Research Report

EMPLOYEE SHARE OWNERSHIP PLANS IN AUSTRALIA: THE CORPORATE LAW FRAMEWORK

Ingrid Landau and Ian Ramsay

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Employee Share Ownership Project

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CCLSR CENTRE for CORPORATE LAW and SECURITIES REGULATION

The Employee Share Ownership Project is a joint initiative of the **Centre for Corporate Law and Securities Regulation**, the **Centre for Employment and Labour Relations Law** and **The Tax Group**. It is funded by an Australian Research Council Discovery Project Grant.

The project subjects the existing regulatory regime for employee share ownership plans in Australia – in tax, corporate and labour law – to technical and empirical scrutiny. It analyses how current legal regulation structures and constrains the use of ESOPs in Australian enterprises. It examines the current incidence and forms of ESOPs in Australia, the diversity of objectives that such schemes serve, the extent to which current corporate, tax and labour law inhibit ESOPs, and the case for reform of the regulatory framework.

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EMPLOYEE SHARE OWNERSHIP PLANS IN AUSTRALIA: THE CORPORATE LAW FRAMEWORK

Ingrid Landau[*] and Ian Ramsay[†]

1 INTRODUCTION

There is no singular piece of legislation regulating the establishment or administration of employee share ownership plans (ESOPs) in Australia. Companies in Australia proposing to offer securities to employees must ensure they comply with a myriad of regulatory requirements. These regulatory considerations emanate principally from corporate law and taxation law. This paper focuses on the corporate law aspects of broad-based employee share schemes.[1]

Rules governing employee share ownership plans within a company may be found in a company's own constitution. Beyond this, the principal statute in Australia governing corporations – the *Corporations Act 2001* (Cth) – contains a number of general requirements relating to disclosure, fundraising and licensing that are relevant to the initial implementation and ongoing administration of an ESOP. While the Act contains several provisions relating specifically to employee share schemes, it does not generally provide for different treatment of employee shares. For this reason, the Australian Securities and Investments Commission (ASIC) has issued a Policy Statement and Class Order that provide conditional relief from specific disclosure and licensing provisions within the *Corporations Act* for companies establishing eligible employee share schemes.[2]

Permeating the Australian corporate law regulatory framework for employee share plans is the concern of regulators to strike an appropriate balance between recognising the public policy objective of promoting broad-based employee share plans whilst protecting the interests of potential employee investors and existing shareholders. Whether the current balance struck between these objectives is the most desirable one remains the subject of contention.

This paper is structured as follows. Part 2 outlines the disclosure requirements upon companies when issuing securities to employees. It identifies the general requirements under the *Corporations Act* and examines the conditional relief from these provisions provided by ASIC. In Part 3, the authors consider how the *Corporations Act* regulates the funding of employee share schemes. Part 4 looks briefly at employee share scheme trusts. Australian Stock Exchange (ASX) Listing Rules relevant to employee share schemes are outlined in Part 5. Part 6 examines potential legal issues arising from companies in relation to financial services licensing and securities hawking. Part

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[1] Broad-based schemes refer to schemes in which a majority of employees within the company are eligible to participate.
[2] In this paper, the terms 'employee share ownership plan' and 'employee share scheme' are used interchangeably.

7 looks briefly at the extent to which companies may impose restrictions upon employee shares. In Part 8, the authors identify and briefly outline relevant corporate governance standards. Part 9 outlines the broad accounting standard requirements upon companies in relation to employee share schemes.

Part 10 of the paper turns to consider how the current law governing directors' duties in Australia may regulate the implementation of employee share schemes. It looks at the duty of directors to act in good faith for the benefit of the company as a whole and the duty to issue shares for a proper purpose. Finally, it identifies how an employee shareholder who believes a director has abused his or her powers may challenge such actions. After exploring the regulatory framework governing the establishment of employee share schemes, this paper turns to consider, in Part 11, the extent to which the *Corporations Act* provides avenues through which employee shareholders can seek to promote and protect their unique set of interests. Finally, in Part 12, the authors identify the key criticisms of the corporate law framework in this area.

2 DISCLOSURE REQUIREMENTS WHEN ISSUING SECURITIES TO EMPLOYEES

2.1 General requirements under the Corporations Act 2001 (Cth)

Companies seeking to offer their employees shares must comply with the general disclosure requirements in Part 6D.2 of the *Corporations Act*, unless there is a specific exemption in the Act or relief is provided by ASIC.[3] Generally speaking, a company intending to offer employees shares is required under Part 6D.2 of the Act to issue a prospectus.[4] Such disclosure requirements are primarily intended to ensure that investors in newly issued securities of a corporation have access to the information which a reasonable investor would require for the purpose of making an investment decision.[5]

There are two exemptions from the disclosure requirements in s 708 of the Act which may potentially provide relief for companies wishing to establish employee share schemes. First, a company may be exempt from the disclosure requirements where the offer is a small scale offering.[6] This exemption applies providing three conditions are met. First, the offers must be personal offers for issue or sale of a body's securities.[7] Second, none of the offers must result in a breach of the 20 investors ceiling. Third, none of the offers must result in a breach of the $2 million ceiling. The 20 investor ceiling will be breached where the offer results in the number of people to whom securities have been issued exceeds 20 in any 12 month period.[8] The $2 million ceiling will be breached if the offer results in the amount raised exceeds $2 million in any 12 month period. ASIC has observed that this exemption for small scale offerings may be useful for small proprietary companies who wish to establish employee share schemes. Even for small companies with more than 20 employees, the exemption could be used repeatedly, providing the 12 month limit has expired each

[3] *Corporations Act* s 706.
[4] *Corporations Act* s 709.
[5] R P Austin and I M Ramsay, *Ford's Principles of Corporations Law* (13th ed, 2007) [22.010].
[6] Section 708(1).
[7] A personal offer is defined in s 708(2).
[8] *Corporations Act* s 708(3)(a).

time.[9] This exemption, of course, will be of limited utility to large companies issuing shares under an ESOP.[10]

A second potential exemption may apply where shares are provided to employees at no cost. Under s 708(15), disclosure to investors is not required when no consideration is to be provided for the issue or transfer of the shares. Section 708(16) provides a similar exemption for options issued for no consideration. Sartori warns, however, that ASIC has taken a narrow view of this exemption, finding that where continued employment is a condition of the securities grant, consideration has been provided.[11]

Finally, where a body is seeking, through an issue of securities, to raise no more than $5 million, the company may use a simpler form of disclosure document – an Offer Information Statement (OIS) – in lieu of a prospectus. Under s 709, a company may use an OIS when the amount of money to be raised by issue of the securities, when added to all amounts previously raised by the issuing body, its related bodies corporate and entities controlled by the issuer's controller and the controller's associates, by issuing securities under an OIS is $5 million or less.[12]

The Government has expressed its opinion that an OIS provides an appropriate level of disclosure for employees of unlisted companies and their financial advisers.[13] However, Austin and Ramsay note that the utility of s 709 for small and medium-sized enterprises is limited due to the requirement in s 715 that an OIS include a copy of an audited financial report with a balance date within the last six months. They observe that many such enterprises are generally not under any requirement to have their financial statements audited, and the appointment of an auditor only for the purposes of the OIS is likely to be disproportionately expensive.[14]

The Corporate and Financial Services Regulation Review Proposals Paper, released by the Parliamentary Secretary to the Treasurer in November 2006, has proposed to increase the threshold amount in s 709(4) from $5 million to $10 million and to provide that amounts issued under employee share schemes by unlisted companies are excluded from this calculation.[15] These reforms are intended to facilitate the spread of employee share schemes in unlisted companies.

