Major Transactions by PNG Companies requiring Shareholder Approval

David Frecker* and Kingsford Wamp**

Introduction

One of the objectives of Papua New Guinea's (PNG) *Companies Act* of 1997 (PNG Act) is to give greater shareholder control over the direction and management of companies. This legislation is based closely on the New Zealand (NZ) *Companies Act* 1993 (NZ Act) which is also aimed at providing recognition of the circumstances in which the interests of existing, and in particular, minority shareholders, need special protection.

Thus, we have, in the PNG Act, section 110 under which "major transactions" require approval by a special resolution of shareholders, and section 91 under which shareholders who vote against a major transaction have a right to be bought out; and then there is section 152, a provision of more general application, under which prejudiced shareholders can seek relief. This paper explores the application and effect of these provisions in PNG. As they are largely adopted from NZ, the comparative NZ provisions are considered and also the relevant NZ cases on their interpretation. Although they do not have direct or binding effect on the PNG courts, they do have high persuasive value.

Statutory provisions

Section 110 of the PNG Act is in the following terms:

> (1) A company shall not enter into a major transaction unless the transaction is-
> (a) approved by special resolution; or
> (b) contingent on approval by special resolution.
>
> (2) In this section-
> "assets" includes property of any kind, whether tangible or intangible;
> "major transaction", in relation to a company, means-
> (a) the acquisition of, or an agreement to acquire, whether contingent or not, assets the value of which is more than half the value of the assets of the company before the acquisition; or
> (b) the disposition of, or an agreement to dispose of, whether contingent or not, assets of the company the value of which is more than half the value of the assets of the company before the disposition; or
> (c) a transaction which has or is likely to have the effect of the company acquiring rights or interests or incurring obligations or liabilities, including contingent liabilities, the value of which is more than half the value of the assets of the company before the transaction.
>
> (2A) In assessing the value of any contingent liability for the purposes of Paragraph (c) of the definition of "major transaction" in Subsection (2), the Directors-
> (a) shall have regard to all circumstances that the Directors know, or ought to know, affect, or may affect, the value of the contingent liability; and
> (b) may rely on estimates of the contingent liability that are reasonable in the circumstances; and
> (c) may take account of-
> (i) the likelihood of the contingency occurring; and
> (ii) any claim the company is entitled to make and can reasonably expect to be met to reduce or extinguish the contingent liability.

* David Frecker BA LLM (Hons) (Sydney), Special Counsel at Ashurst Lawyers.
** Kingsford Wamp LLB (Hons) (UPNG) LLM (UNSW), Senior Associate at Ashurst Lawyers.

(3) Nothing in Paragraph (c) of the definition of the term "major transaction" in Subsection (2) applies by reason only of the company giving, or entering into an agreement to give, a floating charge secured over the assets of the company the value of which is more than half the value of the assets of the company for the purpose of securing the repayment of money or the performance of an obligation.

(4) Nothing in this section applies to a major transaction entered into by a receiver appointed pursuant to an instrument creating a charge over all or substantially all of the property of a company.

This provision is almost identical to Section 129 in the NZ Act. Subsection (2A) is the result of an amendment in 2014 and follows a similar amendment in NZ.

Part III, Division 4 of the PNG Act gives minority shareholders who vote against certain company actions, the right to have their shareholding bought out. The key section is as follows:

Where-

(a) a shareholder is entitled to vote on the exercise of one or more of the powers set out in-
    (i) Section 88(1)(a), and the proposed alteration imposes or removes a restriction on the activities of the company; or
    (ii) Section 88(1)(c) or (d); and

(b) the shareholders resolved, pursuant to Section 88, to exercise the power; and

(c) the shareholder-
    (i) casts all the votes attached to shares registered in the shareholder's name and having the same beneficial owner against the exercise of the power; or
    (ii) where the resolution to exercise the power was passed under Section 103, did not sign the resolution, or refrained from signing it in respect of all the shares registered in the shareholder's name and having the same beneficial owner,

that shareholder is entitled to require the company to purchase those shares in accordance with Section 92.

Section 92 sets out the procedure for a shareholder who wants to initiate a buy-out of the shareholder's shares in the company. These provisions apply to a shareholder who votes against a major transaction under section 110 (by virtue of section 88(1)). The provisions are modelled on similar provisions in the NZ Act. Section 152(1) of the PNG Act provides that:

> A shareholder or former shareholder of a company, or any other entitled person, who considers that the affairs of a company have been, or are being, or are likely to be, conducted in a manner that is, or any act or acts of the company have been, or are, or are likely to be, oppressive, unfairly discriminatory, or unfairly prejudicial to him in that capacity or in any other capacity, may apply to the Court for an order under this section.

Section 152(4) specifically provides that a failure to comply with section 110, is one of the actions by a company, which are prejudicial to its shareholders. The term "entitled person" as used in section 152(1) is defined in section 2 to mean, "a shareholder and a person upon whom the constitution (if the company has one) confers any of the rights and powers of a shareholder". So, section 152 is of limited application as it only applies to shareholders or others who can exercise the powers of a shareholder. But within that context, and so long as the person making the claim is a shareholder or is treated as a shareholder in the company's constitution, that person should be able to seek redress for oppressive conduct against him *in that capacity or in any other capacity*, so long as the conduct relates to the affairs of the company.

These provisions follow closely the provisions in the NZ Act. These and other relevant provisions of the PNG Act are substantially the same as in the NZ Act. For ease of reference, we list below the relevant provisions of the NZ Act and the equivalent provisions in the PNG Act.

