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Groups of Companies: The Parent Subsidiary Relationship and Creditors' Remedies

Richard Craig Schulte

Submitted for the Degree of Doctor of Philosophy

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ABSTRACT

The modern group of companies is founded on the separate legal personality of companies and the limited liability of shareholders. During the past century, the corporate group has evolved universally and pervasively in parallel with the modernisation of enterprise. A feature of this process is the acknowledgement by the law that a parent may legitimately have *complete control* of its subsidiaries. *Complete control* comprises *legal control* and *extra-legal control* – that is, control outside the scope of legal control. Both forms of control are susceptible to abuse by the parent of a corporate group, but no legal mechanism focuses on curbing, in particular, the abuse of extra-legal control. A parent is, typically, not accountable to anyone for the misuse of extra-legal control. Neither jurisprudence nor statutory law has kept pace with this reality; each working within the paradigm of the individual, atomistic company. There is a dissonance between commercial reality and legal ordering. This thesis proposes jurisprudential and legislative reform to achieve better accountability of parent companies to creditors for the exercise of extra-legal control over subsidiaries. To determine the direction for reform, the scope of the relationship between parent and subsidiary companies is explored under UK law to identify inadequacies of creditors' remedies in both case law and legislation. This will demonstrate that company law jurisprudence is plagued by metaphors and burdened with an absolutist conception of corporate personality that needs to be revisited and recrafted with the complexity of corporate groups in mind. This thesis proposes a reversion of jurisprudential processes to a 'first principles' analysis that focuses on conceiving the company as a collection of rules. Each rule needful of testing for legitimacy in the context of its application. The methodology the law should draw on derives from the existing templates of the doctrine of the sham and principles that facilitate a purposive analysis of a cluster of transactions such as those found in tax law. This thesis demonstrates that whilst the legislative response to parental abuse of a subsidiary to the detriment of creditors through extra-legal control is wanting; reform need not be revolutionary to be effective. An examination of a number of other jurisdictions demonstrates that reform measures directed at regulating abuse of extra-legal control can successfully retain separate personality and limited liability, but need not involve liability regimes based on the group as an economic unit.

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My friend Shane Anthony Myler has haunted me since his death on 14 September 1994. *Carpe diem*. I dedicate this work to his memory.

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Declaration

The material contained in this thesis has not been submitted for a degree in this or any other university.

The following related material was published during my period of registration.

- ‘Wrongful Trading: An Impotent Remedy?’ (1996) 4 *Journal of Financial Crime* 38-46.
- ‘Corporate Groups and the Equitable Subordination of Claims on Insolvency’ (1997) 18 *The Company Lawyer* 2-13.
- ‘Enforcing Wrongful Trading as a Standard of Conduct for Directors and a Remedy for Creditors: The Special Case of Corporate Insolvency (1999) 20 *The Company Lawyer* 80-88.

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Introduction

In English law, each company in a group of companies is a separate legal entity. Each company bears its own rights and responsibilities even though the true locus of control may be located in a related or parent company.¹ This situation is of little consequence to creditors during solvency, but when a company's finances are *in extremis*, the question of accountability for the loss places significant pressure on the principles of limited liability and separate personality. English company law demonstrates that the rules of limited liability and separate personality do not respond to economic reality and substantive justice. This problem is identified in the well known passage of Templeman L.J. (as he then was) in *Re Southard & Co Ltd*:²

English company law possesses some curious features, which may generate curious results. A parent company may spawn a number of subsidiary companies, all controlled directly by the shareholders of the parent company. If one of the subsidiary companies, to change the metaphor, turns out to be the runt of the litter and declines into insolvency to the dismay of creditors, the parent company and the other subsidiary companies may prosper to the joy of the shareholders without any liability for the debts of the insolvent subsidiary.³

¹ For the purposes of this work, certain terms are defined as follows. 'Parent' means a company that, is beneficially interested in more than 50% of the issued share capital of a company or can control the constituency of the board of directors of a company. 'Subsidiary' means a company that, has shares held by a parent or has a board of directors that is appointed by a parent. 'Related Company' means a company sharing a common parent with another subsidiary. Reference to the word 'remedies' concerns creditors' remedies.

² [1979] 1 WLR 1198.

³ *Ibid.*, at 1208 F H.

The Cork Committee recognised that principles developed during the C19th were deficient when called on to deal with the C20th commercial reality of group enterprise.⁴ This has led to a host of recommendations for reform.⁵ These range from joint and several liability of each company in a group of companies to the creditors of insolvent subsidiaries to the subordination of loans from the parent if such loans can be properly characterised as capital contributions.⁶ The historical factors which gave rise to the unsuitability of entity law and the opportunity for abuse inherent in the parent subsidiary relationship are dealt with at length in a number of works and will not be reconsidered here.⁷

Control of a group of companies is used to ensure that each member of the group complies with the wishes of the controller – usually the parent. A parent may legitimately exercise complete control of every aspect of a subsidiary ('the *legitimate*

⁴ Cork Committee, Insolvency Law and Practice - Report of the Review Committee Cmnd 8558 (London: HMSO, 1982) at 434, para. 1922 (hereinafter cited as 'Cork')

⁵ Dr Muscat collects the main proposals in his recent work, Andrew Muscat, The Liability of the Holding Company for the Debts of its Insolvent Subsidiaries (Aldershot: Dartmouth, 1996) at 466ff (hereinafter cited as 'Muscat').

⁶ *Ibid.*

⁷ See Jose Engracia Antunes, Liability of Corporate Groups: Autonomy and Control in Parent-Subsidiary Relationships in US, German and EU Law An International and Comparative Perspective (Deventer: Kluwer Law and Taxation Publishers, 1994) (hereinafter cited as 'Antunes'); Dimitris Avgitidis, Groups of Companies: The Liability of the Parent Company for the Debts of Its Subsidiary (PhD Thesis: University of London, 1993) (hereinafter cited as 'Avgitidis'); Phillip Blumberg, The Law of Corporate Groups - Procedural Problems in the Law of Parent and Subsidiary Corporations (Boston: Little Brown & Company, 1983) (hereinafter cited as 'Blumberg '83'); Phillip I. Blumberg, The Law of Corporate Groups - Problems in the Bankruptcy or Reorganization of Parent and Subsidiary Corporations, including the Law on Corporate Guaranties (Boston: Little Brown and Company, 1985) (hereinafter cited as 'Blumberg '85'); Phillip I. Blumberg, The Law of Corporate Groups - Tort, Contract and other Common Law Problems in the Substantive Law of Parent and Subsidiary Corporations (Boston: Little Brown and Company, 1987) (hereinafter cited as 'Blumberg '87'); Phillip Blumberg, The Law of Corporate Groups - Problems of Parent and Subsidiary Corporations under Statutory Law of General Application (Boston: Little, Brown and Company, 1989) (hereinafter cited as 'Blumberg '89'); Paul L. Davies, Gower's Principles of Modern Company Law 6th ed (London: Sweet & Maxwell, 1997) (hereinafter cited as 'Davies'); Muscat, *op.cit.*

control model). The legitimate control model means that many of the actions that are outside legal control, such as the power to influence a director of a subsidiary, is a legitimate exercise of parental power over a subsidiary. Parental control may be divided into the legal and the 'factual' forms. A parent's legal right of voting control enables it to control the content of a subsidiary's articles of association and the constituency of the board of directors. A parent's factual control is outside the scope of legal control. It is an 'extra-legal' form of power. The parent can manipulate or fetter the decision-making processes of a subsidiary's directors by using financial and organisational threats and inducements.

Abuse of extra-legal control by a parent flourishes because the conventional legal view of the parent subsidiary relationship in England treats the parent as no more than a shareholder.⁸ Shareholders are not liable to anyone except to the extent and manner provided in the Companies Act 1985 and some vestigial judge-made constraints (eg. limits on oppressive changes to the articles).⁹ Provided a parent shareholder acts *intra vires* and in good faith, the parent can manage the subsidiary's affairs as it wishes. A subsidiary exists for the benefit of its shareholders. For practical purposes, a parent of a wholly owned subsidiary can exercise control without holding a general meeting. As a shareholder, a parent can lawfully take risks that no prudent man would take. Just as an individual can act like a fool, so too can a parent company.¹⁰ Despite this, even as the majority shareholder in a subsidiary, a parent is not liable to creditors.¹¹ A parent

⁸ *Multinational Gas Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd & Ors.* [1983] 3 WLR 492.

⁹ *Ibid.*, at 501 *per* Lawton L.J. and. at 519 *per* Dillon L.J.

¹⁰ *Ibid.*, at 501 *per* Lawton L.J.

¹¹ *Kuwait Asia Bank E.C. v. National Mutual Life Nominees Ltd*, [1991] 1 AC 187 at 223 e f.

shareholder owes no duty to those who do business with the subsidiary. This is a risk creditors must assess for themselves.

A parent can manipulate a subsidiary's directors. The ability to control totally a subsidiary provides neither a modicum of accountability nor any direct duty between the parent and the subsidiary. This means a parent shareholder is not accountable for its use of extra-legal control. Any duty to a subsidiary is owed directly by its own directors and not by shareholders. The director's fiduciary duty is to be loyal to and exercise that degree of care to the subsidiary as a reasonable person might be expected to take in the same circumstances on his or her own behalf. Although the duty exists, there is little chance of the subsidiary enforcing it. For example, a director's adoption of a parent's decision to act in a particular way may be in dereliction of the director's duty to the subsidiary. Typically, in these circumstances, the parent will absolve the director of their obligations to the subsidiary by ratifying the director's actions making them actions of the subsidiary.¹² This means where a delinquent director has breached his or her duty to the subsidiary, on ratification by the shareholders, the director is immune from any misfeasance action before insolvency. However, there are circumstances where a parent's abuse of extra-legal control exposes it to liability. This occurs where there is *interference* with the subsidiary. For example, a director of a subsidiary is often an employee of the parent. The master servant relationship and the parent's power to dismiss an employee or remove the director from office is good

¹² Thus a parent is unlikely to be treated as a subsidiary's constructive trustee knowingly participating in the director's breach of duty except where there is a dishonest or fraudulent design. *Barnes v. Addy* (1874) LR 9 Ch App 244 at 251-252 *per* Lord Selbourne; See also *Belmont Finance Corporation Ltd v. Williams Furniture Ltd (No 2)* [1982] 1 All ER 393, (CA).

evidence of extra-legal control measures.¹³ A parent's rare breach of duty to the subsidiary may occur when the parent's instructions to the director of a subsidiary override the director's obligations to the subsidiary. Here, the parent has 'interfered' with the affairs of the subsidiary. The parent has acted to inhibit compliance by the subsidiary's directors with their duties.¹⁴ The 'interference' must have sufficient causality to give rise to a duty of care between parent and subsidiary. As such, the parent must directly influence the actions of the subsidiary's directors.¹⁵

Should the mere fact of control make the parent subsidiary relationship susceptible to veil piercing? Rationally, if a corporation is pursuing a course that accords with commercial expectations, avoiding fraud or oppression, then close association between the parent and subsidiary should not deprive companies of legitimate privileges.¹⁶ The parent's desire to limit liability using a subsidiary is not a fraud.¹⁷ If the parental influence is legitimate in terms of societal and commercial norms then mere domination of the subsidiary by a parent is not a badge of impropriety. The problem is that the potential for abuse of parental control is very real. At present, the law remains in stark disregard of the recommendations of the Cork Committee:

It is unsatisfactory and offensive to the ordinary canons of commercial morality that a parent should allow its wholly-owned subsidiary to fail, or that a company should be permitted by other companies in the same group, and particularly by its ultimate parent, to take commercial advantage from its membership of the

¹³ *Kuwait Asia Bank E.C. v. National Mutual Life Nominees Ltd*, [1991] 1 AC 187 at 223 c d.

¹⁴ *Dairy Containers Ltd v. N.Z.I. Bank Ltd* [1995] 2 NZLR 30 at 87-90 *per* Thomas J. and *Kuwait Asia Bank E.C. v. National Mutual Life Nominees Ltd*, [1991] 1 AC 187 (PC) at 223-224 for a discussion of the notion of a parent's 'interference' with a subsidiary.

¹⁵ *Dairy Containers Ltd v. N.Z.I. Bank Ltd* [1995] 2 NZLR 30 at 88-90 *per* Thomas J.

¹⁶ C. E. Brooks, 'Parent and Subsidiary, right of parent or subsidiary to share with other creditors in assets of associated corporation on the latter's insolvency' (1939) 37 *Michigan Law Review* 440 at 448.

¹⁷ *Adams v. Cape Industries Plc* [1990] 1 Ch 433.

group, without there being incurred by those other companies any countervailing obligations.¹⁸

The lack in the United Kingdom of any duty between a parent and subsidiary means no legally enforceable minimum standard of conduct exists. Consequently, a parent can exercise an abusive attitude toward a subsidiary with very little accountability. The possibility of abusive control and the power to manipulate credit and assets in a subsidiary means that a parent will, as a commercial reality, endeavour to gain advantage over other creditors in the case of liquidation.

As we shall see, more sophisticated notions of what constitutes 'legitimate' control has been developed in the US and a number of other countries. There, the very nature of the parent subsidiary relationship warrants the close attention of courts and legislatures. Indeed, the US courts have not only imposed a duty; they have imposed a *fiduciary* duty on controlling shareholders. Countries such as Australia impose legislative duties on a parent in their capacity as a *shadow director*. Thus, it is a premise of this thesis that English law inadequately responds to the problems posed by groups of companies.

THESIS ARGUMENTS

This thesis is concerned with the problem of accountability of a parent to a subsidiary and its creditors for abuse of extra-legal control.

Modes of Reform

It is the objective of this thesis to demonstrate that the law concerning corporate personality and the parent subsidiary relationship – groups of companies – can be

¹⁸ Cork, *op.cit.*, at 434, para. 1924.

improved by reference to a number of sources. First, the basic principles of English law offers reform alternatives. Manipulation of the rich juridical resources of English law can enhance the position of creditors. Such reforms mean we must reconsider the jurisprudential treatment of corporate personality and improve the efficacy of existing legislative provisions. This will occur by clarifying understanding of corporate personality and illuminating the legislative changes necessary.

Second, we can draw on the experience of other countries. The problem of the parent subsidiary relationship and creditor protection is not new. The expertise of other jurisdictions assists the reform process by identifying jurisprudential strategies, legislative mechanisms, and any apparent limitations in the law. Such an examination takes further the call of the Cork Committee to conduct the widest possible review of the law as it applies to creditors and groups of companies.¹⁹ This thesis argues that effective reform of English company law derived from different jurisdictions need not be doctrinally radical. However, the actual reform process will require a substantial legislative overhaul to ensure clarity.

Jurisprudential Reform

If the law is to respond to the challenges of the corporate group then our jurisprudence must inform us of how and when corporate personality will be rejected.²⁰ The imposition of direct liability upon a parent for the responsibilities of a subsidiary is the most powerful weapon available to creditors. On the other hand, it is a devastating consequence destabilising not only the group, but also the entire notion of the corporate

¹⁹ Cork, *op.cit.* at 439, para. 1952.