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[9] Australian Securities and Investment Commission, 'Inquiry into Employee Share Ownership in Australian Enterprises' (Submission in relation to the House of Representatives Standing Committee on Employment, Education and Workplace Relations Inquiry into Employee Share Ownership, 27 July 1999) 2.
[10] J Sartori, 'Employee Share Ownership Plans – Issues Confronting ASX Listed Companies' (2005) 23 *Corporate & Securities Law Journal* 71, 79.
[11] Ibid 79.
[12] *Corporations Act* s 709(4).
[13] Commonwealth of Australia, 'Corporate and Financial Services Regulation Review: Proposals Paper' (November 2006) 64.
[14] Austin and Ramsay, above n 5, [22.300]. The authors note that, while ASIC has identified the circumstances in which it may give relief from this requirement in PS 157, these circumstances appear very limited.
[15] Commonwealth of Australia, above n 13, 64.

2.2 Conditional relief from disclosure provisions provided by ASIC

ASIC has power under the *Corporations Act* to specify exemptions from the disclosure requirements in Pt 6D.2.[16] ASIC has issued a Policy Statement and a Class Order that provide conditional relief to listed companies seeking to establish employee share schemes.

ASIC's Policy Statement 49 (PS 49), first issued in 1993 and substantially revised in 2003, sets out the basis upon which ASIC will provide conditional relief from the disclosure and licensing provisions of the *Corporations Act* for offers made under employee share schemes where the company is listed on the ASX or an approved foreign exchange.[17] It is ASIC policy to give conditional relief to companies where the purpose of the share offer is to involve employees in ownership of the corporate employer rather than for fundraising purposes, and if there are otherwise adequate protections for employees.[18] Policy Statement 49 notes that

> [t]he disclosure provisions and the Australian financial services (AFS) licensing requirements of the Act may apply to ESSs [Employee Share Schemes] in a way that is disproportionately burdensome where financial products are made available in order to promote a relationship between an employer and employee that is ongoing and substantial with a common perceived goal.[19]

ASIC justifies the exemption on the basis that the employer-employee relationship 'is additional to, and distinct from, the interest a shareholder may have in an issuing corporation. The existence of this mutual interdependence reduces some of the risk that the disclosure provisions and the licensing provisions were intended to address.'[20]

The Policy Statement notes that the disclosure relief provided through the Class Order is conditional. The conditions in the Class Order are designed with three objectives in mind. First, to ensure that the aim of the offer is not fundraising. Accordingly, ASIC has imposed a 5% limit on the number of shares that can be issued under an eligible employee share scheme.[21] Second, the offer sufficiently supports the long-term mutual interdependence between the offeror and the offeree. Finally, adequate disclosure is provided to investors.[22] ASIC ensures adequate disclosure to investors through providing that conditional relief will only be granted where the shares offered to employees are in a class listed on the ASX or an approved foreign exchange; the options being issued free or for nominal consideration and the underlying shares are in a class listed on the ASX or an approved foreign exchange; and the company to have been listed for at least 12 months at the time of the offer.[23] Additional conditions

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[16] *Corporations Act* s 741 (1). For the power to grant exemptions from PDS requirements, see s 1020 F(1).
[17] [PS 49.1].
[18] [PS 49.3].
[19] [PS 49.5].
[20] [PS 49.5].
[21] This means that an employee share scheme offer cannot exceed 5% of the total number of issued shares in that class of the issuer at the time of the offer: [PS49.32]. See also [PS 49.33]– [PS 49.34].
[22] [PS 49.20].
[23] [PS 49.20].

of disclosure relief are imposed for contribution plans and offers made through a trust.[24]

PS 49 emphasises that ASIC has not provided class order relief to partly paid shares, on the basis the such offers may expose employees to levels of risk that outweigh the benefits from allowing reduced disclosure. Nonetheless, ASIC will consider case-by-case relief where the arrangements do not expose the employee to significant liabilities.[25]

While the PS does not extend class order relief to casual employees, it does note that ASIC will consider extending relief to offers to casual employees or contractors on a case-by-case basis. In doing so, ASIC will consider the length of time the employee has been in the employment of the company and the likely ongoing relationship between the parties.[26]

ASIC Class Order 03/184, issued in 2003, offers three exemptions from the disclosure provisions of the *Corporations Act*.[27] The first exemption offers disclosure relief for offers of shares, units of shares, options and stapled securities. The second exemption provides disclosure and other relief for offers involving a contribution plan (defined as a plan under which a participating eligible employee may save money by regular deductions from wages or salary towards paying for shares offered under an employee share scheme)[28] and the third exemption provides disclosure relief for offers of options by an unlisted body. The overall effect of these detailed provisions is to provide conditional relief from the need to produce a prospectus for certain offers of shares or options over unissued shares made to full time or part time employees under an employee share scheme.

3 FUNDING EMPLOYEE SHARE SCHEMES

In designing an employee share scheme, companies must choose how the shares offered to employees are to be funded. Shares may be bought on market or issued and paid for by loans from the company to the employee participant or funded out of a share of profits or salary sacrifice arrangements. Less commonly, employees may be issued shares at a market or predetermined price but only required to pay up a small portion of their value, remaining liable for any unpaid amounts of the shares.[29] Most employee share plans involve some financial contribution from the company. In financing the employee shares, a company must comply with the relevant fundraising provisions within the *Corporations Act.*

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[24] [PS 49.21].
[25] [PS 49.25].
[26] See [PS 49.38] – [PS 49.40].
[27] The fourth exemption in the Class Order relates to licensing and hawking relief. This is dealt with in Part VI of this paper.
[28] See CO 04/184, Interpretation [6]. Note that the CO specifies terms and conditions that must be included in the contribution plan.
[29] Employee Share Ownership Development Unit, 'Developing an Employee Share Ownership Plan' (Commonwealth of Australia, 2003). Available at <http://www.workplace.gov.au/workplace/Category/SchemesInitiatives/ESO/>.

3.1 Restrictions on a company acquiring an interest in its own shares

The *Corporations Act* imposes a general prohibition upon a company limited by shares acquiring an interest in shares in itself.[30] This extends to cases where the interest is taken by way of security for repayment of a loan. Section 259B identifies four exceptions to this general rule, including one that specifically relates to 'employee share schemes'.

An 'employee share scheme' is defined in s 9 of the Act as:

> a scheme under which shares (or units in shares) in the company or a holding company may be acquired:
> (a) by, or for the benefit of:
> (i) employees of the company, or of a related body corporate; or
> (ii) directors of the company, or of a related body corporate, who hold a salaried employment or office in the company or in a related body corporate; or
> (b) by a corporation all of whose members are:
> (i) employees of the company, or of a related body corporate; or directors of the company, or of a related body corporate, who hold a salaried employment or office in the company or in a related body corporate.

A company is permitted to take security over its own shares under an employee share scheme, provided that the scheme is approved by a resolution of members in general meeting of the company and, if it has a parent domestic corporation (defined in s 9 to mean a corporation that is incorporated or formed in Australia or external territory), the parent company also approves.[31]

3.2 Restrictions on a company financially assisting a person to acquire its shares

Companies may seek to encourage employees to participate in employee share schemes through offering shares at less than market value, providing low interest loans to employees or offering the shares free. Under the *Corporations Act*, a company is permitted to financially assist a person to acquire shares in itself or in its holding company in stated circumstances, including if the giving of the assistance is exempted by 260C.[32] Providing shares as a gift to employees or at less than market value or making a loan to employees to purchase shares are all forms of 'financial assistance'.[33] Section 260C(4) states that financial assistance is exempted from s 260A if it is given under an employee share scheme that has been approved by a

[30] Section 259A. The rationales behind this general rule are identified in Austin and Ramsay, above n 5, [24.360].
[31] Section 259B(2).
[32] Section 260A(1).
[33] For the making of a gift, see *Re VGM Holdings Ltd* [1942] Ch 235; for the making of a loan to a person to purchase shares in the company, see *Shearer Transport Co Pty Ltd v McGrath* [1956] VLR 316.

resolution of members in general meeting of the company and, if it has a parent domestic corporation, the parent company also approves.[34]

3.3 Employee share buy-backs

A company wishing to establish an employee share scheme may be reluctant to issue new shares as this will dilute the value of existing shares. The Act permits a company to buy back its own shares from existing shareholders so long as the buy-back does not materially prejudice the company's ability to pay its creditors and the company follows the procedures laid down in Pt 2J Div 2 of the Act. The Act provides specifically for employee share scheme buy-backs. The procedure for an 'employee share buy-back' is outlined in s 257B. An 'employee share buy-back' is defined in s 9 as

> A buy-back under a scheme that:
>
> (a) has as its purpose the acquisition of shares in a company by, or on behalf of:
>
> (i) employees of the company, or of a related body corporate; or
>
> (ii) directors of the company, or of a related body corporate, who hold a salaried employment or office in the company or in a related body corporate; and
>
> (b) has been approved by the company in general meeting.