NZ Companies Act	**PNG Companies Act**
Section 17 (Validity of actions)	Section 18
Section 18 (Dealings between company and other persons)	Section 19
Section 110 (Shareholder may require company to purchase shares)	Section 91

NZ Companies Act	PNG Companies Act
Section 114 (Court may grant exemption)	Section 95
Section 115 (Court may grant exemption if company insolvent)	Section 96
Section 129 (Major transactions)	Section 110
Section 164 (Injunctions)	Section 142
Section 170 (Actions by shareholders to require directors to act)	Section 148
Section 172 (Actions by shareholders to require company to act)	Section 150
Section 174 (Prejudiced shareholders)	Section 152(1) – (3)
Section 175 (Certain conduct deemed prejudicial)	Section 152(4) – (5)

What are major transactions under Section 110?

Major transactions are defined in section 110(2) as set out above. In short, a major transaction is where a company buys or sells assets, or enters into an agreement to do so, or enters into a transaction which has, or is likely to have, the effect of the company acquiring rights or interests, or incurring obligations or liabilities, that has a value of greater than half of the value of the company's existing assets. In this context, "assets" include property of any kind, whether tangible or intangible. Rights under contracts are included and their value needs to be considered. The definition of assets does not make clear whether it is gross or net assets.

In the 2013 NZ case of *Jacomb v Wikeley*[1], Justice Kós reasoned that the better view is that they are gross assets. We agree with this proposition because it is consistent with the more literal meaning of the term "assets" and because a "net assets" reading would require one to read in the concept of "assets minus liabilities". This is discussed further below where we consider the concept of "value equation".

The definition of major transaction is subject to the exclusions in subsections (3) and (4) of section 110. Subsection (3) follows an amendment to Section 129 of the NZ Act, although it should be noted that the NZ provision was amended in 1997 to omit the word "floating". The provision was considered in *Fighter Trainers Limited v McCormick*[2] in which the question arose as to whether the giving of a company charge (or "debenture") over all of its assets to secure finance (a very common occurrence) would be a major transaction under Section 129(2)(b). On this point, Salmon J said:

> There are two reasons why I conclude that the definition of "major transaction in para (b) is not intended to catch debentures. The first is that a charge secured over the assets of the company is specifically provided for in para (c) of the definition and subsection (2A). The second reason is that given the prevalence of debentures securing the assets of a company it cannot have been the intention of the legislature to require that all such transactions be approved by special resolution.

Section 110(4) excludes transactions entered into in the name of the company by a receiver appointed under a charge of all or substantially all of its assets. This makes sense because a receiver of all or substantially all of the company's assets will control, and will usually have power to sell those assets for the benefit of the creditor or creditors whom the receiver represents, and the shareholders will only have a residual interest in those assets. In those circumstances, it would be a parody if the shareholders could block a transaction initiated by the receiver.

[1] [2013] NZHC 707.
[2] (1999) 8 NZCLC 261,998.

Value equation

The concept of major transactions and the restriction on them under section 110 are best analysed in terms of an equation stated as follows:

[Transaction Value] is greater than [50% of Company Asset Value].

We call this the value equation. The two key factors can then be considered.

Transaction Value

The Transaction Value in the value equation is one of three things:

1. the value of the assets being acquired by the company;
2. the value of the assets being disposed of by the company; or
3. the value of the rights being acquired or the liabilities being assumed by the company.

The value under 1 or 2 would prima facie be the value placed upon them in the transaction, provided that it is being undertaken at arm's length between unrelated parties. If that proviso does not apply, an independent assessment of market value of the assets may be required before the directors of the company can make the assessment required by the value equation.

The determination of the value under 3 is more difficult. If the transaction involves the acquisition by the company of rights, for example through the assignment of a contract, the present value of those rights may be a matter of judgment. If the transaction involves the assumption of obligations, for example the obligation to repay a debt, the value may be more finite if the debt has a present monetary value; but should that value be discounted if the debt is not payable until sometime in the future? The answer is probably yes. If indeterminate liabilities are assumed, then again, the value of those obligations may be a matter of judgment.

Contingent liabilities are specifically included; and the factors to take into account in determining the value of them are described in subsection (2A), which was introduced by an amendment in 2014 but follows language in the definition of "solvency test" in Section 4(1). Although they are not directly applicable to the meaning of major transactions, it may also be helpful to draw upon the subsections (2) and (4) of section 4 which are in the following terms:

> (2) Without limiting Sections 50 and 53(3), in determining for the purposes of this Act (other than Sections 234 and 235 which relate to amalgamations) whether the value of a company's assets is greater than the value of its liabilities, including contingent liabilities, the directors-
> (a) shall have regard to-
> (i) the most recent financial statements of the company that comply with Section 179; and
> (ii) all other circumstances that the directors know or ought to know affect, or may affect, the value of the company's assets and the value of its liabilities, including its contingent liabilities; and
> (b) may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances.
>
> (4) In determining, for the purposes of this Act, the value of a contingent liability, account may be taken of-
> (a) the likelihood of the contingency occurring; and
> (b) any claim the company is entitled to make and can reasonably expect to be met to reduce or extinguish the contingent liability.

Take a practical example. If (as is not uncommon) a parent company is agreeing to borrow a large loan for group purposes and the lenders require, as a condition of the loan, a guarantee from each of the subsidiary companies in the group supported by a floating charge over its assets. One of those subsidiary companies is not wholly owned by the parent company but has a 30% minority shareholder which is opposed to the loan. If the amount of the loan is more than half the value of the assets of the partly owned subsidiary, both the guarantee and the charge are potentially major transactions of that company requiring approval by a special resolution which the minority shareholder could block. The directors of the subsidiary company must then determine the transaction value of the guarantee and the charge. If the parent company has assets of high value and few other liabilities, the judgment may be made that the loan is most likely to be repaid by the parent company in the normal course and the subsidiary's guarantee is very unlikely to be called upon. In these circumstances, the guarantee may be given a transaction value which is considerably less than the face value of the loan it is guaranteeing. The floating charge should be excluded from the transaction value by virtue of Section 110(3).