²⁰ The term 'veil piercing' is used in this work to refer to any circumstance where corporate personality is rejected.

form. Frequently, over the past century, the judiciary has determined where responsibility and rights lie as between the incorporator and the company. The consequence has been a 'baffling'²¹ and highly inadequate use of the courts equitable jurisdiction to pierce the corporate veil. Academic attempts to expose the 'how and when' of rejecting corporate personality have failed to deliver convincing theory or pragmatic basis for predicting outcomes.²² A common feature of these approaches is the presupposition of corporate personality as a constant – some immutable concept derived from *Salomon*.²³ It is the search for a 'unifying principle' a legal 'philosopher's stone', that undermines the clarity of attempts to resolve the juridical basis of veil piercing. The search for a unified theory demonstrates the yearning for clarity, but also demonstrates a fundamental misunderstanding of the legal nature of corporate personality. Moreover, our understanding of corporate personality should produce dialectic facilitating systematic methodology that determines the existence or non-existence of a company according to the demands of particular circumstances.

The judiciaries' response, until recently, to conceptualising corporate personality has been unsatisfactory. Too often, the judiciary misconceives corporate personality as one-dimensional. The judiciary takes no account of the various rules and their differing rationales that constitute the 'cluster concept' we call corporate personality. The courts

²¹ L. S. Sealy, *Cases and Materials in Company Law* 6th ed (London: Butterworths, 1996) at 56.

²² For example, traditional, academic exposition of these issues involved a detailed analysis of the relevant cases to allow a subject based categorisation such as that suggested by Farrar or the 'voyeurism' of Ottolenghi. See John H. Farrar, Nigel E. Furey and Brenda M. Hannigan, *Farrar's Company Law* 2nd ed (London: Butterworths, 1988) at 61. S. Ottolenghi, 'From Peeping Behind the Corporate Veil, to Ignoring it Completely' (1990) 53 *Modern Law Review* 338.

²³ See for example Lord Templeman's reference to *Salomon* as an 'unyielding rock'; 'Forty Years on' (1990) 11 *Company Lawyer* 10.

must reconsider the way we think of the company. This thesis argues that a company is a cluster of rules. There is an intimate connection between each rule and the factual context in which the rule is applied (or disapplied). A company only exists for the purposes of the law when all rules are applied to a legitimate factual context. This thesis argues that the tests available to determine the contextual legitimacy of a company's use of the rules are ill-suited to the complexity found in group structures. At present, in English law, if the context reveals an 'illegitimate' purpose then the courts have two primary options:

1. vitiate the transaction to which the company was a party while respecting the company's separate personality; or
2. subordinate the rule of separate personality to the imposition of direct liability.

The doctrine of the sham as used in company law facilitates both these options because it focuses on whether the rule under discussion in the instant case produces a legitimate outcome. However, the adequacy of this response is wanting when called on to consider complex group transactional arrangements. This is because the first method of analysis is piecemeal and incapable of identifying the actual purpose of a series of transactions. Second, if the purpose is illegitimate, then there is no appropriate sanction.

The complexity of group arrangements requires a return to 'first principles' analysis. Not only must the courts revisit their mode of analysis, they must draw on a wider range of variables in order to determine the nature of the relationship between parent and subsidiary. If English company law is to respond to the challenges that groups of

companies pose to the law then it must be prepared to cross the boundaries of legal doctrine. For instance, principles used regularly in taxation law to determine the validity of complex arrangements or transactions could be usefully deployed for analogous situations arising in the context of applying some rule of corporate law. There is much to be said in favour of a cross-fertilisation between discrete, but cognate fields of law.

Legislative Reform

The legislature has responded to the general inadequacy of veil piercing jurisprudence to protect creditors with varying degrees of success.²⁴ The primary method of providing a remedy is to set a standard of conduct and then provide a means of recourse to make the wrongdoer accountable for their actions. In English company law, statute does not specifically regulate the liability of the parent for the debts of a subsidiary. Primarily, we place reliance on *Salomon* – the parent is a separate entity and has liability limited to the extent of its shares in the subsidiary. Whilst there is no specific legislation protecting a creditor from the risks of dealing with a group of companies there are a number of remedies for creditors that may apply by implication. This involves a broad interpretation of a number of statutory definitions in order for the parent to fall within the terms of these provisions. As we shall see, this is one of many substantive and procedural barriers a creditor must negotiate to obtain recourse against a parent company for the debts of a subsidiary. Consequently, the courts are still to use creditors' remedies such as wrongful and fraudulent trading against a parent for the debts of a subsidiary. This state of affairs continues despite firm recommendations

²⁴ Labour, taxation, and banking are specific areas where the nature of the group of companies has warranted legislative measures. However, these areas are outside the scope of this work.

from the Cork Committee that a legislative response to the parent subsidiary relationship is necessary.²⁵

Previous reform proposals have offered a variety of alternatives without any real assessment of their viability in the United Kingdom's context. In particular, the reforms ultimately taken are usually modest and not directed at the group of companies.

Factors Influencing Reform

The Cork Committee identified two important issues needing determination owing to the tension between the primary themes of *encouraging entrepreneurial investment* and *creditor protection* concerning group trading. First, to what extent should the members of a group be responsible for the debts of an insolvent member? Second, how should the claims of group companies be treated in the insolvency of a fellow group member?²⁶

Limited Liability and Separate Personality

The first issue is premised on the principles of separate legal entity and limited liability and their legitimacy in the group company scenario. The courts and the legislatures entrenched adherence to the corporate liability rule for the past one hundred years is a profound testament in its defence. The manner in which the commercial world has embraced limited liability and separate personality as established in *Salomon* is certainly not 'calamitous'.²⁷ There is unconvincing reasoning here. If an individual or corporation takes bona fide advantage of a policy legitimated by the law, which is pervasive and commercially valid, then they should be entitled to assume the protection of the corporate form. They are neither unworthy of the right to claim for their labour

²⁵ Cork, *op. cit.*, Chapter 51.

²⁶ Cork, *op. cit.*, at 435, para. 1929.

²⁷ As stated by O. Kahn-Freund, 'Some Reflections on Company Law Reform' (1944) 7

and services nor are they deserving of increased liability. The Cork Committee set out five alternative measures to deal with the perceived problems posed by the group as follows:

- (a) each company in a group should be jointly and severally liable for the external debts of each of the other companies in the group;
- (b) the group responsibility stated in (a) should arise only by means of a contracting-in procedure, that is, the registration of an acknowledgement of group liability, the existence of which would be published on all business documents;
- (c) the group responsibility stated in (a) above should be qualified by a contracting-out procedure, again by registration of a denial of group liability coupled with an indication on all public documents that there was no such responsibility;
- (d) the imposition of liability on one or more of the other companies in the group in the event of a proven departure from a predetermined code of conduct; and
- (e) an imposition of liability on a member of the group by a decision of a Court in the course of the insolvency of another member of the group, the Court having the widest discretion, but being required to have regard to certain guidelines.²⁸

Alternative (a) is the extreme and constitutes the group as an enterprise entity for all purposes. The Cork Committee spent little time in consideration of this issue because of the fundamental difficulties inherent in such a measure.²⁹ Thus, alternative (a) is not

Modern Law Review 54.

²⁸ Cork, *op. cit.*, at 435, para. 1935.

²⁹ Even Professor Blumberg, as one of the foremost proponents for the introduction of

a reform proposal with real possibility. Alternative (b) and (c) on the other hand have precedent in both the German *Konzernrecht* and the former EC Draft Proposal for a Ninth Company Law Directive. Alternative (d) in many respects would constitute a clear extension of provisions such as section 214 Insolvency Act 1986 to the specific circumstance of the parent permitting a subsidiary to trade whilst insolvent. Precedents for such provisions are found in the Australian Corporations Law.³⁰ Alternative (e) transcends the boundary between solvency and the liquidation of a company. Remedies of this nature fall into three basic groups.

First, remedies such as *veil piercing* permit the court to remove the protection of separate personality at any time during the life of a company – be it solvency, insolvency, or liquidation. Whilst clearly available in the United Kingdom, the United States provides the most expansive and liberal use of veil piercing jurisprudence. Also transcending the solvency and liquidation divide is the establishment of clearly defined duties between the participants in a company and its enterprise. Again, the US offers substantial experience concerning the fiduciary duties owed by controlling shareholders and parent companies toward outsiders.

Second, there are remedies designed to operate before liquidation. The incursion of creditors by the use of litigation to interrupt the ongoing management of a company is controversial. Australia has a carefully structured range of remedies that can be used by an ‘interested person’ to gain relief before the liquidation of a company.

enterprise principles, recognises the ‘impracticality’ of introducing piecemeal enterprise principles. See Phillip I. Blumberg, ‘The Corporate Entity in an Era of Multinational Corporations’ (1990) 15 *Delaware Journal of Corporation Law* 285 at 365.

³⁰ Part 5.7B Division 5 Australian Corporations Law.

Finally, there is a host of remedies available to liquidators and other interested parties on a winding up. In the US, there are the equitable remedies of equitable subordination and substantive consolidation. Similarly, New Zealand has provisions in its Companies Act 1993 providing for the contribution by related parties or the pooling of assets for distribution to creditors. This willingness to provide more comprehensive remedies on insolvency was received favourably by the Cork Committee stating, 'given the command which the parent company has in practice over the affairs of the subsidiary, it is absurd and unreal to allow the commercial realities to be disregarded and the technical legal separate status to predominate once the subsidiary has gone into insolvency.'³¹

The emphasis for reform should not focus on elimination of *Salomon* but rather provide carefully considered exceptions. The problem with this approach is that we cannot reform this area in a vacuum and Cork's second concern of how the claims of group companies should be treated in the insolvency of a fellow group member raises a number of issues but primarily, the problem of *pari passu*.

Intergroup Indebtedness and the Problem of *Pari Passu*

In the United Kingdom, the *second issue* influencing reform is how should the claims of groups of companies be treated in the insolvency of a fellow group member? This problem is premised on the legitimacy of *pari passu* and its relationship with the distribution of liquidation dividends amongst outside creditors and group members. Two matters are of concern here; first the possible deferment of intercompany indebtedness in a winding up to the debts owed to external creditors; and the issue of how company assets have been applied for the benefit of other companies in the

³¹ Cork, *op. cit.*, at 435, para. 1928.

group.³² The principle of *pari passu* is at odds with the introduction of remedies that seek to tinker with the equality of distribution process. By contrast, with *Salomon* there has been little criticism of *pari passu* in the context of creditor claims between parent and subsidiary. *Pari passu* has virtually become an article of faith in insolvency law.³³ It is perceived as being uncontroversial because of the evident commercial morality that informs it. Historically, *pari passu* developed to protect creditors. Certain ethical proprieties must be observed in the relationship between the creditor and insolvent debtor and creditors *inter se*.³⁴ These proprieties are necessary to ensure an equitable distribution of assets in a winding up. The basic principle governing the relationship between creditor and insolvent debtor provides that if a person uses their own capital to fund an enterprise then that person cannot gain any priority of payment over the creditors of the enterprise.³⁵ As between creditors, the primary ethical propriety is that there is *equality amongst creditors*. The exceptions to *pari passu*³⁶ are recognition that commercial needs and the distribution of risk in an enterprise can effectively be weighed against concepts that protect creditors. Unusually, the mechanisms of corporate insolvency procedure rely on an ideal of collectivity that results in a differential treatment of a claimant's rights before and after the time of winding up. Individual rights for the payment of a debt are restricted in favour of measures designed to maximise distribution to the majority. The liquidator, for the collective benefit of creditors, pursues only the obvious and fruitful rights and will be easily deterred by

³² *Ibid.*, at 440, para. 1957.

³³ Fidelis Oditah, 'Assets and the Treatment of Claims in Insolvency' (1992) 108 *Law Quarterly Review* 459 at 463.

³⁴ Ian F. Fletcher, *The Law of Insolvency* 2nd ed (London: Sweet & Maxwell, 1996) at 2.

³⁵ Cork, *op. cit.*, at 441, para. 1962. See also *Re Beale* (1876) 4 ChD 246, *Re Meade* (1951) Ch 774.

³⁶ The exceptions to *pari passu* are: setoff, pre-preferential claims, preferential unsecured creditors and statute deferred creditors. Oditah, *op. cit.*, n 33 .

substantive or procedural difficulties attendant on any claim. There is little recognition of the subtle equities that characterise the relationship between the debtor and creditors alike – these are lost in the transfer to collectivity.

Equality in the distribution of an insolvent company's assets is an economically efficient concept that the courts are eager to uphold.³⁷ The pervasive presupposition of *pari passu* is that equals should be treated equally. The remarkable aspect of *pari passu* is the absoluteness of its application subject to exceptions of varying potency. Odith categorises the exceptions into those that assist with the implementation of the collective nature of *pari passu* and those that protect against debtor misbehaviour.³⁸ Provided the corporate form and *pari passu* have been used legitimately, with good faith and honesty, their continued use is condoned. However, *pari passu* and the priority system may fail to deliver true equality in the distribution of an insolvent's assets because there is no provision for adapting the *pari passu* principle when, for instance, a creditor claiming equality of treatment is a parent company responsible for the financial demise of its insolvent subsidiary. Inflexible application of the *pari passu* principle can sometimes deliver formal equality at the expense of substantive justice.

Which Direction?

The virtues of adopting enterprise principles to regulate the relationship between groups and creditors have been the subject of much academic work.³⁹ It will be shown that the English judiciary has rejected the development of enterprise principles as they relate to the group of companies. Despite the perceived advantages of enterprise principles, the

³⁷ *British Eagle International Airlines Ltd v. Compagnie Nationale Air France* [1975] 1 WLR 758.

UK has also rejected their implementation in the guise of legislative reforms aimed at 'harmonising' laws throughout the European Union. The reason for the rejection of the EC proposals will be demonstrated and alternative reform avenues explored. In determining the most fruitful direction of reform, one must take into account the persistent rejection of 'enterprise principles' by the UK legislature and English Judges. Reforms emanating from common law jurisdictions may prove more congenial than more elaborate schemes influenced by German company law, provided, of course that innovations imported from, say, New Zealand and Australia are compatible with the UK's obligations under EU law. That said, we will first look at certain draft directives associated with the European Communities harmonisation project which were heavily influenced by German law. These formulations are similar to alternatives (b) and (c) mentioned in Cork.⁴⁰ As the model used to construct the EC measures, the German experience demonstrates a working example from which we can draw conclusions and subsequently assess the reasons for their rejection.

Generally, United Kingdom company law reformers face a number of conflicting influences in the process of reform. On one hand, there is a natural affinity with England's common law jurisdictional 'offspring'. In examining the US, Australia and New Zealand the object is to identify those factors that have lead these nations to depart from the 'norm' of separate personality and strict application of limited liability in the context of the parent subsidiary relationship. As we shall see, these jurisdictions have employed a number of ideas, some drawn from the work of the Cork Committee and provide useful data as to the practical aspects of the Cork proposals.

³⁸ Oditah, *op. cit.*, n 33 at 465.

³⁹ *Supra*, Introduction on page 25 n 7 and the works cited.

⁴⁰ *Supra*, on page 35.