The procedure for an employee share buy-back will differ depending upon whether the proposed buy back exceeds the 10/12 limit. This limit refers to 10% of the smallest number of votes attached to 'voting shares' at any time 'during the last 12 months'.[35] Where the proposed buy-back does not exceed this limit, a company must lodge notice of its intention with ASIC at least 14 days prior to the intended buy-back,[36] cancel the shares on registration of transfer[37] and notify ASIC of the cancellation of the shares.[38] Where the 10/12 limit is exceeded, a company can still buy back its shares but it must obtain approval of the terms of the buy back agreement in general meeting by ordinary resolution.[39] A company that is listed on the ASX will also need to lodge the relevant documentation with ASX when it decides to make an employee share buy-back.[40]

3.4 On-sale of securities

Where securities are issued under an employee share scheme and then resold within 12 months, the sale could fall under the on-sale provisions in the Corporations Act.[41] The Act seeks to prevent circumstances in which an issuer which offers new shares for investment seeks to avoid its disclosure obligations by issuing the securities to a

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[34] Section 259B(2).
[35] Section 257B(4). A 'voting share' is defined in s 9.
[36] See s 257F.
[37] See s 257H.
[38] Section 254Y.
[39] Section 257C.
[40] ASX Rule 3.8A.
[41] This issue is explored in Sartori, above n 10, 80.

single entity who will then on-sell them to investors through identifying certain circumstances in which a secondary sale will be treated as a first issue.[42] Section 707(3) of the Act requires that a body comply with the same disclosure requirements had the issuer offered its securities directly to investors where the offer of a body's securities for sale is made within 12 months after their initial issue without a disclosure document, and if the initial transaction was for the purpose of subsequent on-sale.

ASIC has issued a Class Order that, providing certain requirements are met, provides relief from the on-sale provisions in the Act for employee share schemes. ASIC Class Order 04/ 671 provides class order relief from s 707(3) where the securities were issued without disclosure to investors under Part 6D.2 because the issuer relied on CO 03/ 184 or on an individual instrument of relief granted by ASIC to the issuer which provided relief from Part 6D.2 with respect to an employee share scheme.[43]

4 ESOP TRUSTS

Employee share ownership plans are generally structured in one of two ways: the shares or options may be issued directly to employees or to a trustee to hold on trust for the employees. A company may choose to administer an ESOP through a trust for a range of reasons, including, for example, to administer the various performance and/ or vesting conditions that apply to an ESOP; to enable the orderly and cost effective acquisition and disposal of smalls hare holdings; and to enable a company to control and manage its share registry costs.[44]

If an ESOP is to be administered through a trust, then the company will need to draw up a relevant trust deed and nominate a trustee. While the *Corporations Act* imposes requirements for trusts, relief may be available under CO 03/184. The Class Order provides conditional relief from the disclosure provisions in the *Corporations Act* in cases where an offer is made through a trust, providing a number of conditions relating to the design and administration of the trust are met.[45]

5 ASX LISTING RULES

Employee share schemes within companies listed on the ASX are also regulated by the ASX Listing Rules.[46] The ASX Rules provide for two main exceptions from generally-applicable requirements for 'employee incentive schemes'. An employee incentive scheme is defined in Chapter 19 as: (a) a scheme for the issue or acquisition of equity securities in the entity to be held by, or for the benefit of, participating employees or non-executive directors of the entity or a related entity; or (b) a scheme which, in ASX's opinion, is an employee incentive scheme.

Under ASX Listing Rule 7.1, an entity must not issue, or agree to issue, equity securities amounting to more than 15% of the issued capital in any rolling 12 month period without shareholder approval unless an exception applies. Rule 7.2, Exception

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[42] Austin and Ramsay, above n 5, [22.030].
[43] Class Order 04/ 671, Schedule D.
[44] Employee Share Ownership Development Unit, above n 29.
[45] See CO 03/184, Schedule, [4].
[46] These rules are binding by virtue of ss 793C and 1101B of the *Corporations Act*.

9, provides that an issue under an employee incentive scheme is exempt from the requirement in Listing Rule 7.1 if, within 3 years before the date of issue, one of the following occurred:

(a) in the case of a scheme established before the entity was listed – a summary of the terms of the scheme were set out in the prospectus, Product Disclosure Statement or information memorandum;
(b) Holders of ordinary securities have approved the issue of securities under the scheme as an exception to this rule. The notice of meeting must have included each of the following:
  - A summary of the terms of the scheme.
  - The number of securities issued under the scheme since the date of the last approval.
  - A voting exclusion statement.

The second exception is found within Chapter 10 of the Listing Rules, which regulates transactions between an entity and a person in a position to influence the entity. Under ASX Listing Rule 10.11, unless one of the exceptions in Listing Rule 10.12 applies, an entity must not, without first obtaining the approval of holders of ordinary securities, issue or agree to issue equity securities to 'a related party' or 'a person whose relationship with the entity or a related party is, in ASX's opinion, such that approval be obtained'. However, Rule 10.12, Exception 4 recognises that Rule 10.11 does not apply to cases in which the person is a person referred to in Rule 10.14 and receives the securities under an employee incentive scheme with approval under that rule.

Rule 10.14 states that an entity must not allow any of the following persons to acquire securities under an employee incentive scheme without the approval of holders of ordinary securities of the acquisition: a director of the entity; an associate of a director; a person whose relationship with the entity or a person referred to in Rules 10.14.1 or 10.14.2 is, in ASX's opinion, such that approval should be obtained.[47] This rule does not apply to securities purchased on market under the terms of a scheme that provides for purchase of securities by or on behalf of employees or directors. Finally, a company proposing to establish an employee share scheme must also notify ASX of the proposed issue of securities in accordance with Listing Rule 3.10.3.

6 FINANCIAL SERVICES LICENCING AND SECURITIES HAWKING

If a company includes advice about the employee share scheme in any document offering shares to employees, it may be providing 'financial services' under the *Corporations Act*. The Act requires that any body providing 'financial services' must hold an Australian Financial Services License (AFSL). A person provides a financial service if he or she performs one of the functions identified under s 766A, including the provision of financial product advice. Companies establishing an ESOP, or trustees issuing securities to employees, may be providing financial product advice, which is defined in the Act as 'a recommendation or a statement of opinion, or a report of either of those things, that:

[47] The notice for this meeting to obtain approval must comply with either Rule 10.15 or 10.15A: Rule 10.14.

(i) is intended to influence a person or persons in making a decision in relation to a particular financial product; or

(ii) could reasonably be regarded as intended to have such an influence.'[48]

Where an employee share scheme has disclosure relief by virtue of ASIC Class Order 03/ 184, ASIC also provides relief from the requirement to hold an AFSL for persons involved in the operation of the employee share scheme. This relief, however, is subject to the condition that the financial service consists '… of general advice reasonably given in connection with an offer referred to in those exemptions (including any general advice given in the offer document) where the offer document for the offer includes a statement to the effect that any advice given by the person in connection with the offer is general advice only, and that employees should consider obtaining their own financial product advice from an independent person who is licensed by ASIC to give such advice.'[49] This exemption from the need to have an AFSL also applies where the employee share scheme is administered through a trust, providing certain conditions are met.[50]

In addition, a company offering securities to its employees may fall afoul of the prohibitions against securities hawking contained in sections 736, 992A and 992AA of the *Corporations Act*. These provisions prohibits the issue or sale of securities arising out of unsolicited contact with investors, including offers made to employees. The prohibitions apply only to unsolicited telephone calls and meetings. They do not apply to other common forms of communications such as email, letters, facsimiles, brochures or media advertisements.[51]

Under para [7] of ASIC Class Order 03/ 184, a person who is eligible for relief from the disclosure provisions in Part 6D.2 of the Act will automatically be exempt from sections 736, 992A and 992AA in relation to offers made in the course of, or because of, unsolicited meetings or telephone calls reasonably held or made in connection with the offer.