Company Asset Value

The Company Asset Value in the value equation will be the same whether 1, 2 or 3 in the definition of "major transaction" is being considered. By its terms, it means the value of the assets of the company before the transaction, without taking into account liabilities: that is gross assets and not net assets. There may appear to be some logic in looking at the net assets of a company, because in company balance sheets that generally equates to shareholders' equity, it may be said that the requirement for shareholder approval under section 110 is designed to protect shareholder equity in a company. However, that is not what the definition states when the clear language of it is interpreted literally.

Furthermore, there is no suggestion (or wording to suggest) that liabilities should be taken into account when determining the transaction value of an acquisition or disposal of assets. If an acquisition involves the grant of a mortgage or charge over the asset being acquired, then there are two transactions: the acquisition of the asset by the company and the grant of security to the mortgagee or charge, each of which needs to be assessed under the value equation. It stands to reason, however, that if the acquisition does not require approval then the grant of security will not require approval because the security is not going to have a higher value than the asset. Further, one has to query the value of a "personal covenant" in a mortgage or charge and whether that needs to be assessed under 3 in the same way as a guarantee. Similarly, if there is a disposal of company assets which are subject to a charge or mortgage, the value of the assets being disposed of should be assessed without taking into account the secured liabilities to be discharged out of the proceeds. Reducing the liabilities of a company is not a transaction within the definition.

So, if liabilities are not to be taken into account in determining the transaction value for an acquisition or disposal of assets, it would be a distortion of the value equation to take into account liabilities when determining the company asset value.

Another important question is, how is the company asset value determined? Initially, it was thought that one needs to only look at the most recent annual accounts or financial statements of the company and take the value of the assets from the balance sheet or statement of financial position. However, this is an inadequate measure of the current value of assets because company accounts are based on the historical value of assets (usually the amount expended to acquire them) adjusted in accordance with accounting principles and standards. Even when accounts are diligently prepared and audited in accordance with those standards, accounting values of assets may differ from "real" value. Valuations are particularly difficult with intangible assets, and where past expenditure is brought to account to represent the value of an asset (as is the case with exploration expenditure in mining companies which is used to value exploration licences).

These difficulties were broadly recognised by the New Zealand Court of Appeal in *Cudden v Rodley*[3]. After considering arguments to the effect that value of assets for the purposes of section 129 should be based on historical cost less depreciation, the court stated categorically that:

> Section 129 is undoubtedly concerned with the market value of the company's assets – value must mean value in the accepted sense of that word, and there is nothing in the context of s.129 to read it in any other way. Shareholders who are concerned with any such issues will be fully aware that accounts which have historical cost as a method of showing book value of assets are not holding that out as reflecting market values. Furthermore, if a dispute arises as to the application of s.129 to

[3] [1999] CA 67/99 – the case does not appear to have been reported elsewhere.

> a particular sale, there can be no doubt the enquiry would be to ascertain market value, which would be established from all relevant evidence.

We submit that the same reasoning applies equally to the determination of the value of company assets under section 110 of the PNG Act.

Applying the value equation

When the directors of a company are considering whether a contemplated transaction needs shareholder approval under section 110, or can be decided upon by the board under governance procedures otherwise applicable, they must apply the value equation (even if they do not ostensibly use the terminology we have used above). The determination of transaction value will be straight-forward in many cases, but the determination of company asset value will often present difficulties. In some cases, where directors for good reasons do not want to seek shareholder approval, it may be necessary for them to obtain professional valuation assistance to justify a decision not to seek shareholder approval.

The New Zealand case of *Re Fletcher Challenge Forests Limited*[4] has made it clear (if there were any doubt) that this test applies to each individual company separately and not to a group of companies collectively. A transaction may be a major transaction for a subsidiary although it is not a major transaction for the holding company. There should be no difficulty in obtaining shareholder approval for a subsidiary's transactions unless there are minority shareholders holding 25% or more.

Consequences of a major transaction being approved under Section 110

Under section 91 of the PNG Act, shareholders who voted against approving a major transaction under section 110, have the right to elect to be bought out by the company. Under section 92, the board of the company may then agree to the purchase of the shares by the company or arrange for some other person to purchase those shares. The price for the purchase of the shares is to be agreed as set out under section 93.

There may be instances where the company would not be able to purchase the shares because doing so would not be in the best interest of the company. In such cases, the board of the company can apply to the court for an order under section 95 or section 96. Both provisions are set out in full below.

> 95. Court may grant exemption.
>
> (1) A company to which a notice has been given under Section 92 may apply to the Court for an order exempting it from the obligation to purchase the shares to which the notice relates on the grounds that—
> (a) the purchase would be disproportionately damaging to the company; or
> (b) the company cannot reasonably be required to finance the purchase; or
> (c) it would not be just and equitable to require the company to purchase the shares.
>
> (2) On an application under this section, the Court may make an order exempting the company from the obligation to purchase the shares, and may make any other order it thinks fit, including an order—
> (a) setting aside a resolution of the shareholders;
> (b) directing the company to take, or refrain from taking, any action specified in the order; or
> (c) requiring the company to pay compensation to the shareholders affected; or
> (d) that the company be put into liquidation.
>
> (3) The Court shall not make an order under Subsection (2) on either of the grounds set out in Subsection (1)(a) or (b) unless it is satisfied that the company has made reasonable efforts to arrange for another person to purchase the shares in accordance with Section 92(2)(b).