On the other hand, the United Kingdom is a part of the European Community with its members drawn primarily from civil law jurisdictions. The European Community has embarked on an ambitious process of harmonising EC company law.⁴¹ Some (perhaps overly) sympathetic commentators have suggested that the EC is a legislator that eagerly searches for the best result to the problems posed when groups of nations seek to reform their laws together.⁴² As we shall see, the attempts to harmonise the law relating to groups of companies expose certain fundamental legal differences. It will become evident that the best way forward in the case of regulating groups of companies is for the Member States to adopt a process of 'adaptation' in pursuing the common goal rather than a process of 'harmonisation'.

The UK is, of course, obliged to receive EC directives and is not simply able to take its own course. The disappointing experience of the Proposed Draft Ninth Directive demonstrates a need for EC law reformers to rethink their heavy handed regulatory approach. The EC must acknowledge the fundamental doctrinal differences at work and seek to employ a lighter regulatory framework that focuses on reformative measures in pursuit of a common goal that are adapted to each member's existing legal framework.

The essential difficulty with the attempt to regulate groups of companies through the European Company Statute and the Proposed Draft Ninth Company Law Directive is the introduction of theory and mechanisms that are incompatible with the entrenched

⁴¹ Article 54(3)(g) of the Treaty of Rome endeavours to co-ordinate, 'to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by Member States of companies and firms... with a view to making such safeguards equivalent throughout the Community.'

⁴² Robert R. Drury and Peter G. Xuereb, 'Introduction' in Robert R. Drury and Peter G. Xuereb eds, European Company Laws A Comparative Approach (Aldershot: Dartmouth,

principles of *Salomon*. In essence, the European Community proposes that intragroup liability concerns be decided according to the principle that 'the parent corporation shall be liable for all unpaid debts and acts of its subsidiaries for the reason that the former controls the latter forming thereby a unitary economic enterprise'.⁴³ This represents a radical departure from the accepted canons of corporate law with equally uncertain possibilities. Most importantly, the EC proposals allow us to determine whether alternatives (a), (b) and (c) above⁴⁴ are plausible reform considerations in the United Kingdom. As we shall see, the UK has faced the competing tension of either adopting principles that complement its firm footing in the *Salomon* doctrine or the adoption of reforms that result in a paradigm shift. Further, we will see that, in the EC context, the adoption of enterprise principles for groups was rejected across the board by all but one of the EC members. This paves the way for the UK to reform the level of protection offered to creditors by using mechanisms that retain *Salomon* as a theoretical basis but temper its strict operation toward creditors. Consequently, the EC proposals and German law are inappropriate models for the reform of English company law.

A CAUTIONARY NOTE

It has often been recognised that the study of other legal regimes serves to enlighten understanding of one's own legal system. However, any enquiry of this nature must be undertaken subject to certain caveats. We must first be conscious of the limitations placed on any process whereby the law from different jurisdictions is considered with a view to obtaining ideas for reform. As we shall see in relation to the Proposed Draft Ninth Company Law Directive and its affinity with the German *Konzernrecht*, we need

1991) at 6.

⁴³ Antunes, *op. cit.*, at 236.

to be conscious of the complexities posed by the ‘transplantation’ of foreign law as a mode of law reform.⁴⁵ There is also a risk of treating the law from another jurisdiction superficially.⁴⁶ In the context of company legislation we must be conscious of the purposes driving the mechanisms used in the legislation from a particular jurisdiction. For example, legislation may prioritise *shareholder welfare* leaving creditors to their own contractual devices or legislation may be multifaceted seeking to balance the interests of all the participants in the enterprise. This risk can be overcome where the methodology used is the same. Any proposed reform measures must have a methodological basis that serves to identify the emphasis and range of analysis used.⁴⁷ In this work, we will examine other common law jurisdictions to ask: ‘What remedies are there for the creditors of a group of companies before and after liquidation?’

The latter part of this work is concerned with the substantive legal aspects of measures used to protect creditors who deal with groups of companies in Germany,⁴⁸ the European Community, Australia, New Zealand, and the United States. Particularly instructive for English law will be legal regimes that offer similar judicial and legislative regimes arising within a common law legal tradition. However, the fluctuating nature of the corporate form across different jurisdictions can be ‘opaque’⁴⁹

⁴⁴ *Supra*, on page 35.

⁴⁵ O. Kahn-Freund, ‘On Uses and Misuses of Comparative Law’ (1974) 37 *Modern Law Review* 1.

⁴⁶ Ferdinand F. Stone, ‘The End To Be Served By Comparative Law’ (1951) 25 *Tulane Law Review* 325 at 329. On this point, concerning the German *Konzernrecht* Professor Hopt states: ‘... if a foreign lawyer simply examined the 1965 Act, he would have a very misleading picture of the German law of groups’. See Klaus J. Hopt, ‘Legal Elements and Policy Decisions in Regulating Groups of Companies’ in Clive M. Schmitthoff and Frank Wooldridge eds, *Groups of Companies* (London: Sweet & Maxwell, 1991) at 85.

⁴⁷ Drury and Xuereb, *op. cit.* n 42 at 4.

⁴⁸ As the German law is considered there are the inherent risks of using translations and in terms of technical accuracy the consideration of this area can only be offered as a rough guide.

⁴⁹ Roberta Romano, ‘A Cautionary Note on Drawing Lessons from Comparative Corporate

thus limiting its value. Largely, the choice of jurisdictions overcomes this problem because the principles espoused in *Salomon* exist as corporate law paradigms in the Australia, New Zealand, and, to a lesser extent, in the US.

In each jurisdiction, we are concerned with corporate groups comprising limited liability companies. We need not distinguish between public and private companies or focus on the structure or complexity of the group because the problem for creditors transcends these differences.⁵⁰ Importantly, each of the jurisdictions chosen has a developed economy that relies on the limited liability company and the corporate group. To varying degrees, each has made some effort to deal with the problem of the parent subsidiary relationship and its alliance with creditors. The common feature in each jurisdiction, again to varying degrees, is the recognition of obligations to creditors on the part of enterprises that form corporate groups. Our concern is with the mechanisms that either modify or erode *Salomon* so that a parent or a related company is held responsible for the debts of a subsidiary. The important feature is the scope of application of the mechanism to the parent subsidiary relationship, be the relationship formed via direct or indirect shareholding or other forms of extra-legal control.

If reflection on the experience of other jurisdictions is to inform a proposal for reform of the parent subsidiary relationship and creditors' remedies in the UK, then we must also be alive to the nuances of language used in each jurisdiction to denote legal meaning. There is little difficulty when we consider the Commonwealth jurisdictions of Australia and New Zealand, which have inherited many familiar terms with similar

Law' (1993) 102 *Yale Law Journal* 2021 at 2021.

⁵⁰ The two basic types of group structure are the a vertical group (a hierarchical structure where one or more companies are controlled by a parent) and the horizontal group (an organic structure where each company is legally and factually independent but under the

meaning, but the US poses a different challenge. US legislation and jurisprudence emerges from a multiplicity of jurisdictions, making difficult definitive statement of the law on a particular point.⁵¹ Indeed, each State ‘discovers’ the common law with varying degrees of conformity.⁵² Consequently, although American legal principles may be expressed in terms familiar to English lawyers, the radically different legal and constitutional framework may render meaningful comparison difficult.⁵³

SUMMARY OF CONTENTS

This thesis is divided into four parts and eight chapters. Part I comprises Chapter 1 and describes the nature of the relationships between creditors, parent companies, and subsidiaries. Chapter 1 briefly introduces the general social and economic tensions that arise through the interaction of creditors and groups of companies. It is acknowledged that enterprise should be encouraged, but that the relationship between these two bodies should be fine-tuned to approach the social ideals of fairness and accountability. It is concluded that if the legal relationship between both bodies is to be reformed then such reform must be sensitive to the well established and legitimate role that groups of companies play in economic and commercial activities. Against this ‘reality’, Chapter 1 then delves into the complex legal relationships that arise in a group of companies. First, it is demonstrated that the principles of limited liability and separate personality are entrenched, logical, and complimentary legal paradigms that have served for over

control of a controlling person or company).

⁵¹ Peter de Cruz. A Modern Approach to Comparative Law. (Deventer: Kluwer Law and Taxation Publishers, 1993) at 96.

⁵² Ferdinand F. Stone, ‘The End To Be Served By Comparative Law’ (1951) 25 *Tulane Law Review* 325 at 328.

⁵³ de Cruz, *op. cit.*, n 51 at 96. Because of this, it should be borne in mind that the scope of terms such as ‘fraud’ and ‘fiduciary’ is much wider in US. This potential for confusion is highlighted where necessary.

100 years. It is shown that whilst limited liability and separate personality are fundamental principles of company law they are also an integral part of the commercial world, a world which is large part founded on these principles. Second, we look in detail at the legal nature of the relationship between a parent and a subsidiary. Can the mere existence of the relationship of a parent owning shares in a subsidiary permit the finding that the two entities are one 'economic entity'? The consequence of such a finding could be that the parent and subsidiary share assets and liabilities. Thus, a creditor of a subsidiary would be at liberty to recover against the assets of the parent. Third, it is demonstrated that the differing roles played by a parent permit a wide range of legitimate conduct.

Part II comprises chapters 2 and 3, and reviews the legal relationship between parent and subsidiary in general terms. It explores the limitations of current veil piercing jurisprudence when called on to deal with claims that seek recourse against the assets of a group of companies. Chapter 2 focuses on the circumstances that allow a court to pierce the veil between parent and subsidiary. This concerns first, the use by the courts of findings of agency as between companies who are members of the same group. As we shall see, such findings of agency differ from those made in strict agency law. *Adams v. Cape Industries Plc*,⁵⁴ has emphasised the importance of formal agency relationships in removing the effect of *Salomon*. Second, we will consider those 'special circumstances' indicating that the company is a 'façade concealing the true facts'. This area of law is examined to determine the qualities and circumstances that give a company the character of a sham. It will be demonstrated that three distinct

⁵⁴ [1990] 1 Ch 433.

types of sham emerge from the cases, the transactional sham, the corporate sham, and the corporate – transactional sham hybrid.

Chapter 3 demonstrates that the current regime for jurisprudential veil piercing is incapable of dealing with the complexity of a group of companies and their associated transactional structure. There are two reasons for this inadequacy in the law. First, the way the courts juridically conceptualise companies needs to be revisited. There is a tendency to treat a company as a real thing, in absolute terms, when it is a creation of the law – a cluster of rules. These rules, and, in that sense, the company, should forfeit their legitimacy if used for inappropriate, unconscionable ends. Second, as a consequence of the treatment of the company as an ‘island of absolute sovereignty’ and its subsequent ‘reification’, the law is reluctant to analyse functionally the use of a company in a group of companies in an empirical and detached manner in order to determine the motivation and real effect of a series of transactions.

Part III comprises chapter 4 and deals with the adequacy of creditors’ legislative remedies to deal with the parent subsidiary relationship. Chapter 4 examines the capacity of each specific remedy to provide recourse against a parent company for the debts or obligations of the subsidiary. First, the regime concerning transactions at undervalue, preferences and defective floating charges are considered. Second, the summary remedy against directors under section 212 of the Insolvency Act 1986 is analysed with a brief digression into the general law of a director’s duty to creditors. It is shown that section 212 offers an avenue to improve the position of creditors yet its operation does not extend to the parent subsidiary relationship. Third, we address the remedy of fraudulent trading. Clearly concerned with a serious form of conduct, the

provision is capable of drawing in a parent. Nevertheless, it remains a remedy for an extreme form of conduct and places heavy evidential burdens on a creditor. It has been shown historically that there is need for a remedy that combats less egregious, but potentially as damaging, forms of conduct and leads us to the final matter – wrongful trading. Wrongful trading under section 214 Insolvency Act 1986 is the only real and potentially effective legislative measure available in England for creditors to gain accountability for abuses by a parent toward a subsidiary. In the remainder of Chapter 4, we identify some of the problems with the proposition that a parent may be a *shadow director* of a subsidiary for the purposes of wrongful trading.

Part IV comprises chapters 5 through 8 and deals with the issue of legislative reform and which direction it should take. Whilst it is accepted that the UK must take direction from the European Union on the issue of reform, it is theme of this thesis that the UK has much to gain from considering the approach adopted in other common law jurisdictions such as Australia, New Zealand and the United States. In doing so the legislation and experience of Germany, the European Union, Australia, New Zealand and the United States in relation to groups of companies is examined. This process identifies in detail the philosophy, themes and mechanisms used in each jurisdiction to provide protection and remedies to creditors. It is then shown that the problem with reforms derived from Germany and the European Union is the paradigm shift necessary to implement their general intention. Whereas, the experience of the other common law jurisdictions, though not without their own deficiencies, retain the principles of limited liability and separate personality, yet use mechanisms developed to deal with the problems posed by the group of companies.

Chapter 5 considers the legislative regime of the *Konzernrecht* contained in the German Stock Corporation Act of 1965 (*Aktiengesetz*) and that offered by the European Union in the form of the Proposed Draft Ninth Company Law Directive. Both the German and the European Union offerings use variants of the economic unity principle and would lead to a dramatic upheaval in the way commerce and companies function in the UK.

Chapter 6 analyses the regime used in the Australian Corporations Law. As we shall see, Australia has a complex legislative framework that seeks to clarify a number of difficulties. This is achieved through detailed legislative drafting and a corporate philosophy that relies on a government body performing a watchdog role and a willingness to allow creditors via the courts to intervene in the day to day management of a company.

Chapter 7 considers some of the legislative measures found in New Zealand. New Zealand offers a clear contractarian ideology with reluctance to intervene in the day to day functioning of the management of a company. Whereas, upon insolvency the courts and creditors are given a number of avenues to gain recourse. New Zealand like Australia have detailed provisions but the recent nature of the legislation in each jurisdiction means there are few decisions that provide prescriptive guidance on how the courts will respond.

Finally, Chapter 8 looks at the position in the United States. Various jurisdictions in the United States have made use of widely drawn legislative provisions that encourage the court to use its equity jurisdiction. Consequently, much of the law protecting creditors from the difficulties posed by groups of companies is derived from a large body of case

law dealing with veil piercing, fiduciary duties, equitable subordination and substantive consolidation. The US demonstrates both the power and the uncertainty inherent in a broad 'open textured' equitable jurisdiction permitting incursion into the parent subsidiary relationship.

In the Conclusion, an answer to the problem of accountability for the abuse by the parent of its extra-legal control over a subsidiary is proposed.

Part I: Groups of Companies and Creditors: The Reality and The Law

Chapter 1

Creditors, Salomon, the Group of Companies and the Parent Subsidiary Relationship

INTRODUCTION

The law is 'the product of many forces [and] inevitably reflects the tension between past needs and present needs, between past and present capacities, as well as the tensions between the ethical demand for justice and the economic pressure for efficiency.'¹ Nowhere is this tension more evident in modern company law than the interface between groups of companies and the creditor. The tension between encouraging entrepreneurial activity and protecting creditors places government regulators in an awkward position. Regulators must strike a balance between the free market, regulation, and resolving the tensions and building on the harmonies derived from the interaction of entrepreneurs and creditors.