The Corporate and Financial Services Regulation Review has recently proposed to extend the relief from the licensing, advertising and hawking requirements of the Act through Class Order 03/184 to unlisted companies that have made the offer of shares under an OIS or other disclosure document.[52]

7 IMPOSITION OF RESTRICTIONS ON SHARES

A company may wish to impose restrictions upon the shares offered to employees under an employee share scheme. Such restrictions may be designed, for example, to discourage employees from selling their shares within a certain time frame; to provide the company with some security that money owing will be collected from employees;

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[48] Section 766B(1).
[49] CO 03/184, [5].
[50] CO 03/184, [6].
[51] Australian Securities and Investment Commission, 'The Hawking Prohibitions: An ASIC Guide' (July 2002, reissued May 2005) 8.
[52] Commonwealth of Australia, above n 13, 64.

or to preserve control of the company.[53] Restrictions on the rights attaching to shares may be desirable within small companies where the company wishes to establish an employee share scheme but wants to ensure control remains with an individual or family. The *Corporations Act* recognises a company may issue different classes of shares and may determine any rights and restrictions attaching to the shares. Where a company's constitution provides for employee shares and designates the incidents attaching to this class of shares, Australian courts have limited themselves to determining the appropriate construction of such clauses.[54]

8 CORPORATE GOVERNANCE STANDARDS

A number of other organisations in Australia are active in setting standards for the implementation and administration of employee share plans, particularly for listed public companies. These include the Investment and Financial Services Association (IFSA), the Australian Institute of Company Directors (AICD), the Australian Shareholders Association (ASA) and the Australian Employee Ownership Association (AEOA). The Employee Share Scheme Guidelines, endorsed by the above four organisations, provide guidance for Boards and shareholders in relation to the development of broad-based employee share schemes.[55] While the Guidelines refrain from recommending any particular structure for employee share scheme on the basis that different plans may be appropriate for different companies, they do articulate several key principles relating to the structure of share schemes; the number of shares and options issued under ESOPs; and transparency and accountability. In relation to designing schemes, the Board should, for example, ensure adequate corporate education processes are in place to explain the inherent risks and rewards of share ownership and the details of the plans operation to employees and should make such a scheme available to all employees where appropriate. In relation to restrictions on share schemes, a 'reasonableness test' should be applied to the volume of shares and options issued under an ESOP. In addition, ordinary shares issued as a result of an ESOP should rank equally with other shares owned by existing investors, including that employee shareholders should be able to receive dividends and voting rights. Finally, the guidelines promote transparency and accountability in employee share schemes, principally through providing that all ESOPs should be fully disclosed and justified to shareholders.

9 ACCOUNTING STANDARDS

In 2004, the Australian Accounting Standards Board (AASB) issued AASB 2: Share-based Payment, which mirrors the International Accounting Standards Board (IASB)'s International Financial Reporting Standard 2: Share-based Payment.[56] All

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[53] N C Brash, 'Does Australian Law Help or Hinder the Establishment of Employee Share Schemes?' (PhD Thesis, The University of Melbourne, 1995) 657–8.

[54] See, eg, *O'Donnell v Thor Industries Pty Ltd and Another* (1977) 14 ALR 61, where a dispute arose concerning whether an employee, when relinquishing his shares upon termination of employment in accordance with the company's constitution, was entitled to payment for his shares; *Stillwell Trucks Pty Ltd v Nectar Brook Investments Pty Ltd* (1993) 12 ACSR 334, concerning valuation of employee shares after cessation of employment.

[55] International Finance and Securities Association, 'Employee Share Scheme Guidelines' (IFSA Guidance Note No 13, May 2000).

[56] AASB 2 is available at <www.aasb.com.au/>.

Australian companies, with the exception of small proprietary companies, are obliged to comply with the Standard by virtue of s 296(1) of the *Corporations Act.*[57]

Very broadly, the Standard requires an entity to recognise share-based transactions, including those with its employees, in its financial statements. An entity is required to disclose information so that readers of its financial statements are able to understand the nature and extent of share-based payment arrangements that existed during the reporting period, including expenses associated with the transactions in which share options are granted to employees; how the value of the equities was determined; and the effect the issue of equities has on the entity's profit or loss.

In its Basis for Conclusions on IFRS 2 Share-based Payment, the IASB articulated its considerations in formulating the Standard.[58] Given that the Australian standard mirrors the international one, it can be presumed that the policy rationales are also similar. The Basis for Conclusions specifically addresses the issue of whether 'broad-based' employee share plans should be subject to the same accounting requirements as other types of employee share plans.[59] The Board recognised concerns expressed by some that broad-based plans should be exempt from an accounting standard on the basis that the plans were not part of remuneration for employee services and that recognition within financial reports of an expense in relation to such plans was inimical to government policy to encourage employee share ownership. The Board concluded, however, that in principle there was no reason to treat broad-based plans differently. This conclusion rested on two broad considerations. First, the fact that the schemes were available only to employees was deemed by itself to be sufficient to conclude that the benefits provided represented employee remuneration. 'Remuneration' is construed widely to include all benefits to employees and the 'services' provided by employees is also broad enough to encompass all benefits provided to the company in return, including, for example, increased productivity or employee commitment. Secondly, the public policy objectives of some governments in encouraging employee share ownership was not, in the Board's opinion, a valid reason for according broad-based plans different treatment.

10 DIRECTORS' DUTIES

In establishing an employee share scheme, directors are required to exercise their powers in accordance with their duties under general law and statute. Of particular relevance to a decision to issue shares to employees are the duties on directors to act in good faith in the best interests of the company, and for a proper purpose. In most cases, a decision to establish an employee share scheme will not be controversial, as it will be easily justifiable on the basis that it has the potential to benefit the company through, for example, attracting and retaining skilled employees or leading to

[57] Section 292. A small proprietary company is not subject to the general statutory requirements to produce a financial report unless it is controlled by a foreign company for all or part of the accounting period, and the small proprietary company's profit or loss for the period is not covered by accounts of the foreign company lodged with ASIC (s 292(2)) or shareholders holding 5% or more of the voting shares in the company direct it to prepare financial statements and reports no later than 12 months after the end of the financial year concerned (s 293) or ASIC requests that the company prepare financial statements (s 294).
[58] 'International Financial Reporting Standard 2: Share-based Payment: Basis for Conclusions' (2006).
[59] International Financial Reporting Standard 2: Share-based Payment: Basis for Conclusions (2006), BC8 – BC18.

improvements in organisational productivity. There are, however, circumstances in which a decision to issue shares under an employee share plan may be deemed by the courts to be an improper use of directors' powers.

This section explores how directors' duties limit the purposes for which directors may establish employee share schemes. It examines the position under Australian law, briefly considering, in turn, the duty of directors to act in good faith in the best interests of the company and the duty to issue shares for a proper purpose. It is in this latter circumstance, where a decision to establish an employee share scheme is taken in the context of a hostile takeover, that the issue of directors duties comes to the fore.