[4] (2004) 9 NZCLC 263,447.

96. Court may grant exemption where company insolvent.

(1) Where—
(a) a notice is given to a company under Section 92; and
(b) the board has resolved that the purchase by the company of the shares to which the notice relates would result in it failing to satisfy the solvency test; and
(c) the company has, having made reasonable efforts to do so, been unable to arrange for the shares to be purchased by another person in accordance with Section 92(2)(b),

the company shall apply to the Court for an order exempting it from the obligation to purchase the shares.

(2) The Court may, on an application under Subsection (1), where it is satisfied that—
(a) the purchase of the shares would result in the company failing to satisfy the solvency test; and
(b) the company has made reasonable efforts to arrange for the shares to be purchased by another person in accordance with Section 92(2)(b),

make—
(c) an order exempting the company from the obligation to purchase the shares; or
(d) an order suspending the obligation to purchase the shares; or
(e) such other order as it thinks fit, including any order referred to in Section 95(2).

Under section 95, the company can ask the court to exempt it from being obligated to purchase the shares because to do so would be disproportionately damaging to the company, or because it would be unreasonable to require the company to finance the purchase, or because it would not be equitable or just for the company to do so. Under section 96, the company can apply to the court to exempt or suspend any obligation of the company to purchase those shares because doing so would result in the company failing to satisfy the solvency test under the PNG Act. These provisions have yet to be tested by the courts in PNG.

Notwithstanding the possibility of relief under these provisions, the existence of minority buy-out rights where a major transaction needs approval under section 110 is a major factor for consideration by directors when proposing a major transaction which may not have unanimous shareholder support. This is also the primary reason why a determination that a transaction is not a major transaction, through a proper application of the value equation and independent evidence of asset value, may be critical.

Consequences of breach of Section 110

If a company enters into a major transaction without shareholder approval, or without the transaction being contingent on shareholder approval, there will be a breach of the statutory prohibition under section 110. This will have a number of consequences directly under the PNG Act (many of which mirror provisions in the NZ Act) and more broadly under the general law.

Consequences under the PNG Companies Act

There are a number of provisions in the PNG Act which could apply and under which action might be taken where a company is about to undertake or has undertaken a major transaction without shareholder approval. These include:

(a) If there is a breach of the statutory prohibition under section 110, an offence is committed by the company (see section 416) and by any director who agrees to the company's action (see section 114 and section 413(2)) for which penalties can be imposed. To this extent, the prohibited transaction is illegal under the Act, but the meaning and broader consequences of this are considered below. The applicable penalties are relatively small.

(b) An affected party could seek an injunction to stop the prohibited transaction (see section 142) but, practically speaking, only if action was taken in advance of or in anticipation of the prohibited transaction.

(c) It is one of the duties of a director not to agree to the company acting in a manner that contravenes the PNG Act (see section 114)[5]. A shareholder or former shareholder could bring an action against directors for breach of this duty (see section 147).

(d) An action by a shareholder against the directors (under section 148) or against the company (under section 150), seeking an order requiring the directors (individually) or the board of the company (collectively) to take the action of submitting a major transaction for shareholder approval, might also be possible. The court needs to be satisfied that it is just and equitable to make such as an order, and given the availability of other statutory remedies, the circumstances in which such an order may be obtained are probably limited.

(e) Application by a shareholder or other entitled person under section 152 for one of the orders set out in subsection (2) is likely to be the best available cause of action by a shareholder affected by a breach of section 110.

There is no provision in the PNG Act which expressly renders certain contracts and transactions void for failure to comply with section 110. In contrast, there are other provisions of the Act which expressly render certain contracts and actions void for failure to comply with the provision (for example, sections 41, 48, 64, 133 and 140). It also renders other contracts and actions voidable (for example, section 119). In addition, the Act provides for a range of different penalties for offences. In short, the PNG Act is an elaborate scheme providing specific consequences for breaches of specific provisions.

Analysis of Section 152

The remedies under section 152 are set out in as follows:[6]

> Where, on an application under this section, the Court considers that it is just and equitable to do so, it may make such order as it thinks fit including, without limiting the generality of this subsection, an order—
> (a) requiring the company or any other person to acquire the shareholder's shares; or
> (b) requiring the company or any other person to pay compensation to a person; or
> (c) regulating the future conduct of the company's affairs; or
> (d) altering or adding to the company's constitution; or
> (e) appointing a receiver of the company; or
> (f) directing the rectification of the records of the company; or
> (g) putting the company into liquidation; or
> (h) setting aside action taken by the company or the board in breach of this Act or the constitution of the company.

Section 152 was considered in the case of *Sabatica Pty Ltd v Battle Mountain Canada Ltd*[7]. In that case, the Supreme Court comprising Amet CJ, Kapi DCJ and Los J adopted and applied the leading New Zealand case of *Thomas v H W Thomas Ltd,* in which the term "oppressive, unfairly discriminatory or unfairly prejudicial" was discussed. The Supreme Court adopted the following wide meaning given to the expression as being applicable to PNG:

> While the New Zealand legislation has significant variations, the use of the words "oppressive, unfairly discriminatory or unfairly prejudicial" is common. In *Thomas and HW Thomas Ltd* [1984] 1 NZLR 686, at page 693 Richardson J said:
>
>> "In employing the words 'oppressive, unfairly discriminatory or unfairly prejudicial' Parliament has afforded petitioners a wider base on which to found a complaint. Taking the ordinary dictionary definition of the words from the Shorter Oxford English Dictionary: oppressive is 'unjustly burdensome'; unfair is 'not fair or equitable; unjust'; discriminate is 'to make or constitute a difference in or between; to differentiate'; and prejudicial, 'causing prejudice, detrimental, damaging (to rights, interests, etc). I do not read the subsection as referring to three distinct alternatives which are to be considered

---

5 Note that section 114 is not specified, as one of the duties, which is owed to the company, and not to shareholders.

6 See section 152(2) of the PNG Act.

7 (2003) SC 709.