Risk and cost are essential features of any enterprise. The investors in enterprise, the State, entrepreneurs (the owners), creditors, and workers all bear part of the risk of success or failure. The begetters of incorporated enterprise and corporate law gave the corporation the quality of separate personality and for those who invest equity, the benefit of limited liability. During this seminal period losses and benefits were

¹ J. Roland Pennock and John W. Chapman, eds Ethics, Economics and the Law (New York: New York University Press, 1982) Nomos XXIV of Yearbook of the American Society for Political and Legal Philosophy at xiii.

allocated via the market dictating its needs to the legislature. Indeed, historiographic analysis demonstrates that limited liability and separate personality were designed with the single company in mind.² Because the notion of limited liability is viewed as a risk minimiser, it has often been described as a device by which the uncompensated risk of enterprise failure is placed on creditors. Contrary to the economic model of pre-act bargaining (whereby creditors factor this risk into the price of their credit) uncompensated losses are suffered by creditors. The reasons for these differing perceptions of creditor's loss are various. A creditor may range from the highly sophisticated risk assessor to the intuitive trader. Accordingly, creditor's knowledge and access to information and resources varies dramatically. Creditors are drawn from the cross-section of the community including financiers, employees, and large and small business traders. All are placed differently with respect to their capitalisation, disposable income, bargaining power, political influence and the effect a debtor's insolvency will have on them and their own creditors in turn. The State plays an integral role in the relationship between creditors and entrepreneurs. Just as the State has sovereign power over money, it has power over credit. Monetary policy often dictates the flow of credit to different business areas. The use of interest rates to steer credit away from stock market speculation and into banks is only one example.³ The freedom of action of individual firms in market settings should be encouraged. Firms should organise their acquisitions and disposals on their own initiative provided they have reasonable expectations of meeting the commitments they undertake. Any producer should be free to manufacture what market information indicates is in demand, subject to the constraints of health and safety. It is not the responsibility of the

² Davies, *op. cit.*, at 18-53, Avgitidis, *op. cit.*

State to provide compensation in case of an enterprise failure. The State's role is to ensure that there is a transparent system of equality of treatment that allows redress for creditors and rehabilitation of enterprises with prospects of viability.

On the other side of the equation, the group of companies is the chosen form of organisation for enterprise both domestically and internationally and is now 'the central actor of the modern corporate world'.⁴ In the Darwinian tradition, it reigns supreme through its ubiquitous presence and economic power. So pervasive is the group that it also represents the hopes and aspirations of large tracts of the community and possesses political power and influence indicative of these interests.

A group of companies provides inherent benefits to its 'controllers' over the creditors it deals with on a day to day basis. The group is 'dominated by an impression of power and hidden activity'.⁵ As such, the primary advantage of a group of companies in relation to creditors is informational. The group allows controllers to minimise the amount of disclosure they must make and creditors are uninformed of data that could effect the nature of their investment and the decision whether to re-invest. In the absence of regulation requiring greater disclosure, the lack of transparency increases the opacity of down-side risk.

Creditors and corporate groups are fundamental social constructions inextricably linked to the economic health of a society. The provision of credit and the commercial activity associated with groups of companies are enormous enterprises dependent on each other

³ Adolf Berle, Power Without Property - A new development in American Political Economy (London: Sidgwick and Jackson Limited, 1960) at 130.

⁴ Antunes, *op. cit.*, at 37.

⁵ J. Attali, M. Holthus, D. Kebschull, G. Peninou and P. Uri, Who's afraid of multinationals? (London: Saxon House, 1978) at 30.

for their prosperity. The provision of credit and the undertaking of commerce each represents a significant concentration of capital and a centralisation of power. Any legal reform that seeks to improve structures and regulate transactions moulded by market forces must be sensitive to the opposing interests of creditors and the interest groupings found within groups of companies. Reform should be a process of amelioration achieving social utility and economic efficiency. In the economic order, the legitimate interests of creditors and the constituencies within groups of companies must be balanced and protected. Companies are entitled to free market competition and the protection of their capital whereas the creditor is entitled to the information necessary to make an informed investment decision and effective remedies when wrongs are done.

It is often said that the law relating to groups of companies and creditors is too indulgent of the interests of the former. The criticism is based on the observation that controllers of the group enterprise are not accountable for the illegitimate, loss causing uses of their power. In reality, it is claimed, the parent controls the subsidiary and should be liable for its losses. In law, the *Salomon* doctrine limits incursions to the parent subsidiary relationship. Therefore, the 'tail' of corporate groups wags the body of the legal dog! To understand the tension between the 'reality' and the law we must understand the boundaries of legitimate parental conduct toward a subsidiary. So how is the relationship between parent and subsidiary fashioned?

The doctrines of separate personality and limited liability informs and shapes the roles each actor plays in a company. For example, the adoption of a particular role by a parent company either willingly or by implication of law may effect the extent of its

obligations, rights, and duties toward the subsidiary and outsiders. A parent may play more than one role at the same time and the law will seek to attribute conduct to the appropriate role in order to maintain separate personality and limited liability, where appropriate. In this way, a parent's exposure to liability is circumscribed by the recognition of the independence of each role. A parent may perform an action that may be construed as an act of a controller, but, because 'controller' is not a legally recognised category, legal consequences in respect of the exercise of this role may be evaded. In ordinary commercial circumstances, when a company's business is a viable solvent concern, the need to characterise conduct and roles is minimal. Attribution of responsibility for conduct that is characterised in accordance with a particular role is only relevant where a company approaches insolvency or some other claim made. Creditors will look for redress from wherever they can find it and the process of liquidation governs these matters.

In a winding up, subject to the priority rules, creditors are entitled to satisfy their debts and obtain benefit from all a subsidiary's resources. Limited liability and separate personality qualify the form of legal recourse available to a creditor. These principles preclude, in the absence of special circumstances or specific legislative provisions, redress against shareholders or officers of the insolvent subsidiary. The strict adherence of the law to these doctrines means the avenues available to a creditor are restricted and a parent can easily avoid responsibility. For example, if the conduct of the parent shareholder complies with normative standards appropriate to the role of shareholder then the creditor has no redress against the parent. The law must respond when the conduct of a parent falls outside these normative standards. The extent of legitimate interaction between parent and subsidiary – the range of circumstances where separate

personality and limited liability apply – defines the circumstances in which a creditor may have recourse against the parent.

SALOMON

The principles of the separate legal personality of companies and the limited liability of shareholders and company officers was established in House of Lords decision in *Salomon v. Salomon & Co*⁶ reversing the decision of the Court of Appeal in *Broderip v. Salomon*⁷.

At first instance, Vaughan Williams J. saw the relationship between Salomon and company as merely principal and agent saying ‘... I wish, if I can, to deal with this case exactly on the basis that I should do if the nominee, instead of being a company, has been some servant or agent of Salomon to whom he had purported to sell his business.’⁸

Accordingly, his Honour held:

[T]his business was Mr Salomon’s business and no one else’s; ... he chose to employ as agent a limited company; ... he is bound to indemnify that agent, the company. The creditors of the company could, in my opinion sue Mr Salomon. Their right to do so depends on the circumstances of the case, whether the company was a mere alias of the founder or not. In this case it is clear that the relationship of principle and agent existed between Mr Salomon and the company.⁹

In the Court of Appeal, the decision was the same only the reasoning differed. Rather than superimposing the principal and agent relationship on to Salomon’s interaction with the company, it was seen more appropriate for the court to avoid perversion of a

⁶ [1897] AC 22.

⁷ [1895] 2 Ch 323.

⁸ [1895] 2 Ch 323 at 330.

⁹ *Ibid.* at 338.

company's legitimate use to cheat honest creditors.¹⁰ The court focused first, on the combination of the company's formation and second, on the issue of debentures. The Court of Appeal dismissed the appeal as a 'mere scheme to enable him to carry on business in the name of the company with limited liability, contrary to the true intent and meaning of the Companies Act 1862, and further, to enable him to obtain preference over the other creditors of the company by procuring a first charge on the assets of the company by means of debentures.'¹¹ The Court of Appeal saw this as Salomon's fraud and used the mechanism of a constructive trust. The company was deemed to have operated the business as a trustee for Salomon who should therefore indemnify the company for all debts incurred in carrying out the trust.

The House of Lords subsequent reversal of the Court of Appeal is one of the most influential decisions in common law history because it establishes the principles of separate corporate personality and limited liability. Rather than impose the requirements of agency, trust law, or the contrivance of fraud on the relationship between Salomon and the company, the House of Lords examined the policy behind the Companies Act 1862. The court established that the purpose of the statute was to enable business people to incorporate their businesses and to avoid incurring personal liability beyond the extent of their shares.¹² Lord Macnaghten explained the relationship between the statute, the company, separate personality, limited liability, and the individual as follows:

When the memorandum is duly signed and registered ... the subscribers are a body corporate 'capable forthwith', to use the words of the enactment, 'of exercising all the functions of an incorporated company'. Those are strong

¹⁰ *Ibid.* at 339 *per* Lindley L.J.

¹¹ *Ibid.* at 339.

¹² [1897] A.C. 22 at 52 *per* Lord Macnaghten.

words. The company attains maturity on its birth. There is no period of minority – no interval of incapacity. I cannot understand how a body corporate thus made ‘capable’ by statute can lose its individuality by issuing the bulk of its capital to one person, whether he be a subscriber to the memorandum or not. The company is at law a different person altogether from the subscribers to the memorandum; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor are the subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the Act. That is, I think, the declared intention of the enactment.¹³

Lord Halsbury LC went further with the notion of separate personality establishing that the intention of the individual promoters and the roles they fulfil after incorporation are also distinct.

[It] seems to me impossible to dispute that once the company is legally incorporated it must be treated like any other independent person with its rights and liabilities appropriate to itself, and that the motives of those who took part in the promotion of the company are absolutely irrelevant in discussing what those rights and liabilities are.¹⁴

Salomon firmly entrenches the principle of corporate limited liability and separate personality into the common law. Whilst the doctrine and the decision remain controversial some one hundred years later, there have been no attempts by the House of Lords to alter the doctrine's strict application of the doctrine in any way. One reason for the strength of the *Salomon* decision is the highly rational relationship between the component doctrines of limited liability and separate personality.

The Relationship between Limited Liability and Separate Personality

Limited liability is a complementary paradigm to the separate personality of a company.

Recently, the relationship between the two was reiterated in *J. H. Rayner (Mincing*

¹³ *Ibid.*, at 51.

¹⁴ *Ibid.*, at 30-31.

Lane) Ltd v. Department of Trade and Industry.¹⁵ The attribution of separate personality to a body corporate by incorporation made self-evident the proposition that the members would not be liable for the obligations of the corporation except where the legislation provided to the contrary. At first instance, Staughton J. held: ‘... separate legal personality is, in English Law, inconsistent with the members of an association being liable for its debts.’¹⁶ This doctrine was further reinforced by Kerr J. in the Court of Appeal:

The interposition of a legal entity between an unincorporated group of persons on the one hand, and third parties who enter into the contracts with the legal entity on the other, has the consequence under the common law that the members of the group have no liability for the contracts made by the entity, unless these were made on their behalf pursuant to the doctrine of agency.¹⁷

The logical consequence in the use of limited liability and separate personality is the strict delineation of roles amongst the participants in a company, be they individuals or other corporate entities.

The Separation of Roles

It flows logically that each corporate entity has its own rights and duties separate not only from members but also from directors,¹⁸ debtors, and creditors. In the New Zealand appeal to the Privy Council of *Lee v. Lee's Air Farming Ltd*¹⁹ the strictness of role delineation using the principle separate personality saw a rational extreme.

¹⁵ [1987] BCLC 667.

¹⁶ *Ibid.*, at 692.

¹⁷ [1988] 3 WLR 1033 at 1087.

¹⁸ *John Shaw and Sons (Salford) Limited v. Peter Shaw and John Shaw* [1935] 2 KB 113 at 134 *per Greer L.J.*, (CA); *Lee v. Lee's Air Farming Ltd* [1961] AC 12, (PC).

¹⁹ [1961] AC 12.

In the New Zealand Court of Appeal, the role of governing director in who was vested all power to govern and control and the role of servant were incompatible. North J. considered,

[The powers of governing director] were moreover delegated to him for life and there remained with the company no power of management whatsoever. One of his first acts was to appoint himself the only pilot of the company, for, although [the articles] foreshadowed this appointment, yet a contract could only spring into existence after the company had been incorporated. Therefore, he became in effect both employer and worker. ... In our view, the two offices are clearly incompatible. There could exist no power of control and therefore the relationship of master-servant was not created.²⁰

Lord Morris of Borth-y-Gest delivering the decision of the Privy Council characterised Lee's role in relation to the company in accordance with the conduct he was exercising at the relevant time of the accident. 'It cannot be suggested that when engaged in the activities [of aerial top-dressing], the deceased was discharging his duties as a governing director.'²¹ Assuming that the company was not a sham, the court confined Lee's conduct to each role thus permitting the allocation of the function of employee and agent for the company.

In their Lordships' view it is a logical consequence of the decision in *Salomon's* case that one person may function in dual capacities. There is no reason, therefore, to deny the possibility of a contractual relationship being created as between [Lee] and the company.²²

The factual situation remained that Lee could not be under the duty of giving orders and the duty of obedience of the same orders. This was not the issue, Lord Morris continued,

Control would remain with the company whoever might be the agent of the company to exercise it. The fact that so long as the deceased continued to be

²⁰ [1959] NZLR 393 at 399.

²¹ [1961] AC 12 at 25.

²² *Ibid.*, at 26.

governing director, with amplitude of powers, it would be for him to act as the agent of the company to give orders does not alter the fact that the company and the deceased were two separate distinct legal persons. ... Just as the company and the deceased were separate legal entities so as to permit of contractual relations being established between them, so also were they separate legal entities so as to enable the company to give an order to the deceased.²³

The real issue for the Privy Council was whether Lee's conduct could be appropriately characterised into a particular role. Did 'the position of the deceased as sole governing director [make] it impossible for him to be the servant of the company in the capacity of chief pilot?'²⁴ The ability of a legal entity to perform functions in different capacities and only attract the attendant responsibility of that capacity is a common and legitimate legal device.²⁵

Limited liability and separate personality are fundamental principles of company law that are inextricably connected to the commercial world and rarely is there a departure from their strict application. Whilst it is recognised that the original purpose of limited liability and separate personality was conceived with the single company in mind, it has been carried over to groups of companies which now constitute a formidable force in commerce. Removal of these doctrines from the operations of companies would radically destabilise settled commercial expectations. We will now turn to how the *Salomon* doctrine operates in the context of corporate groups.

²³ *Ibid.*, at 26-27.

²⁴ *Ibid.*, at 30.

²⁵ For example, a director can exercise a function as a director that does impinge on their relationship with a company in another capacity, such as a debtor. See *John Shaw and Sons (Salford) Limited v. Peter Shaw and John Shaw* [1935] 2 KB 113 (CA). See also *Yukong Lines Ltd v. Rendsberg Investments Corporation (No. 2)* [1998] 1 WLR 294, (QB).