10.1 The duty to act in good faith for the benefit of the company as a whole

Directors are under a fiduciary and statutory obligation to act in good faith for the benefit of the company as a whole.[60] The courts are generally reluctant to closely scrutinise the decisions of directors: as emphasised by Lord Greene MR in *Re Smith & Fawcett,* directors must act 'bona fide in what they consider – not what the court may consider – is in the best interests of the company.'[61] In Australia, not only are directors not under any general or statutory obligation to consider the interests of employees, but, where they do, they may be vulnerable to actions by general shareholders for failing to consider the interests of existing shareholders.[62] Therefore, a decision to implement an employee share ownership plan in a form and manner that substantially benefits employees at the expense of the company could conceivably leave directors vulnerable to an action for breach of their general duty to act in good faith in the interests of the company as a whole. In addition, if circumstances where a decision taken by directors will adversely influence the interests of one class of shareholders (e.g. ordinary shareholders vis-à-vis employee shareholders), the directors are required to act fairly as between the members of the differing classes.[63]

10.2 Takeovers and the duty to issue shares for a proper purpose

It is in the context of hostile takeovers that the use of employee share schemes is most likely to give rise to allegations of breach of directors' duties.[64] A common defensive

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[60] *Re Smith & Fawcett Ltd* [1942] Ch 304; *Corporations Act* ss 181(1) and 184(1).
[61] *Re Smith & Fawcett Ltd* [1942] Ch 304 at 306.
[62] *Parke v Daily News Ltd* [1962] Ch 927.
[63] *Mills v Mills* (1938) 60 CLR 150.
[64] There is a significant body of case law in the United States on this issue. See, for example, *Podesta v Calumet Industries, Inc* Fed. Sec. L. Rep. (CCH) 96, 433 (N.D. Ill. 1978); *Norlin Corp v Rooney, Pace, Inc* 744 F.2d 255 (2nd Cir 1984); *Shamrock Holdings Inc v Polaroid Corp* 559 A.2d 257 (Del. 1989); *NCR Corp v American Telephone & Telegraph Co* 761 F. Supp. 475 (S.D. Ohio 1991); *RCM Sec. Fund, Inc. v. Stanton, 928 F.2d 1318 (1991)*. For discussion, see G M Agresta-Richardson, 'Employee Stock Ownership Plans: Uncertainties Plaguing the Duties of the ESOP Fiduciary with Respect to Voting and Defensive ESOPs' (1999) 14 *Akron Tax Journal* 92; E Grannis, 'A Problem of Mixed Motives: Applying *Unocal* to Defensive ESOPs' (1992) 92 *Columbia Law Review* 851; B McDonnell, 'ESOP's Failures: Fiduciary Duties when Managers of Employee-Owned Companies Vote to Entrench Themselves' (2000) *Columbia Business Law Review* 199; M McLean, 'Employee Stock Ownership Plans and Corporate Takeovers: Restraints on the Use of ESOPs by Corporate Officers and Directors to Avert Hostile Takeovers' (1983) 10 *Pepperdine Law Review* 731; and E Hollo, 'The Quiet Revolution: Employee Stock Ownership Plans and their Influence on Corporate Governance, Labor Unions and Future American Policy' (1991) 23 *Rutgers Law Journal* 561.

tactic employed by directors against a hostile takeover bid is the allotment of shares to a 'friendly' holder. Employee share plans provide a mechanism through which directors may create a substantial group of shareholders – employees – that tend to be sympathetic to management interests.[65] In circumstances where a board of directors decides to implement an employee share scheme in close temporal proximity to the threat of a hostile takeover, the courts are faced with the difficult task of determining whether the share issue was undertaken in good faith in the best interests of the company, and for a proper purpose.[66] In most cases, it will be the duty to issue shares for a proper purpose which will be the subject of scrutiny.

The duty upon directors to exercise their powers, including the power to issue shares for a proper purpose, has its source in general law and in sections 181 and 184 of the *Corporations Act.* In applying the proper purposes doctrine, Australian courts will first identify the nature of the power exercised by the director and the purpose for which it was conferred.[67] This purpose, and the limitations within which the power can legitimately be exercised, will generally be ascertained through a close examination of the company constitution.[68] In the absence of relevant internal rules, the court will infer the purpose from the type of company, its activities and its constitutional structure. The court will then determine the substantial purpose for which the power was in fact exercised, in order to determine whether the power was exercised honestly and in the interests of the company: *Howard Smith Ltd v Ampol Petroleum Ltd*.[69] In seeking to determine whether a particular exercise of power is within the proper purposes for which it was conferred, the courts will look to the subjective motivations of the directors.

The courts have recognised that there are many valid reasons for issuing shares beyond raising capital.[70] Courts will not interfere where they deem the dominant purpose of the share issue to be a legitimate commercial objective. Directors are not, however, entitled to use their powers to issue shares for the dominant purpose of consolidating or ensuring their own continuing control through attempting to preserve

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[65] R Levy, *Takeovers Law and Strategy* (2002) [10.5.2].

[66] Since the *Corporate Law Economic Reform Program Act 1999* (Cth), actions taken by directors in listed companies or those with more than 50 members in the context of a contested takeover will be examined by the Takeovers Panel rather than by the courts: s 659AA. Nonetheless, civil and criminal proceedings can still be brought after the conclusion of a takeover bid, or with the consent of ASIC or the Minister: s 659B(1). The Takeovers Panel is a peer review body with part time members appointed from Australia's takeovers and business communities. It has the power to declare circumstances in relation to a takeover, or to the control of an Australian company, to be unacceptable. The Panel has issued 'Guidance Note 12: Frustrating Action' to provide guidance on actions of target company directors that may frustrate a takeover bid. In this Guidance Note, the Panel emphasises that the task of enforcing directors' duties lies with the courts; the Panel is concerned with the likely effect of action on the target shareholders' ability to decide on the offer [at 12.17]. The Panel may declare there to be unacceptable circumstances even if there is not a breach of directors' duties: GN 12 at [12.18], or may decide not to make a declaration of unacceptable circumstances even where directors' duties have been breached. Nonetheless, as Austin and Ramsay note, whether or not a director has used his or her powers for a proper purpose is still relevant to Panel deliberations. See the discussion in Austin and Ramsay, above n 5, [8.205]. Where the Panel has found circumstances to be unacceptable, it has wide powers to make orders under s 657D of the *Corporations Act.*

[67] *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821.

[68] *Mills v Mills* (1938) 60 CLR 150; *Ngurli Ltd v McCann* (1953) 90 CLR 425.

[69] [1974] AC 821.

[70] *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821; *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483.

the existing majority or creating a new majority.[71] The courts have generally proved more willing to scrutinise board decisions in relation to the duty to exercise powers for a proper purpose than the general duty to act in good faith for the benefit of the company.[72]

10.2.1 *Mixed purposes*

Directors who decide to implement an employee share plan in the context of a takeover bid will generally argue that they have done so for a proper purpose (i.e. to benefit the company through improved employee commitment etc), whereas those who allege a breach of duty will argue that the primary motive of the share allotment was to affect control of the company. In most cases, it will be likely that the evidence will suggest the directors were influenced by both considerations: that is, that they had multiple purposes. In deciding whether a decision motivated by a number of purposes is valid, it has been long established in Australia that one looks to the substantive or dominant objective for which the action was directed: *Mills v Mills.*[73] However, more recently in *Whitehouse v Carlton Hotel Pty Ltd,* Mason, Deane and Dawson JJ, obiter dicta, opined that the preferable test is 'but for' the impermissible purpose, the power would not have been exercised.[74] In circumstances where a decision to implement an employee share scheme is prompted by a takeover bid, the differences between these two tests would appear important. Applying the conventional test, it appears that, even where directors are spurred into reaching a decision to issue shares by the presence of a hostile takeover bid, this will not be held invalid if the decision is otherwise commercially justifiable.[75] However, applying the 'but for' test, the fact that the takeover attempt triggered action would invalidate the decision.[76]

The decisions reached in *Hogg v Cramphorn*[77] and *Condraulics Pty Ltd v Barry & Roberts Ltd,*[78] both concerned with the validity of a decision to implement an employee share plan taken in the context of a hostile takeover bid, demonstrate the difficulty in determining whether a particular share issue is motivated by a proper purpose. In *Hogg v Cramphorn,* the directors of a company that was the subject of a takeover bid established a trust for the benefit of the company's employees, and authorised the company to lend money on an interest-free basis to the trust to permit it to purchase unissued shares in the company. The shares were issued with voting rights that were sufficiently weighted to ensure that the directors, their supporters and the trustees would continue to enjoy majority voting power. The share issue was challenged by a minority shareholder.