> separately in watertight compartments. The three expressions overlap, each in a sense helps to explain the other, and read together they reflect the underlying concern of the subsection that conduct of the company which is unjustly detrimental to any member of the company whatever form it takes and whether it adversely affects all members alike or discriminates against some only is a legitimate foundation for a complaint under s 209. The statutory concern is directed to instances or courses of conduct amounting to an unjust detriment to the interests of a member or members of the company. It follows that it is not necessary for a complainant to point to any actual irregularity or to an invasion of his legal rights or to a lack of probity or want of good faith towards him on the part of those in control of the company.

This passage is helpful in indicating the nature of the cause of action under section 152 of the Act and we would adopt it.

The shareholder bringing the claim under section 152 for breach of section 110 must satisfy the court that the breach of Section 110 was a conduct that was "*oppressive, unfairly discriminatory or unfairly prejudicial*" to that shareholder. Section 152(2) empowers the court, where it considers it just and equitable to do so, to "make such orders as it thinks fit" including by making an order 'setting aside action taken by the company or the board in breach of this Act'. The existence of this power makes it plain that contracts entered into in breach of section 110 are not void. Rather they are voidable and only voidable where that consequence is just and equitable.

Two NZ cases are illustrative of the other orders which may be made under section 152 (the equivalent of which is section 174 in the NZ Act where a company has proceeded with a major transaction without obtaining shareholder approval through a special resolution. In *Zhao v Yang*[8], the judge decided to make an order for substantial monetary compensation in favour of the prejudiced shareholder under section 174(2)(b); and in *Kim v Pink Nails Limited*[9], the situation represented such a breakdown in the relationship between shareholders in a private company that the judge considered that the most appropriate form of remedial relief was to make an order under section 174(2)(g), placing the company in liquidation.

General consequences of breach of a statutory prohibition

A contract or transaction made in breach of a statutory prohibition can have both a statutory consequence (which turns on the construction of the statute itself) and a common law or equitable consequence, limited to withholding, or imposing conditions on, the grant of a remedy to enforce the contract or transaction at the suit of one or more of the parties (the application of which turns on considerations of public policy).

The High Court in Australia has considered the consequences of breach of a statutory prohibition, or statutory illegality as it is otherwise called, in a few cases in recent years. Although these cases are not binding authority in PNG, they should have high persuasive value as they enunciate an evolving position.

In *Equuscorp Pty Ltd v Haxton*[10], the majority (French CJ, Crennan J, and Kiefel J) in their joint judgement stated (based on earlier High Court decisions) that:

> an agreement may be unenforceable for statutory illegality where:
>
> (i) the making of the agreement or the doing of an act essential to its formation is expressly prohibited absolutely or conditionally by the statute;
>
> (ii) the making of the agreement is impliedly prohibited by statute. A particular case of an implied prohibition arises where the agreement is to do an act the doing of which is prohibited by the statute;

---

8 [2013] NZHC 1323.

9 [2010] NZHC 1446.

10 (2012) 246 CLR 498 at 513 [23]; [2012] HCA 7.

(iii) the agreement is not expressly or impliedly prohibited by a statute but is treated by the courts as unenforceable because it is a "contract associated with or in the furtherance of illegal purposes.

This threefold categorisation was endorsed by the majority (French CJ, Kiefel J, Keane J and Nettle J) in the next leading Australian High Court case of, *Gynch v Polish Club Limited*[11], in which it was held that a lease entered into in contravention of certain provisions of the *Liquor Act 2007* (NSW) was not for that reason rendered void and unenforceable.

The separate judgement of Gageler J, in which he concurred with the majority in reaching this conclusion, is the most comprehensive recent analysis of the consequences of statutory illegality and warrants close attention. Gageler J identified the statutory consequences of a breach of a statutory provision as follows:

> The nature and extent of any statutory consequence of breach of a statutory prohibition on making, or on some step in making, an agreement is a question of statutory construction which is distinct from the question of statutory construction which determines the scope of that prohibition (if the prohibition is express) or the existence and scope of that prohibition (if the prohibition is implied). A statutory consequence of making an agreement in breach of an express statutory prohibition is sometimes set out in exhaustive terms in the statutory text. Almost inevitably in the case of an implied prohibition, and sometimes in the case of an express prohibition, the statutory consequence is left in whole or in part to statutory implication.

Justice Gageler also added that:

> There is no reason why an implied statutory consequence cannot stop short of rendering an agreement made in breach of a particular statutory prohibition wholly unenforceable by all parties in all circumstances. An implied statutory consequence might be limited, for example, to rendering an agreement unenforceable by a contravening party in the occurrence or non-occurrence of particular events.

The few PNG cases are generally consistent with this analysis. In *New Ireland Development Corporation Ltd v Arrow Trading Ltd*[12] the National Court had to determine whether it could enforce a lease entered into at a time when the lessee was not certified as a foreign enterprise under the *Investment Promotion Act* 1992. Lay J, first considered whether the consequence of a breach was expressly provided for in the statute and as there was one, it was unnecessary for the court to consider whether there was any implied consequence.

