means of cross-vesting legislation.
- Any amendments that the commonwealth parliament made to its Corporations Act would automatically apply in each of the states without the need for the state parliaments to pass further amendments.
- The commonwealth government was given enhanced voting on the ministerial council (which is constituted by the relevant commonwealth and state government ministers) in order to strengthen its role.

Chapter III of the constitution did not allow the state governments, even with the agreement of the commonwealth government, to invest federal courts with state jurisdiction.

In summary, despite the fact that the High Court judgment in *New South Wales v Commonwealth* meant that the commonwealth parliament did not have the power to deal with the incorporation of companies and therefore there would need to be some form of state companies legislation, a strong effort was made to have national regulation of companies. This structure is now under substantial challenge as a result of several recent judgments.

THE RECENT CHALLENGES

Re Wakim

In *Re Wakim* (1999) 31 ACSR 99;17 ACLC 1,055, the High Court struck down the cross-vesting legislation referred to above. Although all the state governments and the commonwealth government had agreed that it was appropriate for the Federal Court to play a role in disputes arising under the state Corporations Acts, the High Court held that this was unconstitutional on the basis that Chapter III of the constitution did not allow the state governments, even with the agreement of the commonwealth government, to invest federal courts with state jurisdiction.

The effect of this judgment has been to eliminate virtually all of the Federal Court's jurisdiction to hear matters arising under the state Corporations Acts. The consequences of the decision have been profound. First, in order to overcome the threat that all previous judgments of the Federal Court dealing with state Corporations Act matters are invalid, the state governments have passed what can be described as emergency legislation to deem these previous Federal Court decisions to be decisions of the various state Supreme Courts and therefore valid. However, there are currently several challenges to these validating acts and these challenges are expected to be heard by the High Court later this year.

Second, cases commenced in the Federal Court before the *Re Wakim* judgment needed to be recommenced in the relevant state Supreme Court with additional costs imposed on the parties. Third, we have seen a substantial number of judgments since *Re Wakim* in which courts have endeavoured to more clearly identify what jurisdiction remains with the Federal Court and there is still uncertainty in relation to this important issue. Fourth, a number of commentators have found it regrettable that the Federal Court, which had built up over the course of the past 10 years considerable expertise in corporate law matters (and often was quicker in terms of being able to hear such matters than a number of the state Supreme Courts), is now effectively precluded from hearing these matters. Finally, some commentators have also found it regrettable that the situation which had successfully worked for the previous 10 years of allowing litigants in matters arising under the state Corporations Acts to have a choice of courts (the Federal Court or the relevant state Supreme Court) no longer exists. Statistics on the effect of *Re Wakim* were tabled in federal parliament on 30 May 2000 by the attorney-general, Daryl Williams. The High Court handed down its decision in *Re Wakim* on 17 June 1999. In the 24 months up to June 1999, 1,500 Corporations Law cases were filed in the Federal Court, an average of 62 cases each month. In the period from July 1999 to March 2000, only six Corporations Law cases were filed in the Federal Court — on average, less than one case a month.

Bond v The Queen

A further challenge to the federal structure of Australia's corporate law has resulted from the decision of the High Court in *Bond v The Queen* (2000) 33 ACSR 563 on 9 March of this year. In brief, the High Court held that the commonwealth director of public prosecutions does not have the power to appeal against a sentence imposed for a breach of a state Corporations Act. The commonwealth DPP does have the power to initiate and institute prosecutions for such breaches, but it does not have power to appeal against sentences.

As a result of this judgment, such appeals will need to be instituted by the relevant state DPP. However, the commonwealth parliament has recently passed legislation with the objective of restoring the role of the commonwealth DPP.

The Queen v Hughes

This decision of the High Court was delivered on 3 May 2000 and is reported at (2000) 34 ACSR 92; 18 ACLC 394. The decision has received extensive media coverage, including editorials in national newspapers.

The commonwealth DPP alleged that Hughes had breached the Corporations Act of Western Australia by obtaining \$300,000 from investors in Western Australia and investing this through a United States securities house, PaineWebber Incorporated, without complying with the disclosure and other requirements in the WA Corporations Act. The investors had been promised that they could double their money, although they only regained their principal and this was almost three years after they invested.

In order for the commonwealth DPP to have the power to prosecute a breach of the WA Corporations Act, section 29(1) of that act provides that commonwealth laws apply as

laws of Western Australia in relation to an offence against the relevant provisions of the WA Corporations Act, as if those provisions were laws of the commonwealth. This means that an offence against an applicable provision of the WA Corporations Act is taken to be an offence against the laws of the commonwealth, in the same way as if that provision was a law of the commonwealth.

They state that “urgent legislative action is required to restore certainty to, and business confidence in, corporate regulation in Australia”.

Hughes argued that this was unconstitutional. The High Court rejected this argument. The court stated that it was valid to impose powers and functions on commonwealth officers such as the DPP where those powers are conferred by state law and with respect to the prosecution of state offences, provided that the commonwealth parliament has the power under the constitution to create its own offences against commonwealth law in relation to those matters.