It was undisputed that the employee share scheme was formulated in such a manner as to effectively thwart the takeover bid. The court found that but for the takeover bid,

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[71] *Hogg v Cramphorn* [1967] Ch 254; *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] 1 All ER 1126; *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285.
[72] Austin and Ramsay, above n 5, [8.060].
[73] (1938) 60 CLR 150.
[74] (1987) 162 CLR 285 at 294. The 'but for' test was applied by Hodgson J in *Darvall v North Sydney Brick & Tile Co Ltd* (1987) 16 NSWLR 212.
[75] *Pine Vale Investments Ltd v McDonnell & East Ltd* (1983) 8 ACLR 199.
[76] Austin and Ramsay note in relation to the 'but for' test: '[p]resumably, this would exclude an improper consideration that was subordinate to other proper considerations but which triggered action'. Austin and Ramsay, above n 5, [8.250].
[77] [1967] Ch 254.
[78] (1984) 2 ACLC 408.

the scheme would not have come into existence. The court also accepted, however, that in implementing the scheme, the directors honestly believed their actions to be in the best interests of the company and its employees. The court concluded that 'an essential element of the scheme, indeed its primary purpose, was to ensure control of the company by the directors and those whom they could confidently regard as their supporters…'[79] Referring to precedent that established that the purpose of issuing shares to create a sufficient majority to retain control was not recognised as a proper purpose, the court held that the directors had used their power improperly to issue shares.

In the more recent case of *Condraulics Pty Ltd v Barry & Roberts Ltd,*[80] the Supreme Court of Queensland was also asked to consider whether a proposal to introduce an employee share scheme made in the context of a takeover bid was a proper exercise of directors' powers. The initial proceedings were brought by two companies who were seeking to takeover a third company. Shortly before their official take-over announcement, the plaintiffs received a notice convening the annual general meeting of the target company, which proposed a motion to consider and pass a resolution which authorised the board of directors to provide money to a trustee for the purposes of administering an employee share scheme. The plaintiffs sought an injunction restraining the defendant from passing this resolution on two bases, one of which was that the proposal to establish an employee share scheme was motivated by an improper purpose on the part of the board of directors. The plaintiffs did not, however, object to evidence provided by directors demonstrating that they had been considering the introduction of an employee share scheme for some time before the takeover threat eventuated.

On appeal, McPherson J, with whom Derrington J concurred, held that the evidence provided only allowed for a 'possible inference' that the scheme proposed by directors had been prompted by a lack of good faith. McPherson J observed that, on the basis of *Mills v Mills,* the substantial or primary motive influencing the director must be improper. His honour observed:

> A coincidence in the timing of the proposal with the making of the take-over offer is, without more, not ordinarily sufficient to raise an inference of the necessary impropriety of purpose: *Winthrop Investments v Winns Ltd* (1979) 4 ACLR 1, 12; *Pine Vale Investments Ltd v McDonnell & East Ltd* (1983) 8 ACLR 1999, 210.[81]

McPherson J accepted, as the trial judge had, evidence provided by the managing director of the company that the company had been considering introducing such a scheme for some time before the take-over announcement. He also accepted the managing director's explanation that the overriding motivation of the members of the board of directors was to give effect to a long held belief that the introduction of such a scheme would encourage employee loyalty and so benefit the company. McPherson J proceeded to uphold the initial finding that the plaintiffs had failed to make a case that the directors had breached their duty to exercise their powers for a proper purpose.

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[79] At [267], per Buckley J.
[80] (1984) 2 ACLC 408.
[81] At 920.

These two cases show the fine distinctions that the courts are asked to draw on the basis of the evidence before them. The task before the court is to determine as a question of fact whether the exercise by directors of a corporate power was such that, but for the existence of the takeover threat, an allotment of shares under an employee share plan would not have taken place. Directors appear to have a much greater chance of defending their actions where they can demonstrate that they were considering introducing an employee share scheme prior to the existence of the hostile takeover bid.[82]As Austin and Ramsay conclude, 'There seems to be no escape for the tribunal of fact from the difficult task of deciding whether one of a number of purposes can be taken to have been more important than others in the minds of the directors.'[83]

10.2.2 *Standing to challenge*

Shareholders who believe a director abused his or her powers to allot shares to employees may wish to challenge the decision. An individual shareholder may be granted leave by the court to bring a derivative action for breach of duty by a director on behalf of the company under Pt 2F.1A of the *Corporations Act*, where the company is unwilling or unable to bring an action on its own behalf.[84] A shareholder may also have standing to bring a personal action where the breach of duty constitutes a breach of a personal right. Where a court deems an allotment of shares to be a breach of a directors duty, the allotment is voidable rather than void.[85]

11 EMPLOYEE SHAREHOLDERS: RIGHTS AND REMEDIES

A further set of corporate law considerations arise after an employee share scheme has been established. In seeking to protect their interests as (commonly) minority shareholders, employee shareholders have available to them the range of statutory and equitable remedies that are available to all minority shareholders in Australian companies. Commentators, however, have questioned whether employee share ownership has the potential to bring employee voice into the corporate governance structures of companies.[86] The following section examines whether corporate law in

[82] Levy notes that 'directors of a company will be better able to defend a decision to issue shares if they can demonstrate that they have been considering the particular share issue or transaction for some time before any takeover bid emerged'. See R Levy, *Takeovers Law & Strategy* (2nd ed, 2002) 147.
[83] Austin and Ramsay, above n 5, [8.240]
[84] A court will grant an applicant permission to bring a derivative action under Pt 2F.1A if five criteria are satisfied: (i) it is probable that the company will not itself bring the proceedings, or properly take responsibility for them; (ii) the applicant is acting in good faith; (iii) it is in the best interests of the company that the applicant be granted leave; (iv) there is a serious question to be tried by the court; and (v) either at least 14 days before making the application to the court, the applicant gave written notice to the company of the intention to apply to the court for leave and of the reasons for applying; or it is appropriate for the court to grant leave even though notice was not given to the company: s 237(2). See further I M Ramsay and B J Saunders, 'Litigation by Shareholders and Directors: An Empirical Study of the Statutory Derivative Action' (Research Report, Centre for Corporate Law and Securities Regulation, The University of Melbourne, 2006).
[85] *Winthrop Investments Ltd v Winns Ltd* [1975] 2 NSWLR 666*; Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483.
[86] See, eg, H Collins, 'Employee Shareholders' (1987) 16 *Industrial Law Journal* 268; J Hill, 'At the Frontiers of Labour Law and Corporate Law: Enterprise Bargaining, Corporations and Employees' (1995) 23 *Federal Law Review* 205; J Michie and C Oughton, 'Employee Share-Ownership Trusts and Corporate Governance' (2001) 1; *Corporate Governance* 4; A Reynolds, 'Do ESOPs Strengthen Employee Stakeholder Interests?' (2001) 13 *Bond Law Review* 95; J Michie and C Oughton,

Australia provides legal mechanisms through which employee shareholders can pursue their interests as *employees*, not simply as shareholders. It identifies and briefly explores three avenues: the right to call general meetings and propose resolutions; the minority oppression provisions in the Corporations Act and statutory constraints on variation of class rights.[87]

11.1 Capacity to call shareholder meetings and propose resolutions

Providing that the employee shareholders hold at least 5 percent of the votes that may be cast at a general meeting or constitute at least 100 members, they have the statutory power under the *Corporations Act* to call an extraordinary general meeting.[88] The meeting must be held for a proper purpose, which means that the resolution that the members seek to be passed 'must be within the power of the members to consider and pass'.[89] They may also put forward a resolution to be considered at a general meeting.[90] Any such resolution, however, cannot relate to matters which are vested by the company's constitution in the company's directors.[91] This may limit the extent to which employee shareholders can bring employment-related matters to the attention of shareholders.[92]

The capacity of employee shareholders to use the general meeting to influence the conduct of the business, however, will generally be very limited due to the fact that, in most cases, employees only hold a very small minority of the company's shares. Nonetheless, as Anderson and Ramsay have argued in relation to union shareholder activism, while such methods may not lead to the successful passage of resolutions, they may be effective in placing matters on the AGM and board's agenda and bringing pressure to bear on the company.[93]

11.2 Minority oppression

Under s 232 of the *Corporations Act*, a court may make impose a range of orders where it is satisfied that the company's affairs are being conducted in a way that is 'contrary to the interests of the members as a whole' or 'oppressive to, unfairly prejudicial to, or unfairly discriminatory against, a member or members whether in that capacity or in another capacity.' This is one of the most commonly used

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'Employee Participation and Ownership Rights' (2002) 2 *Journal of Corporate Law Studies* 139; and J Lenne, R Mitchell and I Ramsay, 'Employee Share Ownership Schemes in Australia: A Survey of Key Issues and Themes' (2006) 14 *International Journal of Employment Studies* 1.