SALOMON AND THE PARENT SUBSIDIARY RELATIONSHIP

The application of *Salomon* to the relationship between parent and subsidiary entails non-liability of the parent for the debts or other responsibilities of a subsidiary and *vice versa*. In the absence of a contract creating some additional right, the creditors of a subsidiary can look only to that company for payment of their debts, they cannot look to the parent for payment.²⁶ In the Court of Appeal's decision of *Albacruz v. Albazero*, *The Albazero*²⁷ it was made clear a parent is entitled to plead the defence of separate personality to any claim made by a subsidiary's creditors.²⁸

Liability for debts cannot be imposed unless the parent has not in some way intimated its willingness to accept responsibility. In normal circumstances a parent is not in law economically united with its subsidiary. While a finding of economic unity may be appropriate in certain circumstances, generally it is not a viable option for creditors as in the words of Lord Wilberforce in *Ford & Carter Ltd v. Midland Bank*,²⁹ 'When creditors become involved, as they do in the present case, the separate legal existence of the constituent companies of the group has to be respected.'³⁰

²⁶ *Industrial Equity Ltd v. Blackburn* (1977) 137 CLR 567 at 577 *per* Mason J. quoting *Walker v. Wimborne* (1976) 137 CLR 1 at 6 (HC of Aust).

²⁷ [1977] AC 774.

²⁸ '[S]uch defences are able to be advanced because of [a fundamental principle] of English law long established and now unchallengeable by judicial decision, at least in this court, ... that each company in a group of companies (a relatively modern concept) is a separate legal entity, possessed of separate legal rights and liabilities so that the rights of one company in a group cannot be exercised by another company in that group even though the ultimate benefit of the exercise of those rights would enure beneficially to the same person or corporate body irrespective of the person or body in whom those rights were vested in law.' *Albacruz v. Albazero, The Albazero* [1977] AC 774, (CA) at 807 d g *per* Roskill L.J.; Affirmed by the Court of Appeal (Slade, Mustill and Ralph Gibson L.JJ) in *Adams v. Cape Industries Plc* [1990] 1 Ch 433 at 532 d e *per* Slade L.J.

²⁹ (1979) 129 NLJ. 543.

³⁰ *Ibid.*, at 544.

Legally, parent is no more than a shareholder of the subsidiary with the rights, obligations, and duties incumbent in that role. To emphasise, 'English law insists on the recognition of the distinct legal personality of companies unless the relevant contract or legislation requires or permits a broad interpretation to be given to members of a group of companies or the legal personality is a mere façade or sham or unlawful device.'³¹ Despite this, courts have, on occasion entertained the proposition that the relationship between parent and subsidiary should be regarded as one of unity rather than separation because of close economic interpenetration between the two entities.

THE NOTION OF ECONOMIC UNITY

Economic unity of the enterprise existing between parent and subsidiary has been held out as a powerful justification for excluding the strict application of *Salomon* to a group of companies.³² From a creditor's perspective, treatment of a group of companies as an economic unit removes the barriers of *Salomon*. A creditor would be able to access the assets of not only the direct contracting party but also any of the other members of the group. In its extreme form this proposition suggests that the mere relationship of parent and subsidiary should allow the courts in their own discretion, to treat both companies as one. Less radical versions seek to ascribe responsibility according to the extent of control a parent has over a subsidiary. In the past, to a very limited extent, the courts have been prepared to entertain the notion of economic unity in a group of companies. Significantly though, the circumstances where the courts have justified a relaxation of *Salomon* have rarely involved the satisfaction of a creditor's claims on insolvency. With this in mind, let us consider the United Kingdom's foremost judicial exponent of

³¹ *Acatos & Hutchinson v. Watson* [1995] 1 BCLC 218 at 223 e g per Lightman J.

³² See Hugh Collins, 'Ascription of Legal Responsibility to Groups in Complex Patterns of

the view that group of companies can be viewed as single entities on the basis of economic unity.

Lord Denning - The Radical View

The radical view is that parent/subsidiary companies should be regarded as single entities because of findings of economic unity. In *Littlewoods Mail Order Stores Ltd v. Mc Gregor (Inspector of Taxes)*,³³ Lord Denning M.R. seized the opportunity to introduce this radical proposition into company law. In *Littlewoods*, a taxpayer had used a wholly owned subsidiary to hold property with a view to evade payment of taxation. Lord Denning M.R. stated:

I decline to treat the [subsidiary] as a separate and independent entity. The doctrine laid down in *Salomon v. Salomon & Co* has to be watched carefully. It has often been supposed to cast a veil over the personality of a limited company through which the courts cannot see. But that is not true. The courts can and often do draw aside the veil. They can, and often do, pull off the mask. They look to see what really lies behind. The legislature has shown the way with group accounts and the rest. And the courts should follow suit. I think we should look at the [subsidiary] and see it as it really is - the wholly owned subsidiary of the taxpayers. It is the creature, the puppet, of the taxpayers in point of fact; and should be so regarded in point of law.³⁴

In *DHN Food Distributors Ltd v. London Borough of Tower Hamlets*,³⁵ Lord Denning M.R. again concluded that legislative provision for group accounts and the realities of control allowed a finding of single entity on the basis of economic unity.³⁶ Thus Lord

Economic Integration' (1990) 53 *Modern Law Review* 731.

³³ [1969] 3 All ER 855.

³⁴ *Ibid.*, at 860 F H.

³⁵ [1976] 3 All ER 462, [1976] 1 WLR 852.

³⁶ 'We all know that in many respects a group of companies are treated together for the purpose of general accounts, balance sheet, and profit and loss account. They are treated as one concern. Professor Gower in his book on company law (L. C. B. Gower, *The Principles of Modern Company Law* 3rd ed (London: Stevens & Sons, 1969) at 216.) says: 'there is evidence of a general tendency to ignore the separate legal entities of various companies within a group, and to look instead at the economic entity of the whole group.' This is especially the case when a parent company owns all the shares of the subsidiaries,

Denning, emphasised criteria such as: (1) the parent owns all the shares in the subsidiary; (2) the parent has complete control of the subsidiary through share ownership and the power to appoint directors; and (3) the group of companies are treated together for the purpose of general accounts, balance sheet, and profit and loss accounts under companies legislation. Radically, the scope of this proposition was not confined to the application of the compulsory purchase legislation that fell to be interpreted in the case. Goff L.J. adopting a more tempered view, recognised that the court could look at the realities of the situation in the instant case (unusually the subsidiary company was the owner of the expropriated land) but was at pains to stress that his judgement did not go beyond the application of the legislation to the very particular facts of *DHN*.³⁷

Lord Denning M.R. showed greater regard for the legal separation of companies in *Lonrho Ltd v. Shell Petroleum Co Ltd*.³⁸ In Lord Denning's view, the 'presumption' of economic unity in a corporate group could be rebutted. Lonrho was engaged in a large commercial arbitration against Shell and BP. The issue before the court was whether Shell or BP as the parents of certain partially and wholly owned subsidiaries

so much so that it can control every movement of the subsidiaries. These subsidiaries are bound hand and foot to the parent company and must do just what the parent company says. A striking instance is the decision of the House of Lords in *Harold Holdsworth & Co. (Wakefield) Ltd. v. Caddies*. So here. This group is virtually the same as a partnership in which all the three companies are partners. They should not be treated separately so as to be defeated on a technical point. They should not be deprived of the compensation which should justly be payable for disturbance. The three companies should, for present purposes, be treated as one, and the parent company DHN should be treated as that one. So DHN are entitled to claim compensation accordingly.' [1976] 3 All ER 462 at 467 b e per Lord Denning M.R.

³⁷ 'I would not at this juncture accept that in every case where one has a group of companies one is entitled to pierce the veil, but in this case the two subsidiaries were both wholly owned; further, they had no separate business operations whatsoever; thirdly, in my judgement, the nature of the question involved is highly relevant, namely, whether the owners of this business have been disturbed in their possession and enjoyment of it.' *Ibid.*, at 469 d e.

incorporated in South Africa and the former Rhodesia were obliged to reveal documents that were properly the property of each subsidiary. Were the subsidiaries' documents in the 'possession, custody or power' of the parent? The subsidiaries had refused to provide lists of documents or information on the basis that it was against their interests because such a disclosure would potentially expose the officers to criminal proceedings. Lord Denning M.R. recognised that this was quite a different prospect to, 'the concept of a one man company – or a 100 per cent company – which is operated entirely with the self-same directors, or a 100 percent parent with various subsidiaries. It is important to realise that the subsidiaries of multinational companies have a great deal of autonomy in the country concerned.'³⁹ Although subsidiaries might be wholly owned, it was the question of effective control that was fundamental to the entire notion of the group as an economic entity. Shaw L.J. agreed, 'that a document can be said to be in the power of a party for the purposes of disclosure only if, ... on the factual realities of the case [the party is] virtually in possession (as with a one man company) in relation to documents of the company.'⁴⁰

Although the parents had voting control of the subsidiaries, in this case, the issue was whether the parents had 'power' over the documents of the subsidiaries. Lord Denning M.R. considered the previous authority and indicated,

it seems to me that even if we lift up the veil in this case: even if we look at the rules of management and the articles of association: in this particular case it is entirely different. Although the parent companies may have owned 100 per cent or 50 per cent each of the shares in the subsidiaries, it seems to me that in regard

³⁸ [1980] 1 QB 358, (CA).

³⁹ *Ibid.*, at 372 a b.

⁴⁰ *Ibid.*, at 375 g h.

to the documents which are in the possession of the South African and Rhodesian companies, the parent companies have no power over them.⁴¹

The parent companies had sufficient voting control to exercise the 'power' to remove the directors of the subsidiaries and replace them with officers that would comply with the will of the parent. However, this was not a viable option in the circumstances. As each director was obliged to comply with their duties and act in the interests of the subsidiary the change of directors may have had little effect. Alternatively, the parent could force a change in the articles of association of the subsidiary to give shareholders a right to inspect company documents. However, in normal circumstances, a shareholder has no obligation to take any of these steps.

The contrast between *Littlewoods*, *DHN* and *Lonhro* shows that the essence of economic unity is not group accounts or voting control but *functional and pervasive control or power* by the parent of the affairs of the subsidiary. Effective control comprises both legal and extra-legal measures. Not only is necessary to have voting control (a legal measure) but the parent must be able to use 'extra-legal' control to dominate or override the decisions of the board of directors. In *Lonhro*, it was sufficient to show that the directors were relatively independent decision-makers and non-compliant with the requests of the parent shareholder to negate any element of 'extra-legal' control. However, it will be shown that total dominance by a parent of the affairs of a subsidiary is legitimate in most circumstances. Further, findings of single entity based on economic unity between parent and subsidiary in genuine commercial situations is no longer legally acceptable⁴² except in a few specific situations.

⁴¹ *Ibid.*, at 373 d e.

⁴² *Infra*, The Rise of Creditors Interests - Rejecting Economic Unity and Restating *Salomon* on page 77.

Legal Recognition of Economic Unity - A Reflection of Commercial Reality

Despite the legitimacy of dominance and functional control by a parent over a subsidiary, the judiciary is willing to relax *Salomon* and its concomitant principles in a few limited circumstances. For example, where there is an admission of economic unity, or where the interpretation of an agreement or particular statute is concerned. These exceptions demonstrate the willingness of the courts to accept a relaxation of *Salomon* during solvency of group members. The exceptions often work in favour of the group but are little comfort to creditors because recourse against a parent during insolvency for the debts of a subsidiary is not effected. Rather, the scope of the statutory or contractual terms interpreted or implied, draw in both parent and subsidiary in order to make commercial sense.

Admission of Economic Unity

If it is admitted by either a parent or subsidiary that the relationship is one of economic unity then the courts seem readily willing to accept such proposals contrary to the strict application of *Salomon*. In *The Roberta*⁴³ agents, acting on behalf of a subsidiary signed bills of lading. At the trial, it became apparent from a very frank witness that the subsidiary was really the parent in a different jurisdiction. Consequently, it was conceded that in so doing the agents had made the parent responsible for the bills of lading.⁴⁴

⁴³ (1937) 58 Lloyds LR 159

⁴⁴ Langton J. described the admission as proper because: 'The Dordtsche Co. [the subsidiary] are a separate entity from Walford Lines Ltd. [the parent], in name alone, and probably for the purposes of taxation. Walford Lines Ltd. own all the issued shares of the Dordtsche Co., and in fact supply two out of the three directors.' *Ibid.*, at 169.

⁴⁵ *Ibid.*, at 169.

In *George Fischer (Great Britain) Ltd v. Multi Construction Ltd, Dexion Ltd (Third Party)*⁴⁶ the Court of Appeal freely accepted evidence that the relationship between parent and subsidiary was so close that a loss in the subsidiary equated to a loss for the parent. In light of this evidence, all members of the Court of Appeal rejected the proposition that the loss of the parent might not be pound for pound with the subsidiary because '[e]ach corporate entity is a separate entity. The overall decision making of their management and their overall trading may improve, or damage, the value of the investment which the holding company has in each subsidiary.'⁴⁷ The Court of Appeal accepted that the relationship between this parent and subsidiary was such that profits from the subsidiary were distributed to the parent through dividends. Thus, it was clear the loss would be pound for pound.⁴⁸

In doing so, the Court of Appeal accepted that groups of companies could be economic units for calculating consequential loss. The differentiating feature between *The Roberta* and *George Fisher* is that in *George Fisher* there is no legal responsibility attributed to the parent. *George Fisher* extends the definition of consequential loss in the context of parent subsidiary relations. A parent may claim the loss incurred by a subsidiary as a component of consequential loss. The decision does not give the parent *locus standi* to sue on the behalf of the subsidiary. The benefit of such an interpretation accrues, not to outsiders such as creditors, but to the group of companies.

⁴⁶ [1995] 1 BCLC 260.

⁴⁷ *Ibid.*, at 269 c f.

⁴⁸ *Ibid.*, at 268 a d.

Agreement

Whilst not derogating from *Salomon*, the courts recognise that the closeness of the relationship between parent and subsidiary may be sufficient to justify a wide interpretation of contractual terms. In *Harold Holdsworth & Co. (Wakefield) Ltd. v. Caddies*,⁴⁹ a parent entered a service agreement with Caddies to act as the managing director. The issue arose whether the scope of duties under the service agreement included him devoting time toward the management of the subsidiaries. Caddies argued that his duties as a managing director in respect of the subsidiary were confined to co-ordinating the parent's business with that of the subsidiaries or making an investigation of the subsidiaries affairs. Nothing further was required, as each subsidiary was a separate legal entity each under the control of its own board of directors. Lord Reid took the view that this was 'too technical an argument. This is an agreement in *re mercatoria* and must be construed in light of the facts and realities of the situation.'⁵⁰ It was clear that the parent wholly owned the subsidiaries and appointed its nominees to their boards to control their internal functioning. To this extent, management of the parent included management of the subsidiary and as such Caddies was obliged to devote time to the management of the subsidiaries.

The courts can justify the departure from *Salomon* because holding the parent liable for the debts of a subsidiary is not an issue.