In applying these principles to section 110 of the PNG Act, while the section is itself silent as to the consequence of a breach of the requirement for shareholder approval of major transactions, the PNG Act as a whole is not. This is demonstrated by the list of consequences, and potential action by various parties, set out above under the heading 'Consequences under the PNG Act'. The prescription and availability of these statutory consequences renders it less likely that a contract or transaction would be deemed to be unenforceable or even void simply because it is entered into in breach of the statutory prohibition. Such a result may be the consequence of one or more orders under section 152, but only after the rigours of a judicial process instigated by a shareholder who has been affected prejudicially. Unless and until that power is exercised, it is reasonable to conclude that a contract or transaction entered into in breach of section 110 is binding on the parties and effective in dealing with property.

Common law or equitable consequences

Historically, the consequence at general law of a contract being illegal, was that it was unenforceable, in the sense that a court will not recognise or enforce it, and therefore, there is no ability to recover money or property under the contract. In colloquial terms, any loss lies where it falls. Of course, this being the consequence, confirms that the transaction itself if carried out was effective to pass title to property and put into effect other legal acts; that is, the transaction is not and

[11] [2015] HCA 23 at [35] although Gageler J in his separate judgement said that this "tripartite classification" was useful but not comprehensive – see [60].

[12] (2007) N3240 at paragraph 24.

never has been void at common law. In any event, as Gageler J demonstrated in *Gynch v Polish Club Limited*, the more modern position is that not every prohibited contract will be unenforceable:

> An agreement which is not denied legal operation by statutory force may still be unenforceable at the insistence of one or both parties by operation of the common law by reference to considerations of public policy. The cases in which that might occur, however, must now be closely confined.
>
> It is important to identify the considerations of public policy that might be in play in such cases. Although other considerations might arise in some circumstances, two overlapping considerations have generally been recognised in the decided cases to predominate. One of those considerations has long been identified in terms that a person ought not to be permitted by law to base a cause of action on an immoral or illegal act. The other, more focussed, consideration has been identified in terms that a person ought not to be assisted by law to benefit from an immoral or illegal act. That other consideration is reflected in what has been described as "the more specific rule that the court will not enforce the contract at the suit of a party who has entered into a contract with the object of committing an illegal act.[13]

It is not immoral or contrary to public policy for a person to enter into a transaction with a company which is a major transaction for that company. Rather, the rationale is to give shareholders a say and to give them remedies in the event that they vote against the transaction, but the special resolution is passed and the transaction proceeds.

Gageler J explains further:

> The consideration of public policy that a person ought not to be permitted by law to found a cause of action on an immoral or illegal act is the product of an earlier age. The broader consideration of public policy is now rarely recognised by the common law to have application in relation to illegality which arises under a modern regulatory statute. That is the import of the observation by Mason J in Yango that "[t]here is much to be said for the view that once a statutory penalty has been provided for an offence, the rule of the common law in determining the legal consequences of commission of the offence is, thereby diminished". It is not the function of the common law to seek to improve on a regulatory scheme by supplementing the statutory sanctions for its breach. If a statute itself does not operate to deny legal operation to an agreement made in breach of one of its prohibitions, or to render that agreement unenforceable by reason of that breach, the coherence of the law is best served by a court respecting and enforcing that legislative choice.[14]

In the case of section 110, in the broader context of the PNG Act, it is reasonable to conclude that Parliament's intention was for the general law not to apply; that is, contracts entered into in breach of section 110 should be enforceable unless and until the court determines otherwise under section 152. There is simply no room within this regulatory regime for common law or equitable principles to apply.

Gageler J also recognized the importance of whether or not the party seeking to enforce a prohibited contract was aware of the breach of the prohibition:

> A court examining the application of that consideration of public policy to the enforcement of an agreement made in breach of a statutory prohibition will examine the intention of a person in entering into the agreement and in seeking to enforce the agreement. The court will recognise that, "whilst persons who deliberately set out to break the law cannot expect to be aided by a court, it is a different matter when the law is unwittingly broken". The court will weigh the consequences of withholding a remedy to enforce the agreement in light of the objects or policies which the statute seeks to advance and the means which the statute has adopted to achieve that end. Ordinarily, it would be open to the court to conclude that withholding a common law remedy from a person whose intention was, and remained, to flout the statute was justified by reference to the narrower consideration of public policy only if the consequence of withholding the remedy could be determined by the court to be both proportionate to the seriousness of the illegality and not incongruous with the statutory scheme. The moulding of an equitable remedy, if sought, might involve other considerations and permit of greater flexibility.[15]

---

13 [2015] HCA 23 at 71.
14 [2015] HCA 23 at 73.
15 [2015] HCA 23 at 75.

In summary, therefore, there should be no common law or equitable consequence as the PNG Act itself prescribes the consequences of a breach of section 110.

Papua New Guinea cases

There is only one PNG case which deals with the consequences for a transaction entered into in breach of section 110: *Madang Cocoa Growers Export Co Limited v National Development Bank Ltd*.[16] In that case, Cannings J observed that:

> Section 110 does not require the conclusion that the agreement becomes illegal or unenforceable or that its existence cannot be taken into account for the purposes of an assessment of damages.

We do not entirely agree with this statement. The agreement was illegal in that it was entered into in breach of a statutory prohibition and an offence was thereby committed. However, as analysed above, the agreement is not necessarily unenforceable as a result, nor was the agreement void, so that it could not be considered for other purposes, such as, damages.

In *Rainbow Holdings Pty Ltd v Central Province Forest Industries Pty Ltd*[17], the Supreme Court was required to consider whether a contract to sell logs was enforceable when the seller had obtained the logs without the requisite statutory authorisation. The court referred to *Yango* and *Archbolds (Freightage) Ltd v S Spangler Ltd*[18] in holding that, even if the relevant statute did not expressly or impliedly prohibit the relevant contract, the court should consider whether having regard to public policy, the contract should not be enforced, if it could only be performed in breach of the statute or was intended to be performed for an illegal purpose. The court concluded that given the scope and purpose of the relevant statutory prohibition, and given that this purpose would not be advanced by declining to enforce the contract, that the relevant contract for sale of the logs was enforceable.