[87] Reynolds, above n 86, 105–6.

[88] Section 249D.

[89] *NRMA v Snodgrass* (2001) 19 ACLR 769. For further discussion, see K Anderson and I Ramsay, 'From the Picketline to the Boardroom: Union Shareholder Activism in Australia' (Research Report, Centre for Corporate Law and Securities Regulation and Centre for Employment and Labour Relations Law, University of Melbourne, 2005) 52–5. For a substantially revised and abbreviated version of this paper, see K Anderson and I Ramsay, 'From the Picketline to the Boardroom: Union Shareholder Activism in Australia' (2006) 24 *Company and Securities Law Journal* 279.

[90] Section 249N.

[91] See *Gramaphone and Typewriter Ltd & Standley* [1908] 2 KB 89; *John Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 KB 113. See also Anderson and Ramsay (2005), above n 89, 51.

[92] Anderson and Ramsay, (2005), above n 89, 51–2.

[93] Ibid.

corporate law remedies used by shareholders.[94] Key to the use of this action by employee shareholders is that the conduct, act or omission may affect the member in his or her capacity as a member or in any other capacity.[95] Austin and Ramsay have observed that this may provide a basis for action for a member employed by the company where he or she is prejudiced in the capacity of employee. They note that whether 'the section is attracted would seem to depend on whether, in the circumstances, the employment relation was a way in which the member received a return for investment or whether the employment was independent of being a member'.[96]

The breadth of instances in which this remedy may be used makes it a potentially powerful tool for employee shareholders. In particular, it has been used in the past to appeal against payment of excessive remuneration to directors; the improper diversion of business; and the denial of access to information. While such concerns may be felt by all shareholders, they may be felt particularly acutely by employees concerned with maintaining job security.

11.3 Challenging the validity of a variation of class rights

If employee shareholders are recognised as members of a particular class, they may be afforded the statutory protections offered to class right holders in Part 2F.2 of the Act. In particular, they may have a cause of action to challenge a variation or cancellation of shares under s 246D.

A category of shares will constitute a 'class' where the shares differ sufficiently in respect of rights, benefits, disabilities, or other incidences, as to make them distinguishable from any other category of shares.[97] In *Clements Marshall Consolidated Ltd v ENT Ltd*,[98] Neasey J of the Supreme Court of Tasmania found on the facts of the case that the employee shares did constitute a 'class' as they were a category of shares that differed sufficiently from ordinary shares in respect of voting rights, dividend rights, liability to calls and other aspects.[99]

The classification of employee shares as a particular class of shares becomes important if the company seeks to vary or cancel the legal rights attaching to the shares. A company seeking to do this must follow the procedures prescribed in s 246B of the *Corporations Act.* Moreover, where the procedures are followed and the class of shares is varied or cancelled, s 246D(1) of the Act provides that members with at least 10 percent of the votes in a class may apply to the court to have the variation, modification or cancellation set aside.[100] The Court is empowered to set aside the variation, modification or cancellation if it is satisfied that it would unfairly prejudice the members of the class.[101]

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[94] I Ramsay, 'An Empirical Study of the Use of the Oppression Remedy' (1999) 27 *Australian Business Law Review* 23.
[95] Section 233(e).
[96] Austin and Ramsay, above n 5, [11.470].
[97] *Clements Marshall Consolidated Ltd v ENT Ltd* (1988) 6 ACLC 389 at 393.
[98] (1988) 13 ACLR 90.
[99] At 93.
[100] This application must be made within one month of the variation, modification or cancellation.
[101] Section 246D(6).

12 KEY CRITICISMS OF THE CORPORATE REGULATORY FRAMEWORK FOR EMPLOYEE SHARE SCHEMES

The adequacy of the current corporate law framework governing employee share ownership plans has been the subject of considerable contention. Critics of the current laws include the Australian Employee Ownership Association (AEOA) and the Employee Ownership Group (EOG), both committed to promoting employee share ownership in Australia; a number of ESOP plan managers and consultants and the authors of the *Shared Endeavours* Majority Report. The following section divides the current body of criticism into two broad categories. First, it looks at the most significant and sustained criticism of the current regulatory regime: the difficulties it poses to the implementation of ESOPs in small and medium-sized companies. It then turns to consider specific criticisms directed at the nature of relief offered by ASIC.

12.1 Obstacles to employee share ownership in unlisted companies

The corporate law regulatory regime is criticised for imposing costs and compliance burdens that may effectively deny unlisted companies access to ESOPs.[102] As explained above, the ASIC Policy Statement 49 only provides relief to companies listed on the Australian Stock Exchange for more than 12 months. Unlisted companies or 'sunrise' companies that are newly listed are not eligible for ASIC class order relief. Many commentators have emphasised the costs imposed to unlisted, particularly smaller, businesses by the disclosure requirement under s 708 of the *Corporations Act 2001* (Cth), which requires any company making an offer in excess of 20 people or for over $2 million to issue a prospectus.[103] In its submission to the Nelson Inquiry, for example, Ernst & Young emphasised:

> The ASIC policy statement 49 could be described as a general prohibition on the issue of shares or options to employees of an unlisted company without a prospectus. Whilst the prospectus requirement may not be onerous for companies associating an ESOP with an initial public offering (IPO) they are very significant and often unsurmountable for small/medium unlisted companies.[104]

The difficulties posed to small and medium companies by the current prospectus rules was recognised by the *Shared Endeavours* Majority Report. The Report noted, although limited reforms would be implemented through the Corporate Law Economic Reform Program (CLERP):

> Nevertheless, the Committee does recognise that the amended legislation and Policy Statement 49 together may not provide sufficient relief for certain types of enterprise. Consequently, the existing

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[102] See, eg, Australian Employee Ownership Association, 'Our Policy', available at <www.aeoa.org.au>; Employee Ownership Group, 'Employee Share Ownership in Australia: the Future', available at <www.eogroup.org.au>; E Charles, 'Share and Share Alike' (2005) 75 (10) *In the Black* 28; Lenne, Mitchell and Ramsay, above n 86, 26–7; and numerous submissions to the House of Representatives Standing Committee on Employment, Education and Workplace Relations' inquiry into employee share ownership in 2000, available at < http://www.aph.gov.au/house/committee/ewr/eso/index.htm>.

[103] Charles, above n 102.

[104] Ernst and Young, 'Employee Share Ownership Plans: Comments regarding Issues for Small/Medium Companies and Possible Solutions to Enable Such Companies to Offer Participation in ESOPs' (Submission No 20.1 to the House of Representatives Standing Committee on Employment, Education and Workplace Relations' Inquiry into Employee Share Ownership, 2000).