Statute

The courts have acknowledged the legitimacy of *Salomon* yet treated the relationship between parent and subsidiary as one of economic unity for the purposes of the

⁴⁹ [1955] 1 WLR 352.

regulatory scheme of a particular statute. In *J. R. McKenzie Ltd v. Gianoutsos and Booleris*⁵¹ the plaintiff was a company ('the parent') engaged in conducting a chain of stores. The majority of the stores businesses were conducted through subsidiaries. The parent purchased a property known as Lambton Quay and formed a subsidiary with the intention of using the subsidiary to conduct business from the store located on the property. The parent sought to obtain possession of the tenanted property and one of the tenants refused. The tenant argued that as it was the subsidiary and not the parent that was intended to occupy the premises. The New Zealand Court of Appeal rejected this argument recognising that the relationship between the parent and subsidiary was not an agency or partnership but rather they were 'essentially one'.⁵³ The subsidiary's profits went to the parent or other purposes connected with the group. The parent had absolute control; 'the voice of the Lambton Quay company [the subsidiary] is but the echo of the voice of J. R. McKenzie Ltd [the parent]'.⁵⁴

In *Scottish Co-operative Wholesale Society Ltd v. Meyer*⁵⁵ a parent owned nearly 51 per cent of a subsidiary. The minority was made up of two shareholders. All members had reaped the rewards of the business's success and the parent sought to acquire the minority shares at a price below market value. The minority rejected the offer and the parent set about transferring the subsidiary's business to one of its own departments, forcing devaluation in the shares of the subsidiary. The minority argued pursuant to

⁵⁰ *Ibid.*, at 367.

⁵¹ [1957] NZLR 309, (CA).

⁵² *Ibid.*, at 315.

⁵³ 'The whole purpose of the artificial life of the subsidiary is to further the interest of its parent - the appellant. Strictly speaking the subsidiary is neither the agent nor the servant of the appellant; nor is it a tenant. The relationship is a special one, not uncommon in these days, and in this case such as to warrant regarding the two companies as being virtually one even though they are separate legal entities.' *Ibid.*, at 330 (line 7 - 19).

⁵⁴ *Ibid.*, at 325 (line 15).

section 210 Companies Act 1948 that the parent's conduct was oppressive. The parent argued that it was merely a shareholder and did not conduct 'the affairs of the company'. Viscount Simmonds rejected this argument:

My Lords, it may be that the acts of the [parent] of which complaint is made could be regarded as conduct if the affairs of the [subsidiary] if the [parent] and [subsidiary] were bodies wholly independent of each other, competitors in the rayon market, and using against each other such methods of trade warfare as custom permitted. But this is to use false analogy. It is not possible to separate the transactions of the [parent] from those of the [subsidiary]. Every step taken by the latter was determined by the former.⁵⁶

The fact of control and its possible illegitimate use were matters the subject of section 210. Consequently, the court was justified in looking at the business realities of a situation and not being confined to *Salomon*. Lord Simmonds continued,

The truth is that whenever a subsidiary is formed as in this case with an independent minority of shareholders, the parent company must, if it is engaged in the same class of business, accept as a result of having formed such a subsidiary an obligation so to conduct what are in a sense its own affairs as to deal fairly with its subsidiary.⁵⁷

In *Instituto Chemioterapico Italiano S.p.A. and Commercial Solvents Corporation v. Commission of the European Communities*,⁵⁸ the court had to consider whether the relationship between parent and subsidiary justified their treatment as separate 'undertakings' for the purposes of articles 85 and 86 of the EEC Treaty. Advocate General Warner believed application of *Salomon* would 'serve only to divorce the law

⁵⁵ [1959] AC 324, HL.

⁵⁶ *Ibid.*, at 342.

⁵⁷ *Ibid.*, at 343.

⁵⁸ Cases 6 and 7/73 [1974] ECR 223.

from reality'.⁵⁹ Common sense and reality did not permit *Salomon* to be misapplied to defeat legislative intention.⁶⁰

In *Revlon Inc. v. Cripps & Lee Ltd*⁶¹, the court not only circumvented the strict operation of *Salomon*, but also avoided the principle laid down by the House of Lords in *Macaura v. Northern Assurance Co*⁶² that the assets of a company are its own. Here, a subsidiary was the proprietor of a particular trademark. The question for consideration by the court was whether goods owned by the parent were 'connected in the course of trade with the proprietor ... of the trade mark'.⁶³ Buckley L.J. decided that the goods of the parent were connected to the course of trade of the subsidiary opined:

Since, however, all the relevant companies are wholly owned subsidiaries of [the parent], it is undoubted that the mark is, albeit remotely, an asset of [the parent] and its exploitation is for the ultimate benefit of no one but [the parent]. It therefore seems to me to be realistic and wholly justifiable to regard [the subsidiary] as holding the mark at the disposal of [the parent] and for [the parent's] benefit. The mark is an asset of the ... group of companies as a whole, which all belongs to [the parent]. This view does not, in my opinion, constitute what is sometimes called 'piercing the veil'; it recognises the legal and factual position resulting from the mutual relationship of the various companies.⁶⁴

In *Lewis Trusts v. Bambers Stores Ltd*,⁶⁵ the Court of Appeal, *obiter*, suggested that to determine the date of manufacture of certain garments under the provisions of the Copyright Act 1956, it was proper to treat the receipt by a parent company's subsidiaries of components for the garments as the date of manufacture by the parent.⁶⁶

⁵⁹ *Ibid.*, at 263.

⁶⁰ *Ibid.*, at 263-264.

⁶¹ [1980] FSR 85.

⁶² [1925] AC 619, (HL).

⁶³ Pursuant to the terms of Section 4(3) Trade Marks Act 1938 (UK).

⁶⁴ [1980] FSR 85 at 105.

⁶⁵ [1983] FSR 453, (CA).

⁶⁶ *Ibid.*, per May and Dillon L.JJ. agreeing. See also *Canada Enterprises Corporation Ltd v. MacNab Distilleries Ltd* [1987] 1 WLR 813, (CA) concerning the interpretation of a group

Statutory erosion of *Salomon* as it applies to a group of companies is justified because there is an expression of legislative intention to diminish strict application of a common law principle. Again though, the law is dealing with the group during periods of solvency and the interests of creditors need not be considered.

The 'Eye of Equity'

As with all rules, there are exceptions. In *Atlas Maritime Co SA v. Avalon Maritime Ltd, The Coral Rose (No.1)*⁶⁷ the Court of Appeal dismissed an application to discharge or vary a Mareva injunction as between parent and subsidiary. The relationship between parent and subsidiary needed to be taken into account in exercising the discretion of the court.

There are cases where, notwithstanding [*Salomon*], the 'corporate veil' between two companies can be pierced so that one company is to be regarded as the alter ego of the other. But this is not such a case, ... Nevertheless in the exercise of a discretion in relation to injunctive relief 'the eye of equity' ... can I think look behind the corporate veil in order to do justice.⁶⁸

This is permissible because in the context of an injunction the character of the company or the nature of the persons who control the company may be a relevant feature. The court may go behind the veil to consider who are the shareholders or persons who direct and control the activities of a company.⁶⁹

Similar principles were exercised in a later case *Atlas Maritime Co SA v. Avalon Maritime Ltd, The Coral Rose (No. 3)*.⁷⁰ In the same circumstances as the above case

of companies as one of economic unity for the purposes of RSC, Ord 47, r 1(1)(a).

⁶⁷ [1991] 4 All ER 769, (CA).

⁶⁸ *Ibid.*, at 776 d f per Neill L.J.

⁶⁹ *Ibid.*, at 776 f g quoting Danckwerts L.J. in *Merchandise Transport Ltd v. British Transport Commission* [1962] 2 QB 173 at 206. and followed by Stocker L.J. and Staughton L.J.

⁷⁰ [1991] 4 All ER 783, (CA).

except the subsidiary applied to have funds released from the operation of the Mareva injunction in order to pay its lawyers fees and expenses. The subsidiary argued that it was unable to pay the lawyers fees other than out of the funds frozen by the Mareva injunction because the subsidiary had no legal right to require the parent to pay the fees. As there were reasonable grounds for believing that the subsidiary retained its relationship with its parent and there was no evidence to the contrary ‘the eye of equity’ allowed the court to look further than the question of legal rights to the reality of the situation.⁷¹

Nicholls L.J. focused on the mutual business dealing between parent and subsidiary and the fact that the parent controlled the purse strings on an item by item basis.⁷² The consequence of the decision was not far reaching – liability for the subsidiary’s debt was not imposed on the parent. Rather, ‘the eye of equity’ in the Mareva jurisdiction allowed the court to examine previous conduct and recognise a ‘quasi-estoppel’ preventing the parent from denying that it was reasonably likely to meet the indebtedness. This raises a general issue concerning the way the courts approach equitable remedies and the company. The *Atlas Maritime* cases demonstrate the willingness of the courts to use an ‘open textured’ analysis for the purposes of equity. Oddly though, veil piercing for the purposes of exposing a parent to liability for the debts of a subsidiary, as a function of equity, is an area where the courts are generally reluctant to use the same principles.

⁷¹ *Ibid.*, at 792 j.

⁷² *Ibid.*, at 793 h j.

Comments

To summarise, the courts can utilise the notion of economic unity of groups of companies to assist in the interpretation of a statute or scope of a contractual term. In doing so, the court is not considering the legitimate use of *Salomon* and deciding whether or not to allow a creditor to recover. Rather, the courts perceive the parent subsidiary relationship in the context of the legislation or contract in order to make commercial sense. At its highest, the courts can only recognise the economic unity of a group - as an issue of commercial reality – during solvency when the interests of creditors are not concerned.

To argue that in the recovery of its debts a creditor should be able to sue a parent as it would sue a subsidiary because the two 'are in reality' economically one is wrong. Economic unity is only a valid argument in relation to groups where there is solvency of the group members, creditors are not involved, and the court is concerned with a clear admission of economic unity, the interpretation of a contractual term, statutory provision, or the scope of operation for an injunction. When insolvency looms and the interests of creditors rise, economic unity is categorically rejected and *Salomon* firmly applied.

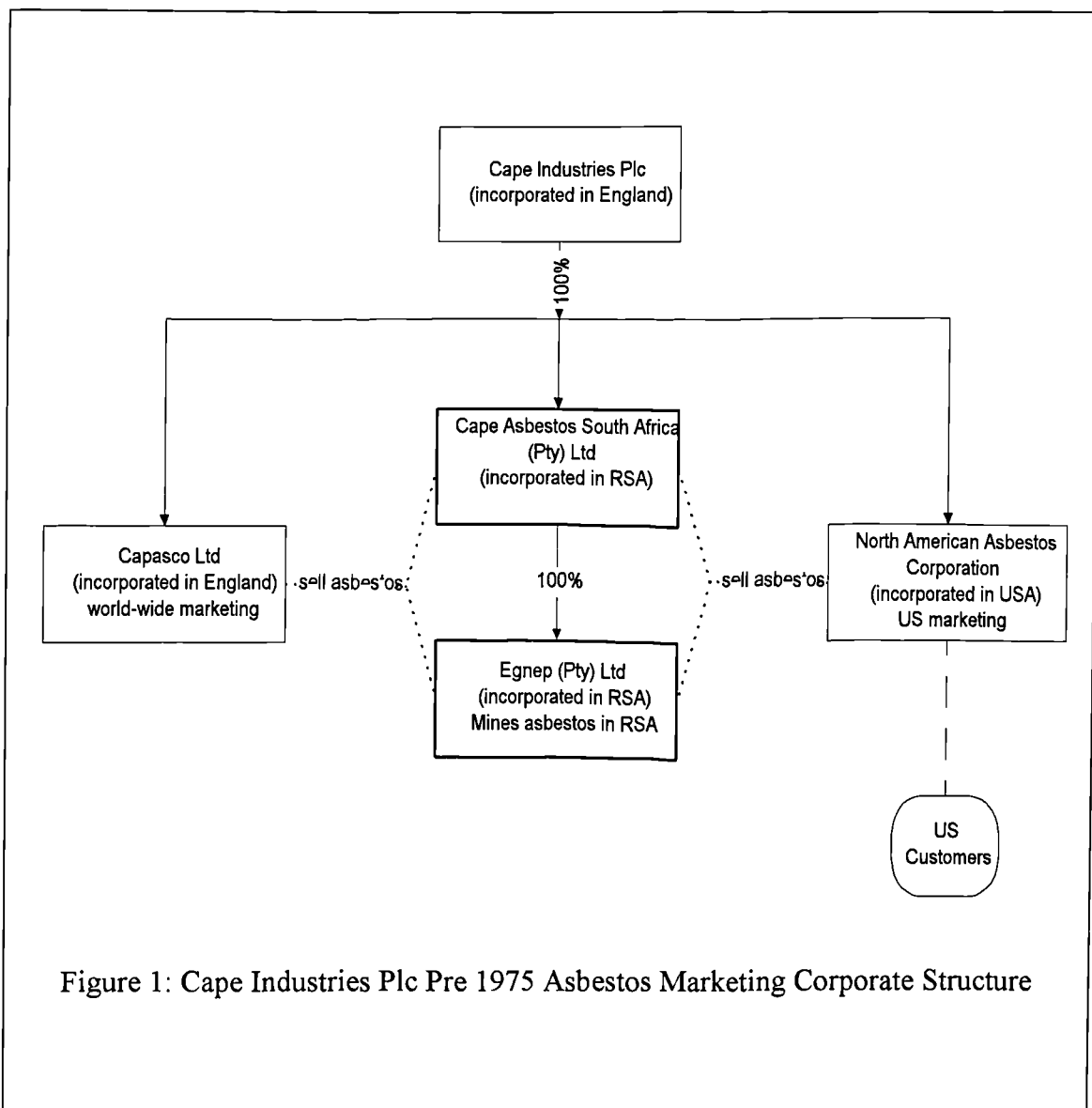
THE RISE OF CREDITORS INTERESTS - REJECTING ECONOMIC UNITY AND RESTATING *SALOMON*

A creditor seeking to impose liability on a parent via the notion of economic unity will receive no assistance from the courts in genuine commercial circumstances. The

decision of the Court of Appeal in *Adams v. Cape Industries Plc*⁷³ deals with a number of aspects concerning veil-piercing jurisprudence.

The two aspects of the case we will deal with are the notion of enterprise unity and the sham (dealt with later in this work). Where possible this thesis uses diagrams to explain the structure instead of an extensive written exposition of the facts.⁷⁴

The history of the Cape Industries plc group structure can be divided into the corporate structure for marketing asbestos before December 1975 and the asbestos marketing structure used after 1975.



Cape Industries Plc ('Cape'), an English company, utilised a group of subsidiaries to mine and sell asbestos. Asbestos from the Egnep mines in South Africa was sold via Capasco initially and subsequently by NAAC to a factory in Owentown, Texas. In 1974, some 462 workers in the factory brought an action ('Tyler One') for injuries suffered from exposure to asbestos dust against defendants including Cape, NAAC, Egnep, and Capasco. Believing that it was almost impossible for the Owentown workers to visit liability upon the companies that had mined the asbestos and sold it to the United States,⁷⁵ Cape and its subsidiaries, NAAC and Egnep, became defendants alleging a lack of jurisdiction but also took a number of procedural steps in connection with the Tyler One action.⁷⁶ It seems that Cape was caught in the rush to settle the action with significant pressure being applied from the presiding judge. Cape and subsidiaries were faced with the prospect of having to take the jurisdiction point to trial on their own with all other defendants having agreed to settle. In view of the costs involved with mounting a single-handed defence, Cape and subsidiaries agreed to participate in the settlement process to the extent of \$5.2 M.