The same approach was adopted in *New Ireland Development Corporation Ltd v Arrow Trading Ltd.*[19] In that case, the court had to determine whether it could enforce a lease entered into at a time when the lessee was not certified as a foreign enterprise under the *Investment Promotion Act* 1992. Lay J held that because the Parliament had provided for an express remedy in section 41A, enabling a court to set aside a contract entered into by an uncertified foreign enterprise, it would be wrong for the court to render the contract unenforceable by applying common law public policy concepts. That is similar to the position applying in relation to section 110 of the PNG Act given the remedy available under section 152.

Effect on dealing with third parties

The overall scheme of the PNG Act is to validate corporate action notwithstanding any failure to comply with the Act (sections 18 and 19). In particular, a company cannot assert, against a person dealing with the company or a person who has acquired property, rights or interests from the company, that the PNG Act has not been complied with, unless that person was aware of, or by virtue of his position, ought to have been aware of, the non-compliance. So in the absence of any knowledge of a breach, it would be inequitable for a court to give the party bringing a claim a remedy because by doing so, that party would be granted the benefit of a remedy which the PNG Act expressly denies it.

In relation to the question of whether a party (not a shareholder) dealing with a company can take action to overthrow a major transaction entered into by the company in breach of section 110, based on our analysis, the only way a transaction made in breach of section 110 can be overthrown is by way of an application made under section 152. As only a shareholder or former shareholder (or an "entitled person") can make an application under section 152, it follows that it is not open to a party

[16] (2012) N4682.
[17] [1983] PNGLR 34.
[18] [1961] 1QB 374.
[19] (2007) N3240.

that is not a shareholder who is dealing with a company to take action to declare void a major transaction.

In this regard, under section 78, a shareholder means a person who is entered in the share register as the holder of one or more shares or, until a person's name is entered in the share register, a person who is named as shareholder in an application for the registration of a company at the time of registration of the company, or a person who is entitled to have that person's name entered in the share register under a registered amalgamation proposal, as a shareholder in an amalgamated company. The meaning of shareholder in section 78 appears to exclude a person who is named as a transferee in a share transfer instrument or a share sale agreement in relation to shares in the company but whose name is yet to be entered on the share register of the company.

Section 18(1) of the PNG *Companies Act* provides that:

> No act of a company and no transfer of property to or by a company is invalid merely because the company did not have the capacity, the right, or the power to do the act or to transfer or take a transfer of the property.

This is not materially different from section 17(1) of the NZ Act. In *Hansard v Hansard*[20], a case in which the failure to obtain shareholder approval under section 129 was one of the issues, the New Zealand Court of Appeal said that:

> Failure to comply with the requirements of s.129 does not, however, affect the validity of the transaction for present purposes. Section 17(1) of the *Companies Act* provides that no transfer of property by a company will be invalid merely because the company did not have the capacity, the right or power to transfer that property. That is so even where the transfer is not in the best interests of the company.

Section 19(1) of the PNG Act provides that:

> A company, or a guarantor of an obligation of a company may not assert against a person dealing with the company or with a person who has acquired property, rights, or interests from the company that:
>
> (a) this Act or the constitution of the company has not been complied with; or
>
> …
>
> unless the person has, or ought to have, by virtue of his position with or relationship to the company, knowledge of the matters referred to in any of Paragraphs (a), (b), (c), (d), or (e), as the case may be.

This is not materially different from section 18(1) of the NZ Act. It follows that a breach of section 110 does not enable the company to assert against a party dealing with the company that Section 110 has been breached unless the counterparty was aware of the breach. Put another way, the failure of a company to comply with section 110 (by not seeking the approval of shareholders to enter into the contract), does not mean a contract is invalid and of no effect in the company's dealings with other parties. On the contrary, it infers that the contract is effective according to its terms and the company cannot assert a breach of section 110 to resist enforcement, unless the counterparty was aware of the breach.

This interaction between a company's contract which is illegal because it is in breach of the PNG Act, and the section of the Act preventing the company asserting this illegality in dealings with other persons, was considered in a New Zealand case in 1997: *Waller & Anor v. Paul*.[21] This case was about a company with a sole director and a sole shareholder, and an agreement whereby that person sold intellectual property to the company in return for an issue of shares. It was held that the issue of shares was in breach of the NZ Act because it did not adhere to the procedures in Sections 40 (Contracts for issue of shares) and 47 (Consideration to be decided by the Board). The liquidators of the company were seeking to recover from the shareholder the amount for which the shares were deemed to have been issued. It was held that the agreement was an illegal contract, and therefore

20 [2014] NZCA 433.
21 (1997) 8 NZCLC 261.

could not be relied upon by the shareholder to resist the liquidator's claim. Master Faire, in his judgment, said that:

> This agreement, being an agreement to issue shares, is an illegal contract because the defendant, as the board of the company, has not complied with s.47 of the Act. In short, the statutory basis for holding an illegal contract in this case has been made out for the purposes of s.40 of the *Companies Act* 1993.

And further:

> This case involves a defendant who is the sole director and sole shareholder of the company. He alone has the power to comply with the constitution of the company and for that matter the obligations cast on him both as director and shareholder under the provisions of the *Companies Act* 1993. For that reason, it seems to me that the prohibition contained in s.18(1) from asserting that the constitution of the company and the provisions of the *Companies Act* have not been complied with, do not apply in this case by reason of the concluding words contained in s.18(1). This is because the defendant clearly is a person who ought to have, by virtue of his position with the company, knowledge of the non-compliance with the constitution and the *Companies Act* requirements. There is simply no other person who is obliged to carry out the obligations specified in s.47(3), (4) and (5) of the *Companies Act* 1993. If the provisions of s.47 alone are considered, i.e. without reference to the concluding part of s.18(1) of the *Companies Act* 1993 then, in my view, non-compliance will not by itself make the contract of no effect….