> disclosure arrangements may still act as a disincentive to those enterprises when they consider establishing an employee share plan.[105]

The two principal advocacy groups for employee share ownership in Australia – the AEOA and EOG – are both critical of the current disclosure requirements imposed on unlisted companies. Both organisations describes the prospectus requirements for unlisted companies and small companies as ‘a major obstacle’ to the diffusion of employee share schemes in unlisted companies.[106] This contention appears to be supported by empirical research: a survey of 1000 businesses commissioned by the Department of Workplace Relations Employee Share Ownership Development Unit (ESODU) in 2004 found that ‘burdensome corporations law requirements’ were seen as a ‘significant barrier’ to business in taking up ESO.[107]

The *Shared Endeavours* Majority Report recommended ASIC and the Government take a number of steps in relation to the corporate law requirements for employee share plans. These included:

- that ASIC monitor the provisions of CLERP and Policy Statement 49 in respect to employee share plans;
- advise the Government as to any required amendments to facilitate the operation of the CLERP in respect of employee share plans without unduly increasing investor risk;
- if necessary, amend Policy Statement 49 so as to facilitate the creation and operation of employee share plans, especially in regard to unlisted, small and medium companies, and those in sunrise industries without unduly increasing investor risk; and
- advise the Treasurer on the feasibility of a specific disclosure document designed to be used by the operators of employee share plans that cannot otherwise use the disclosure exemption provisions or the OIS provisions of the CLERP Act.[108]

The Government rejected this recommendation, arguing that the limited nature of the exemption from prospectus requirements offered by ASIC was necessary in order to ensure that the primary purpose of issuing shares to employees was to foster the employment relationship, rather than as a means of corporate fundraising.[109] Moreover, it argued that CLERP had introduced certain exemptions from the fundraising regime with a focus on assisting small and medium companies and that these reforms struck an appropriate balance between the objectives of facilitating efficient fundraising and ensuring appropriate investor protection. The Government also rejected the Majority Report’s recommendations that ASIC monitor the use of employee share schemes and report to the Government on the basis that ASIC was not

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[105] Standing Committee on Employment, Education and Workplace Relations, House of Representatives, *Shared Endeavours: Inquiry into Employee Share Ownership in Australian Enterprises* (Majority Report, September 2000) 180, 185 (‘*Shared Endeavours*’).
[106] Australian Employee Ownership Association, above n 102.
[107] TNS Social Research, ‘Executive Summary: Employee Share Ownership: Aligning Interests’ (Research commissioned by the ESODU, 2004). Available at < http://www.workplace.gov.au/workplace/Category/SchemesInitiatives/ESO/ESOinAustralia.htm>.
[108] *Shared Endeavours,* above n 105, 186.
[109] ‘Government Response to “Shared Endeavours: An Inquiry into Employee Share Ownership in Australia’. Available at < http://www.treasurer.gov.au/tsr/content/publications/NelsonResponse.asp>.

ordinarily responsible for law reform or for reporting to Government on specific issues. Instead of a formal reporting process to Government, ASIC has the ability to review and modify its policy statements should it consider further relief is warranted or grant individual relief on a case by case basis. More recently, however, the Corporate and Financial Services Regulation Review Consultation Paper identified the potential expense and effort required for unlisted companies to compile a prospectus as an issue for consultation.[110]

Today, both the AEOA and the EOG offer proposals for reform of the current disclosure regime for unlisted companies seeking to introduce employee share schemes. The AEOA proposes lifting the prospectus requirements for unlisted companies in cases where complete 'downside risk protection' on the value of shares is provided.[111] The EOG proposes that ESOPs should be exempt from the prospectus requirements. Necessary investor protection, they argue, can be secured by a minimum prescribed disclosure regime. A proposed 'ESOP Disclosure Document' is appended to the EOG Policy. The model is based on the OIS (as defined in s 715(1) of the *Corporations Act)*, and, it is proposed, would apply to offers made to employees to acquire shares in the company, but not in cases where an ESOP is being used to acquire a majority of the ordinary shares in a company. In the latter case, s 709 of the Act would prevail. The EOG proposes that this regime be implemented either by ASIC, in reliance on its powers of exemption or modification, by Government direction to ASIC in relation to the exercise of these powers, or by legislative reform.[112]

The Business Law Section of the Law Council of Australia has also expressed an opinion in relation to the relief available for unlisted companies, arguing that the current regime should not be fundamentally changed as there is no reason to presume that, in most cases, employee investors are any more informed than other retail investors. It follows that employee investors should be afforded similar protections to retail investors under Chapter 6D of the *Corporations Act*. The Council does, however, argue that there is scope for extending relief in minor ways where the investor protection principles of Chapter 6D have been satisfied. These include, for example, extending the relief offered by ASIC Class Order 03/184 to unlisted companies where nominal consideration is provided and the company satisfied other conditions which ensure that the potential employee investors are reasonably informed.[113]

The Corporate and Financial Services Regulation Review Proposals Paper, released by the Parliamentary Secretary to the Treasurer in November 2006, while proposing to extend the relief offered in Class Order 03/184 in respect to licensing, advertising and hawking requirements to unlisted companies, does not endorse extending relief to unlisted companies in relation to disclosure requirements.

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[110] Commonwealth of Australia above n 13, 34.
[111] Australian Employee Ownership Association, above n 102; Employee Ownership Group, above n 102, 5.
[112] Employee Ownership Group, above n 102, 6.
[113] See Law Council of Australia, 'Submission in Response to the April 2006 Consultation Paper for the Corporate and Financial Services Regulation Review' (24 May 2006), 18–19.

12.2 Limitations of ASIC Class Order Relief

12.2.1 *The five percent ceiling*

To be eligible for relief under ASIC Policy Statement 49, an offer of shares to employees must not exceed more than five percent of the shares issued in that class of shares as at the date of the offer. As noted above, this requirement is imposed by ASIC to ensure that the share issue is not proceeding for fundraising purposes. During the Nelson Inquiry, a number of listed companies with employee share plans criticised this requirement as it significantly restricted the number of shares the company could offer to employees.[114]

12.2.2 *Limitation of relief to full and part-time employees*

ASIC Policy Statement 49 does not extend class order relief to the provision of shares to casual employees. ASIC will, however, consider extending relief to offers to casual employees or contractors on a case-by-case basis. In doing so, ASIC will consider the length of time the employee has been in the employment of the company and the likely ongoing relationship between the parties.[115] The limitations of the Class Order raise equity concerns. Inequities in access and entitlements to company shares, which are common in practice due to varying eligibility requirements within and between organisations, would appear to be exacerbated by the relevant requirements in the ASIC Policy Statement. The restriction is also contrary to the policy of the Australian Council of Trade Unions (ACTU) on employee share schemes, which stresses the need for all employees within an organisation to be eligible to participate.

13 CONCLUSION

Australian companies seeking to implement broad-based employee share ownership plans must comply with a range of regulatory requirements embodied in the *Corporations Act* relating to disclosure, fundraising and licensing. These provisions are intended to protect investors in relation to public share offerings. While they no doubt offer protection to employees who are considering taking up shares in the company for which they work, they are generally ill-suited to serving the different objectives for which companies implement employee share ownership plans. In recognition of the public policy objective of promoting employee share ownership, ASIC now provides conditional relief from specific provisions within the Act for companies establishing eligible employee share schemes.

Critics have argued that the current regime, while facilitating the diffusion of employee share ownership in larger, listed companies, does little to enable employee share ownership in small and medium-sized companies. It is also argued that the conditional relief provided by ASIC significantly limits the extent to which companies may confer significant shareholdings upon employees and offer shares to casual employees.

The extent to which the current regulatory regime shapes and constrains current employee share ownership practice in Australia remains unclear. Tentative

[114] See *Shared Endeavours,* above n 105, 182.
[115] See [PS 49.38] – [PS 49.40].

observations suggest that its impact is significant: for example, employee share ownership remains relatively rare in the SME sector; employee share ownership is noted for its ‘shallowness’ (while there are many employees owning shares, they own relatively few) in larger companies; and casual employees are much less likely to be employee shareholders. More work is needed, however, to understand whether current practice is a reflection of the objectives and priorities of industry actors or whether it is the result of the significant constraints imposed by the corporate law regulatory regime.