From the facts it seems clear that the settlement process instigated an alteration in the corporate structure Cape had employed to sell its asbestos in the US. The timing of the settlement process for the Tyler One action enabled Cape to rearrange its corporate structure knowing that subsequent claimants were waiting to lodge further claims (Tyler

⁷³ [1990] 1 Ch 433, (CA).

⁷⁴ *Infra*, A Criticism of *Adams* on page 88 and *Adams* and the *Ramsay Principle* on page 178.

⁷⁵ *Ibid.*, at 449 BD *per* Scott J.

⁷⁶ *Ibid.*, at 446 A.

Two).⁷⁷ On 1 November 1977, the Board of Cape decided not to contest any of the future Tyler Two actions and accepted the risk of default judgement being given against the company in the United States. It was also decided that the organisation of the group's selling arrangement in the United States should be changed and that NAAC should be wound up. The reason for the rearrangement of Cape's affairs was given by the former president of NAAC (Mr Morgan) as: 'to disassociate the parent company [Cape] as fully as possible from the operating companies ... It does not imply any change in the method of operation or the present responsibilities of individuals concerned...'.⁷⁸ As we shall see, the structure takes on a highly complex form.

⁷⁷ *Ibid.*, at 447 G.

⁷⁸ *Ibid.*, at 473 E.

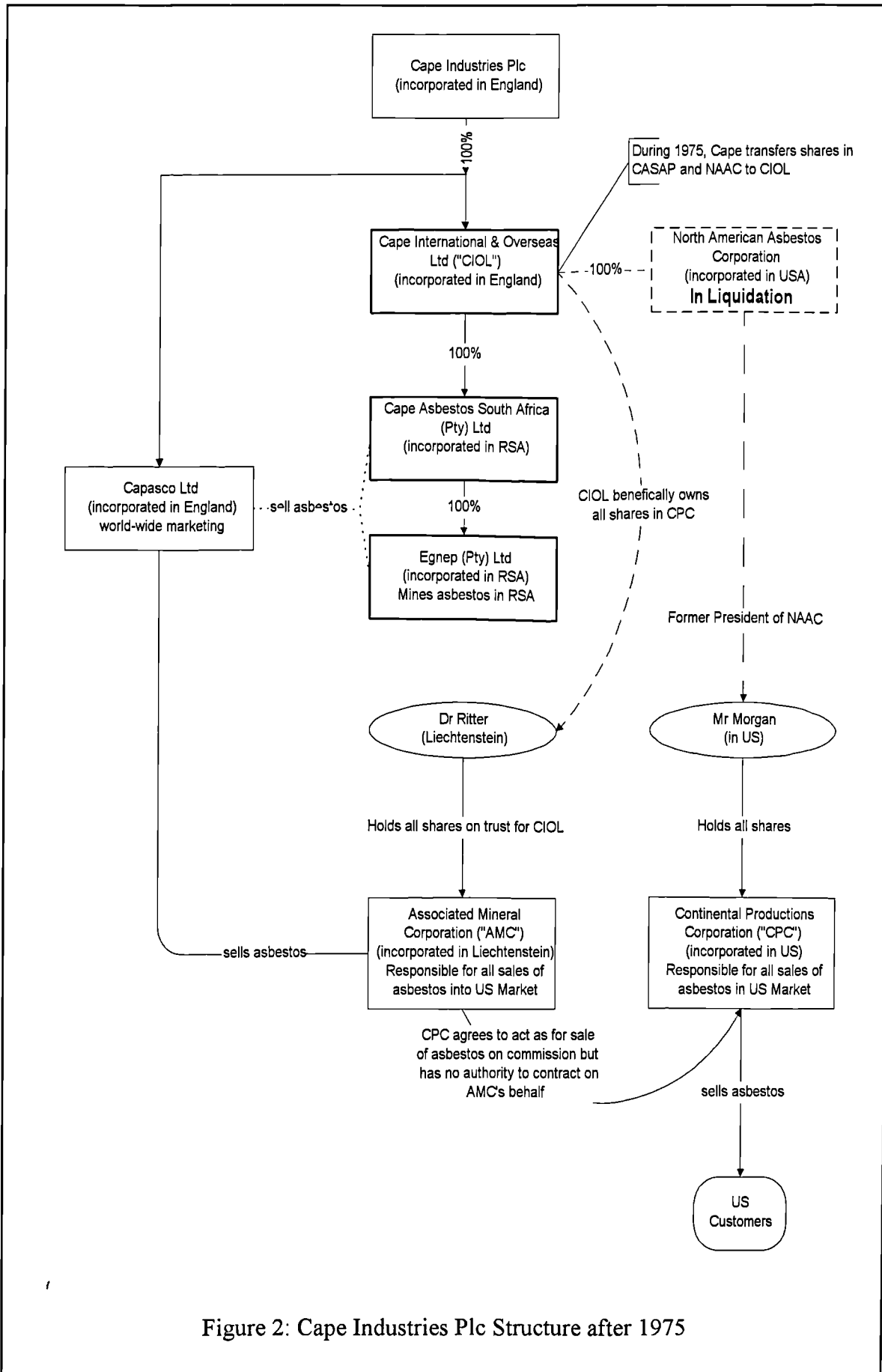


Figure 2: Cape Industries Plc Structure after 1975

CPC, Morgan, and AMC signed an agency agreement whereby CPC agreed to act as AMC's agent for the sale of asbestos in the US.⁷⁹ The court inferred from the statement by Mr Morgan and the agency agreement that Cape would use the same method of operation and also dictate the financial aspects of CPC's management as it had done with NAAC. Notably, the agency agreement included an option whereby AMC (beneficially owned by Cape) could acquire all of Morgan's shares in CPC at their 'net book value excluding goodwill'. Thus, AMC (or more correctly, Cape, as AMC was later held by the Court of Appeal to be a façade) could purchase all the shares in CPC for next to nothing. This meant that Cape could remove Morgan should he not comply with Cape's wishes – a classical method of *extra-legal control*.

Morgan's statement that the method of operation after the change in the structure was to remain the same was contrary to his later affidavit evidence that he believed AMC was an independent company unconnected with Cape.⁸⁰ This led Scott J., at first instance, to conclude that Morgan's evidence was disingenuous and false. It is remarkable that the court remained prepared to accept as legitimate, Cape's stated purpose of disassociating the parent company as fully as possible from the operating companies.

Although this inconsistency was evident, the court did not make further enquiry. Arguably, the inconsistency entitled the court to be much more 'fact sensitive' of the purpose behind the complex restructure. The court had a number of facts before it that justified questioning the veracity of the stated purpose of 'maintaining business in the US' with more emphasis on the reason for the disassociation of the parent from the

⁷⁹ NAAC ceased to act on behalf of the Cape companies from 31 January 1978 and was subsequently dissolved on 18 May 1978. It would not seem merely coincidental that CPC commenced business on 1 February 1978.

⁸⁰ *Ibid.* at 480 H – 481 A.

operating companies. For example, factors such as the timing of the restructure, the terms of the agency agreement giving Cape (through an intermediary) the right to obtain legal ownership of shares in the US operating company (CPC).

So why did the court not consider these factors further? First, because a group of companies is not an economic unit, second, *Salomon* and third, English jurisprudence does not permit the court to consider the complex arrangement in its entirety, but only as a series of separate transactions..

Economic Unity Where Justice So Demands?

The consequence of a finding that Cape and its US operating companies were an economic unit was that the presence of the subsidiary in the jurisdiction was the same as the parent being in the jurisdiction. The Court of Appeal recounted a number of cases submitted as authority for the proposition that the court will in appropriate circumstances, ignore the distinction in law between members of a group when it considers *that justice so demands*.⁸¹ The Court rejected the proposition that legal technicalities produce an injustice in cases involving groups of companies and that such technicalities should not be allowed to prevail.⁸² Such a proposition draws too wide a rule to be acceptable. The Court saw cases such as *Harold Holdsworth & Co. (Wakefield) Ltd. v. Caddies*,⁸³ *Scottish Co-operative Wholesale Society Ltd v. Meyer*,⁸⁴ *Revlon Inc. v. Cripps & Lee Ltd*⁸⁵ and *Instituto Chemioterapico Italiano S.p.A. and Commercial Solvents Corporation v. Commission of the European Communities*,⁸⁶ as

⁸¹ *Ibid.*, at 532 d - 536 b.

⁸² *Ibid.*, at 536 f g.

⁸³ *Supra*, n 49.

⁸⁴ *Supra*, n 55.

⁸⁵ *Supra*, n 61.

⁸⁶ *Supra*, n 58.

justifying the parent and subsidiary as one unit because of the wording of a particular statute or contract. Even the radical decision of Lord Denning M.R. in *DHN Food Distributors Ltd v. London Borough of Tower Hamlets*⁸⁷ was to be confined in this way - if not only for the House of Lords doubts as to its correctness in *Woolfson v. Strathclyde Regional Council*.⁸⁸ Against this background, it now seems clear:

Our law for better or worse, recognises the creation of subsidiary companies which though in one sense the creatures of their parent companies, will nevertheless under the general law fall to be treated as separate legal entities with all the rights and liabilities which would normally attach to separate legal entities⁸⁹

This statement collects previous authority and adds weight to the argument that the *legitimate control model* is accurate description of the parent subsidiary relationship.

Presence of a Subsidiary Exposes Parent to the Jurisdiction?

The alternative argument raised in *Adams* was that CPC's presence in the US was the same as Cape's presence. Although certain documentation had a 'somewhat conspiratorial flavour' because it demonstrated that Cape's senior management wanted to ensure that the connection with CPC did not become public knowledge, Scott J. decided that it deserved no further consideration.⁹⁰ Yet Scott J. held that AMC, the Liechtenstein corporation interposed between CPC in the US and Cape in England, 'was no more than a corporate name'⁹¹ - merely an invoicing company with no employees of its own. The factor that separated the AMC façade and CPC was the commercial purpose attributed to the latter. Scott J. stated:

⁸⁷ *Supra*, n 35.

⁸⁸ [1978] SLT 159 at 161 *per* Lord Kieth of Kinkel (with whom Lord Wilberforce, Lord Fraser and Lord Russell agreed). *DHN* was also distinguished in *Stewarts Supermarkets Ltd v. Secretary of State* [1982] NI 286.

⁸⁹ *Adams v. Cape Industries Plc* [1990] 1 Ch 433 at 536 *per* Slade L.J.

Each corporate member of the Cape group *had its own well defined commercial function designed to serve the overall commercial purpose* of mining and marketing asbestos. But that does not constitute a reason why Cape, the parent company, should be treated as present and amenable to be sued in each country in which a subsidiary was present and carrying on business.⁹² (Emphasis added)

On this point, the Court of Appeal reiterated the principle set out by Lord Keith of Kinkel in *Woolfson v. Strathclyde Regional Council*,⁹³ ‘that it is appropriate to pierce the corporate veil only where special circumstances exist indicating that it is a mere façade concealing the true facts’.⁹⁴ The Court held that the interposition of AMC between CPC in the US and Cape in the UK was a mere façade because AMC was a ‘creature of Cape’⁹⁵ having no commercial purpose. However, CPC had a commercial purpose because Cape was entitled to arrange its affairs to ensure future sales of asbestos in the US. The Court of Appeal emphasised:

It is not suggested that the arrangements involved any actual or potential illegality or were intended to deprive anyone of their existing rights. Whether or not such a course deserves moral approval, there was nothing illegal as such in Cape arranging its affairs (whether by the use of subsidiaries or otherwise) so as to attract the minimum publicity to its involvement in the sale of Cape asbestos in the United States of America ... we do not accept as a matter of law that the court is entitled to lift the corporate veil of a defendant company which is the member of a corporate group merely because the corporate structure has been used so as to ensure that the legal liability (if any) in respect of particular future activities of the group (and correspondingly the risk of enforcement of that liability) will fall on another member of the group rather than the defendant company. Whether or not this is desirable, the right to use a corporate structure in this manner is inherent in our corporate law.⁹⁶

The decision in *Adams* demonstrates the credence commercial purpose gives to a particular company or transaction. The manner in which the courts characterise

⁹⁰ *Ibid.*, at 479 b d.

⁹¹ *Ibid.*, at 479 e f.

⁹² *Ibid.*, at 482 h - 483 b.

⁹³ *Supra*, n 88.

⁹⁴ *Ibid.*

⁹⁵ *Adams v. Cape Industries Plc* [1990] 1 Ch 433 at 543 e g.

⁹⁶ *Ibid.*, at 544 c f.

conduct as ‘commercial’ is more problematic. In *Adams*, the court accepted the parent’s view although there were factual inconsistencies that should have alerted the court and encouraged further enquiry looking at the whole arrangement rather than one facet.

Further Rejection of Economic Unity

The *Adams* decision makes it quite clear that the economic entity argument is insufficient as a method of drawing parent and subsidiary together merely because they have close business relations. The rationale is that ‘[The courts] are concerned not with economics but with law. The distinction between the two is, in law, fundamental and cannot here be bridged.’⁹⁷ Whilst economics may use the law as a tool, the law is unable to exercise the same freedom. It follows, contrary to Lord Denning M.R.’s comments in *Littlewoods*,⁹⁸ that just because the law requires group accounts to be prepared it does not follow that the parent and subsidiary are one economic unit. This was the unanimous decision of the High Court of Australia in *Industrial Equity Ltd v. Blackburn*.⁹⁹ Indeed, in the New South Wales Court of Appeal decision of *Briggs v. James Hardie & Co Ltd*¹⁰⁰ it was agreed that the decision in *Industrial Equity* had effectively foreclosed the adoption of the notion of economic unity in respect of the parent and subsidiary in Australia.¹⁰¹ *Briggs* concerned a claim for damages by a former asbestos mine employee for asbestosis. The mine was operated by a subsidiary that was completely controlled by a parent company. The employee sought to sue the parent as if it had been the employer and subsequently liable for the personal injury.

⁹⁷ *Bank of Tokyo Ltd v Karoon* [1986] 3 All ER 468, (CA) at 486 d e per Robert Goff L.J.

⁹⁸ [1969] 3 All ER 855 at 860 F H.

⁹⁹ (1977) 137 CLR 567 at 577 per Mason J. (with whom all members of the court agreed).

¹⁰⁰ (1989) 16 NSWLR 549.