The concluding words of the quotation above from the judgment in *Waller v Paul* do indicate that the qualification about knowledge at the end of section 18(1) [i.e. section 19(1) in the PNG Act] is of paramount importance. The Master's statement is that, if that qualification is not applicable, non-compliance with a provision of the NZ Act will not, by itself, make the contract or transaction of no effect.

A further consideration in the circumstances might be whether there is any application of the rule in *Turquand's* case and the "indoor management rule" derived from it. These rules are generally applied in circumstances where the board of directors or management of a company have not complied with provisions in the company's constitution or memorandum and articles of association, or where there has been some irregularity in the convening or holding of shareholder or board meetings at which approval or authorisation is given. In those circumstances, a third party (an outsider) dealing with the company is entitled to assume that inside the company everything has been done in accordance with the requirements of its public documents, unless the third party has knowledge to the contrary or there are suspicious circumstances putting the outsider on inquiry. The question is whether a third party can rely upon this rule in respect of a requirement for shareholder approval prescribed by statute.

In answering this question, the facts of *Turquand's* case are quite helpful. There was, for the company in that case, a registered deed of settlement under which the board of directors were authorised to borrow on bond such sums as should from time to time be authorised by a resolution of the company in a general meeting. The board borrowed money from the bank on a bond bearing the company's seal. It was held that, even if no resolution had in fact been passed by the company in a general meeting, the company was nevertheless bound. Jervis CJ said:

> We may now take for granted that the dealings with these companies are not like dealings with other partnerships and that the parties dealing with them are bound to read the statute and the deed of settlement. But they are not bound to do more. And the party here, on reading the deed of settlement, would find, not a prohibition from borrowing, but a permission to do so on certain conditions. Finding that the authority might be made complete by a resolution, he would have a right to infer the fact of a resolution authorising that which on the face of the document appeared to be legitimately done.

The *Turquand's* case was decided at a time when modern company law was in its infancy, and the registered joint stock company had only recently been distinguished from a partnership as an entity through which to conduct business. Its authority today may therefore be questioned. However, the statements made by Jervis CJ still appear to be sound in principle: that a third party dealing with the company is bound to read the governing statute, but is not bound to check that conditions found in it have been satisfied by the company; and that the third party may infer the fact of a resolution required to satisfy a condition and authorise "that which on the face of the document appears to be legitimately done". We submit there is no valid distinction in this regard between a requirement for a shareholders' resolution in the company's public document (as in *Turquand's* case) and a requirement for a shareholders' resolution in a section of the PNG Act. In both cases, the requirement is overt, but the compliance with it is a matter inside the company which is not apparent in any public document or disclosure.

The application of the rule in *Turquand's case* and the indoor management rule was discussed by Cannings J in *Raikos Holdings Ltd v Porche Enterprise Ltd*[22], where His Honour commented:

> What effect does that have on enforceability of the agreement? This depends on whether the rule in Turquand's case (Royal British Bank v Turquand (1856) 119 ER 886) applies. Where a person dealing with a company acts in good faith and with no notice of reasonable grounds for suspicion of irregularity or impropriety, he is not affected by any actual irregularity or impropriety in a matter of internal regulation. It is incumbent on a person seeking the protection of this rule to prove absence of reasonable grounds for suspicion of irregularity or impropriety (Sangara (Holdings) Ltd v Hamac Holdings Ltd (In Liquidation) [1973] PNGLR 504; AGC (Pacific) Ltd v Woo International Pty Ltd [1992] PNGLR 100; New Ireland Development Corporation Ltd v Arrow Trading Ltd (2007) N3240; Kui Valley Business Group Inc v Kerry Wamugl (2009) N3667). The defendant has failed to discharge that onus. It was aware of the dispute as to ownership and control of the plaintiff as it and its then managing director, Tony Tai Tung Chi, were parties to the proceedings regarding disputed ownership and control of the plaintiff. The defendant was reasonably expected to know of the reasonable possibility that the persons who approved and executed the agreement were in fact unauthorised. It cannot in these circumstances gain the protection of the rule in Turquand's case.

As this case demonstrates, the state of knowledge of the other party dealing with the company is paramount. That party cannot rely upon the indoor management rule if he or she knows that the company is not dealing with external transactions in accordance with its own proper internal procedures.

Conclusion

The requirement in section 110 of the PNG Act that major transactions must be approved by a special resolution of shareholders (or be conditional upon such approval) certainly presents some interpretative challenges, not least of all in determining in diverse circumstances what is a major transaction. Ultimately, such determinations may come down to difficult evidentiary questions of value.

Difficult as these issues may be, directors will ignore them at their peril. Proceeding with a major transaction without the requisite approval means that the transaction and any associated contract entered into by the company is illegal. It involves statutory illegality if not illegality at common law. But that does not, in our view, render the transaction and any contract unenforceable or void. The statute, the PNG Act makes detailed provision for the consequences of the breach which displace the application of unenforceability under the general law; and illegal transactions are not void as a matter of course. They are still valid for the purposes of an outside party unaware of the illegality.

But the statutory consequences are serious, and may make the company and its directors liable under direct action by any shareholder, or may result in orders under section 152 at the behest of a prejudiced shareholder. These might include an order for compensation, or an order that the transaction be set aside, or in a dire case, an order that the company be placed into liquidation.

[22] (2012) N4776.