Because Hughes had invested the \$300,000 in the United States, the High Court held that the appropriate constitutional power was section 51(i) of the constitution — granting the commonwealth parliament power to legislate with respect to trade and commerce with other countries and section 51(xxix) of the constitution which gives the commonwealth parliament power to legislate with respect to external affairs.

Section 51(xx) of the constitution gives the commonwealth parliament power to legislate with respect to foreign corporations and trading or financial corporations formed

within Australia but it was doubtful whether this could apply in the circumstances because Hughes had not used a company to offer the investments.

IMPLICATIONS

The implications of the decision in *Hughes* are significant. The High Court has emphasised the need for specific power under the constitution where the commonwealth parliament imposes functions on commonwealth bodies in relation to state legislation. Because the constitution only gives the commonwealth parliament limited powers, there is a significant grey area concerning a number of existing powers. For example, an important function of ASIC is the regulation of managed investments, which are typically structured as trusts. The High Court specifically left open whether the current regulation of managed investments is constitutionally valid, although the court did note some arguments in support of the validity of the existing arrangements. There is also some doubt about the existing arrangement whereby ASIC regulates the incorporation of companies given that in its 1990 decision (*New South Wales v Commonwealth*) the High Court ruled that the commonwealth parliament has no power to regulate the incorporation of companies.

Further challenges following the *Hughes* decision were quickly predicted. This is because of the narrow basis of the decision — the court was able to uphold the power of the commonwealth DPP to prosecute Hughes essentially because he had invested the funds overseas and there is specific power in the constitution dealing with external affairs and trade and commerce with other countries. Indeed, one of the High Court judges, Justice Kirby, specifically stated that it was only the “peculiar circumstances of this case” — that is, the fact that Hughes invested the funds offshore — that meant the power of the DPP to prosecute was valid under the constitution. Justice Kirby clearly highlighted the threat of further challenges to the power of the DPP and ASIC when he said that “the next case may not present circumstances sufficient to attract the essential constitutional support”.

The further challenges have already commenced. In *GPS First Mortgage v Lynch*, a person facing bankruptcy at the behest of a

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company incorporated under the Corporations Law is arguing, on the basis of *Hughes*, that the company's incorporation by ASIC was invalid and therefore the company does not exist. The federal attorney-general has stated that this case goes to the validity of the incorporation of (more than 660,000) companies which no doubt have been transacting business since incorporation (*The Australian*, 8-9 July 2000, page 5).

RESPONSES TO THE HUGHES DECISION

The commonwealth attorney-general and the minister for financial services and regulation issued a joint media release following the *Hughes* decision in which they stated that the decision has added uncertainty to our existing system of corporate regulation. They state that "urgent legislative action is required to restore certainty to, and business confidence in, corporate regulation in Australia".

SOME POSSIBLE SOLUTIONS

What solutions might there be to the unravelling of the federal structure of corporate regulation? One possibility is a referendum to amend the constitution to grant enhanced power to the commonwealth government in relation to corporate regulation.

A second possibility is a referral by each of the state governments to the commonwealth government of their power to regulate companies. Such a referral is permitted under section 51(xxxvii) of the constitution. The commonwealth attorney-general and the minister for financial services have each called for a referral by all of the state governments of their power to regulate companies to the commonwealth government. The chairman of ASIC, Alan Cameron, has also stated that a referral of power is a necessary step that should be taken without delay.

The attorneys-general of Western Australia and South Australia have indicated opposition to a referral. However, just because one or two states do not refer their power to the commonwealth, the other states are not prevented from referring their power. If a majority of states did this, the remainder might quickly fall into line if they realised that substantial costs would be imposed on companies which are incorporated within their state boundaries if they did not join the national scheme. It may be, for example, that

companies incorporated in these states would need to register as foreign companies in the states which had joined the national scheme in order to conduct business in those states. The concept of companies incorporated in one state being required to register as a foreign company in another state in which the company wanted to do business was required under earlier companies legislation.

A third possibility would be for there to be a split system of regulation between the states and the commonwealth. State governments would regulate the incorporation of companies and possibly some other matters while the commonwealth government would regulate matters such as takeovers and fundraising by companies. Australia would not be the first country to have such a system. In the United States, there is a split system of regulation with each of the 50 states regulating the incorporation of companies and other matters while the Securities and Exchange Commission (the federal regulatory agency) deals with other matters such as fundraising by companies. Whether such a split system would work in Australia must be subject to some doubt, particularly given the uncertainty as to where the power of the state governments to regulate companies ceases and where the power of the commonwealth government to do so begins. A number of the issues associated with state government versus commonwealth government regulation of companies are examined in articles including: M. Whincop, 1999, "The Political Economy of Corporate Law Reform in Australia", 27 *Federal Law Review* 77, and I. Ramsay, 1990, "Company Law and the Economics of Federalism". 19 *Federal Law Review* 169.

CONCLUSION

Few would doubt that Australia's federal system of corporate law has worked successfully for the past decade. Not everyone may be fully satisfied but we no longer hear the substantial complaints that we did in the 1980s about a lack of uniform administration of companies legislation. The judgments referred to in this article pose substantial challenges to our existing system of corporate regulation. Inevitably, the solution lies with a negotiated settlement between the state governments and the commonwealth government. One hopes that solution is reached quickly. **J**

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