

Choosing the Company Rule-Book - Constitution vs Replaceable Rules?

Since July 1998, all newly formed companies must be governed by a set of rules. Modern companies can either adopt a constitution, the Replaceable Rules, or a combination of both. Prior to 1998, companies were usually governed by 'articles of association' (supported by a 'memorandum of association').

Regardless of whether you adopt Replaceable Rules or a constitution, it is important that all company directors and shareholders understand the rules governing the company and their conduct. Having a well drafted constitution document can often be a more convenient way to understand each person's rights and obligations in relation to the company. Should an internal disagreement occur, a constitution provides all parties with an easy point of reference so that disputes can be settled more quickly.

Constitution vs Replaceable Rules

Replaceable Rules are contained in section 141 of the *Corporations Act 2001* (Cth) ('the Act'). These are the 'default' rules and regulations prescribed by the Act which govern the powers of directors, appointment of directors, transfers of shares and rules relating to meetings.

Instead of adopting the Replaceable Rules, a company can choose to adopt a constitution instead. A constitution is a detailed document which sets out the rules governing the company's internal operations, and overrides the Replaceable Rules contained in the Act. The constitution operates as a contract between the company and each member, director and company secretary. It also acts as a contract between each member – see section 140(1) of the Act.

The following table shows the potential benefits and disadvantages of a constitution compared with Replaceable Rules.

Constitution	Replaceable Rules
<p style="text-align: center;">Benefits</p> <ul style="list-style-type: none"> • A constitution can govern a wider range of companies. 	<p style="text-align: center;">Benefits</p> <ul style="list-style-type: none"> • Inexpensive means of acquiring a system of internal governance. • As Replaceable Rules are part of the Act, if the Act is amended then so are the

<ul style="list-style-type: none"> • A constitution can be tailored to the specific wants and needs of its officers and shareholders. • A constitution can allow for better succession planning and control. For example, it may require that shares are offered and sold to existing shareholders first. • A constitution allows a company to be governed with a higher level of specificity. This is particularly beneficial with regards to establishing several classes of shares and rights attached to those shares. • The shareholders can amend a constitution. This makes a constitution far more flexible than Replaceable Rules. • A constitution is a single document that is easily accessible. • A constitution can regulate behaviour relating to any owned subsidiaries. 	<p>rules of your Company (at no cost to you).</p>
<p style="text-align: center;">Disadvantages</p> <ul style="list-style-type: none"> • A constitution can be more expensive to draft and maintain. • A constitution requires a Special Resolution to amend or adopt, which may cause issues when conditions change suddenly. • Any modifications imposed by legislation must be adopted in order to keep the constitution up to date with the current laws. 	<p style="text-align: center;">Disadvantages</p> <ul style="list-style-type: none"> • Replaceable Rules are fixed and cannot be amended (however, a constitution can be adopted at a later date replacing the Replaceable Rules). • The provisions formulating Replaceable Rules are spread out throughout the Act, and its huge size and complexity may be difficult to interpret and understand. • Replaceable Rules are the default position under the Act, which may make them inappropriate for individual circumstances.



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Deciding whether to use a Constitution or adopt Replaceable Rules can be confusing. Although Replaceable Rules are the cheapest option, they may not be the most appropriate option (or even an option at all) in the circumstances. For example, a small business run through a sole director/sole shareholder company is not allowed to use Replaceable Rules – instead, the Act says that they must adopt a company constitution. Other companies which cannot adopt Replaceable Rules include no liability public companies and special purpose SMSF companies.

The larger the size and complexity of the company, the more likely the company will need a constitution. Where companies involve non-related parties, then the need for a constitution becomes even more important as there may be specific circumstances or agreements between parties that are not properly dealt with by the Replaceable Rules.

Companies with more complex affairs (such as where there are many unrelated shareholders and/or where shareholders have unequal powers) can also consider a Shareholders' Agreement which stands side-by-side with the constitution. A Shareholders' Agreement provides protection by further regulating the conduct of Shareholders and the company. However, Shareholders Agreements are highly customised documents which require legal advice from a solicitor practicing in that area.