The court was invited to draw the inference that the subsidiary was not a truly independent functioning corporate entity. Rogers A.J.A. recognised that this was no different to the everyday situation of a parent and its subsidiary. To weight such propositions with any probative value would clearly be in error because a holding company customarily exercises complete dominion and control over the subsidiary. To hold that there was some form of agency would extend such a conclusion to all intercompany holdings, which would in turn leave *Salomon* in tatters.¹⁰² The mere issue of complete dominion and control of a subsidiary and the implication of economic unity consequently was seen as entirely too simplistic to justify piercing the veil.¹⁰³

The law pays scant regard to the commercial reality that every holding company has the potential and more often than not, in fact, does exercise complete control over a subsidiary. If the test were absolute ... then the corporate veil should have been pierced in both *Industrial Equity* and *Walker v. Wimborne*.¹⁰⁴

In the United Kingdom, *Adams* and rejection of economic unity of the corporate group has recently been affirmed in *Re Polly Peck International plc (In Administration)*.¹⁰⁵ A parent set up a wholly owned subsidiary for raising finance to develop the group's business activities by means of a number of bond issues. The parent exercised complete control of every facet of the financing arrangements. The parent went into administration in 1990 and a scheme of arrangement was approved in May 1995. The scheme included a provision prohibiting 'double proof' by any creditor. The subsidiary went into liquidation in March 1995. The liquidator lodged a notice of claim for £485m with the parent's scheme supervisors in respect of the sums owed by the parent

¹⁰¹ *Ibid.*, at 576 G per Rogers AJA, with whom Hope and Meagher JJA agreed.

¹⁰² *Ibid.*, at 576 C F per Rogers AJA.

¹⁰³ *Ibid.*, at 577 D E.

¹⁰⁴ *Ibid.*

¹⁰⁵ [1996] 2 All ER 433. *Adams* has also been affirmed in the recent decision of the Hong Kong Court of Appeal in *China Ocean Shipping Co v. Mitrans Shipping Co Ltd* 1995-3

to the subsidiary. The bondholders lodged claims amounting to £85m against the parent pursuant to its guarantees of the subsidiary's bond issue. The issue was whether the relationship of complete control justified the parent and subsidiary being treated as economically one entity for the purposes of the parent's administration, so that any claims by the subsidiary should be ignored in the distribution of dividends.¹⁰⁶

Robert Walker J. followed *Adams* in rejecting the suggestion of economic unity, or in the alternative, that a further exception should be added to the Court of Appeals statement of principle.¹⁰⁷ Counsel submitted that the exception was justified because 'a rule of law founded in public policy (the rule against double proof) would be frustrated by ignoring the economic reality of a single group.'¹⁰⁸ The court rejected this argument because in law internal rights and obligations cannot be disregarded because *substance means legal substance, not economic substance* and the separate legal existence of group companies is particularly important when creditors become involved.¹⁰⁹

A CRITICISM OF *ADAMS*

It has been argued that the decision in *Adams* misunderstands the scope of the *Salomon* doctrine because, whilst it is legitimate to create a company to limit the liability of members, it must be done with the intention of not doing anything dishonest or unworthy. In the words of Dr Avgitidis: '[In *Adams, Salomon*] was upheld although it was accepted that there was, if not a fraudulent, at least a dishonest use of [AMC]; [AMC] was considered to be a mere façade used merely for the concealment of the real

HKC 123; [1995] HKC Lexis 156 at *6.

¹⁰⁶ *Ibid.*, at 441 c f per Robert Walker J.

¹⁰⁷ *Adams v. Cape Industries Plc* [1990] 1 Ch 433 at 536.

¹⁰⁸ [1996] 2 All ER 433 at 448 a b.

¹⁰⁹ *Ibid.*, at 448 e g.

situation and for the avoidance of liability and jurisdiction.¹¹⁰ On the other hand, we can argue that the logic in reaching such a conclusion perpetuates the same error made by the Court of Appeal in *Salomon*.¹¹¹ The Court of Appeal in *Salomon* perceived Mr Salomon's conduct as a fraudulent scheme unworthy to merit limited liability. Whereas the House of Lords later considered the same conduct genuine commercial behaviour.

This illustrates that there is a fine line between illegitimate conduct, such as fraud and dishonesty, and legitimate commercial behaviour. In essence, the difference can come down to the legitimacy of using the corporate form to avoid a *current* or *contingent liability* as opposed to avoiding a *future liability*. This contrast is best exemplified in the decision of Richard Southwell QC in *Creasey v. Breachwood Motors Ltd.*¹¹² There a company with a *contingent liability* to an employee became insolvent upon transfer of all its assets to another company with the same shareholders and directors. The court pierced the veil permitting the second company to be visited with liability. The essence was an illegitimate dishonest use of a company because in *Creasey*,

[n]othing ... in the evidence could justify the their conduct in deliberately shifting Welwyn's assets [the first company] to Motors [the second company] in total disregard of their duties as directors or shareholders, not least the duties created by Parliament as a protection to all creditors of a company.¹¹³

In *Adams*, it was not suggested that the changes in the arrangements of Cape's group structure involved any actual or potential illegality or were intended to deprive anyone of their existing rights.¹¹⁴ What was done by the Cape group was done to avoid *future liability*. Whereas, in *Creasey* the facts on which the liability was founded had already

¹¹⁰ Avgitidis, *op. cit.*, at 146.

¹¹¹ *Supra*, *Salomon* on page 57ff.

¹¹² [1992] BCC 638.

¹¹³ *Ibid.*, at 648 A B.

¹¹⁴ *Ibid.*, at 574 c.

occurred and been proven. Consequently, the decision in *Adams* bears out, that liability was not evaded dishonestly, but rather Cape's structure recast in order to ensure the continuation of its business in the US. Secondary to this legitimate purpose was the variation of the Cape group structure with the intention of avoiding the *future liability* of the Tyler Two claims.

Even so, *Adams* does not leave one convinced! The difficulty with *Adams* is the characterisation of the Tyler Two claims as *future liabilities*. This is because of the proximity in time between the Tyler One claims, reorganisation of the Cape group, and the knowledge of the impending Tyler Two claims. On the facts, it was arguable that the Tyler Two claims had the character of *contingent claims* in the same way that the employee had a *contingent claim* in *Creasey*. Cape was fully aware of the ambient claims and their likelihood of success. The difference in *Adams* and *Creasey* was that the Cape group structure was highly complex.

The Cape structure permitted the parent to let the subsidiaries in the US go into bankruptcy. Business was immediately recommenced by Cape in the same jurisdiction (a legitimate commercial purpose) using a new and contrived company and transactional structure. Whereas, in *Creasey*, there was no complex structure, assets were moved out of the company for no apparent commercial purpose other than to evade the ripening of a contingent liability. It is submitted that had a commercial purpose existed in *Creasey* – even a specious one – the court would have been reluctant to pierce the veil.

SIMPLE LAW – COMPLEX GROUPS

The complexity of groups poses significant problems for the law. Notably the courts use a different approach when called on to consider relatively simple as opposed to highly complex company and transactional structures. It will be shown that the mechanisms of the English law facilitate the derivation of a legitimate commercial purpose where there is a complex company and transactional structure.

In support of this proposition we can turn to the decision of Young J. in the Supreme Court of New South Wales case of *Pioneer Concrete Services Ltd v. Yelnah Pty Ltd*.¹¹⁵ Pioneer was involved with a complex transaction and numerous parties including individuals, parent, and subsidiaries. In essence, Pioneer had entered a contract to supply cement with a group of individuals and their related companies. The group of individuals later perceived Pioneer as a competitor and not an ally and through a number of new companies related to them entered into a different supply agreement with another party. Pioneer then alleged that the individuals and the related companies in the first agreement were in breach. Pioneer alleged that it was unreal to treat the companies as being otherwise than in a group because ‘the directors took the view that the company *c'est moi*’. It was submitted that,

... the family motto of the Ward, Hargreaves and Armstrong families should be ‘Les Compagnies Ces Sont Nous et Nous Sont Les Compagnies’. They (and their counsel) habitually refer to and conceive of themselves as Hi-Quality, the Hi-Quality Group ... (various transcript references and references to the interrogatories are then given and the submission continues) there is no distinction between parent and subsidiary or any member of the Hi-Quality Group and the Group itself. The Group is virtually a partnership between

¹¹⁵ (1986) 5 NSWLR 254.

Messrs Ward, Hargreaves and Armstrong.¹¹⁶ ... The companies in the Group are puppets dancing at the bidding of their directors¹¹⁷

In reply it was put that the doctrine of the corporate veil is: '... out of place in the world of Hi-Quality, a world in which the doctrine of *Salomon's* case ... is unknown. In that world human realities, not corporate formalities, reign.'¹¹⁸

One of the factors crucial to the decision effecting the 'human reality' was that the agreements between Pioneer and the group members was prepared by an expert draftsman and settled between solicitors on instructions from their clients. Young J. followed the principle of 'special circumstances' raised by Lord Kieth of Kinkel in *Woolfson v. Strathclyde Regional Council* in stating,

In my view the plaintiff's submissions [i.e. Pioneer] take the *DHN* case too far and it is only if the court can see that there is in fact or in law a partnership between companies in a group or alternatively where there is a mere sham or façade that one lifts the veil. The principle does not apply in the instant case where it would appear that there was good commercial purpose for having separate companies in the group performing different functions even though the ultimate controllers would very naturally lapse into speaking of the whole group as 'us'.¹¹⁹

COMMENTS

The similarity between *Pioneer* and *Adams* is that first, there was a complex corporate and transactional structure, and second, there was a duality of purposes with a perceived predominant legitimate commercial purpose. The duality of purpose in *Adams* was the legitimate commercial purpose of continuing business in the US and the avoidance of the *future liability* of the Tyler Two claims. Whereas, in *Pioneer* the second agreement

¹¹⁶ *DHN Food Distributors Ltd v. London Borough of Tower Hamlets* [1976] 3 All ER 462, approved in *Amalgamated Investment & Property Co Ltd v Texas Commerce International Bank Ltd* [1982] QB 84 and *Lewis Trusts v. Bambers Stores* [1983] FSR 54.

¹¹⁷ *Wallersteiner v. Moir* [1974] 3 All ER 217 at 238.

¹¹⁸ *Pioneer Concrete Services Ltd v. Yelnah Pty Ltd* (1986) 5 NSWLR 254 at 265 B D.

¹¹⁹ *Ibid.*, at 267 B

avoided compliance with the first supply contract. The group's business was able to avoid assisting a perceived competitor.

Second, the approach of the court is uncharacteristically awry. The courts are usually readily aware of circumstances where there are attempts to evade liability, but in *Adams* and *Pioneer* there is a form of 'reversed analysis'. For example, in *Adams* rather than ask whether Cape has used a genuine transaction to achieve the advantage of continuing its business in the US, the Court of Appeal instead legitimated the motive of 'continuing business' with the flow on effect that the subsequent transactions were legitimate.¹²⁰

This variation in approach is demonstrably compounded when we consider *Creasey*, *Adams*, and *Pioneer* together. In *Creasey*, simplicity in the corporate and transactional structure means there is proximity between controllers and the purpose of the transaction, and the company. This proximity forces the court to consider the factual circumstances in their entirety without the evidential quarantining effect of *Salomon* and the apparent commercial purpose justifying a myriad of transactions. We will term this approach 'global objectivity' because it looks for a net change in the overall commercial purpose. Bearing this in mind, if we now reconsider the facts of *Adams* in their entirety then we see that the commercial purpose has not changed but the structure is radically different. The reason for this, when viewed with 'global objectivity', is the illegitimate evasion of liability. Whereas, if the court uses the objective of the group controller as a legitimating canon (as the Court of Appeal did in *Adams*) each transaction, though contrived *en masse*, independently calls for separate consideration

¹²⁰ *Adams v. Cape Industries Plc* [1990] 1 Ch 433 at 540 C F *per* Slade L.J.

and legitimisation. We will return to this form of analysis, which we will term ‘group objectivity’.¹²¹

The doctrine laid down in *Salomon* has to be watched carefully.¹²² ‘Piercing’ or ‘lifting’ of the veil of incorporation is the process whereby the courts remove the ‘façade’ of a subsidiary’s or parent’s separate personality. The consequence is the exposure of the parent, associated subsidiary, individual or group of individuals to liability for debts or obligations of the subsidiary. The court must not ‘be blinded or deceived by mere forms of law’¹²³ and arguments based on economic unity could be seen as an advance in realism. However, the dominant trend in the case law indicates that the analysis of a group of companies is guided by the proposition that *substance means legal substance, not economic substance (if different)*. Outside of fraud¹²⁴ and specific legislation, only when there is sufficient factual indicia to invoke a legal relationship that goes beyond a mere relationship of dominance, such as agency, is there a merger of identity between the parent and subsidiary. However, the courts are very reluctant to find an agency relationship between a member as a principal and the company as an agent.¹²⁵ Merely because a parent owns all the shares in a subsidiary and exercises complete dominion and control does not rebut the presumption of separate personality,¹²⁶ *a fortiori* where there is a simple parent subsidiary relationship without ‘complete dominion and

¹²¹ *Infra*, Chapter 4.

¹²² *Littlewoods Mail Order Stores Ltd v. McGregor (Inspector of Taxes)* [1969] 3 All ER 855, (CA) at 860 *per* Denning M.R. See also *Pioneer Concrete Services Ltd v. Yelnah Pty Ltd* (1986) 5 NSWLR 254 at 264 *per* Young J., SC(NSW).

¹²³ In the US: *Anderson v. Abbott* 321 US 349 (1944) at 362-3 *per* Douglas J.

¹²⁴ *Guildford Motor Co. Ltd v. Horne* [1933] Ch 935, (CA); *Jones v. Lipman* [1962] 1 All ER 442.

¹²⁵ *Salomon v. Salomon & Co* [1897] AC 22 at 31 *per* Lord Halsbury, at 42-3 *per* Lord Herschell, at 51 *per* Lord Macnaghten, at 56-7 *per* Lord Davey (HL).

¹²⁶ *Salomon v. Salomon & Co* [1897] AC 22; *Gramophone and Typewriter Ltd v. Stanley* [1908] 2 KB 89 at 98-9 *per* Fletcher Moulton L.J., (CA); *Hobart Bridge Co Ltd v. Federal*

control'. We can conclude at this stage of our study that the law permits limited incursions into the *Salomon* doctrine, but rarely at the behest of creditors. Let us now examine the roles a parent can adopt in its interaction with subsidiaries and what, if any, claims a creditor may bring on proof that the parental dominance and control took a particular form.

THE ROLES OF A PARENT

A parent can play three roles in the organisation of a subsidiary. *First*, a parent is a shareholder. As a shareholder, a parent owes no duty to the subsidiary or its creditors. The parent may be guided by self-interest alone. *Second*, a parent is a controller of a subsidiary. Control has legal and extra-legal dimensions. Legal control comprises the control of a shareholder and any contractual forms of control. Extra-legal control comprises matters such as the ability to influence and often dictate management policy to the board of directors of a subsidiary. The decision in *Adams* verifies that both legal and extra-legal forms of control are legitimate notwithstanding that the parent may exercise complete control over a subsidiary. Nevertheless, as we shall see, attempts have been made to provide some accountability for the parent's actions via the use of tortious doctrines such as vicarious liability and the joint tortfeasor. *Third*, a parent can fill the role of a creditor. As a creditor, a parent can impose contractual requirements on the management of a subsidiary. Contractual control is a form of *legal control*, but it is sufficiently important to warrant separate attention. For example, a parent can enter any number of contractual arrangements with a subsidiary such as security

documentation, management, agency and partnership,¹²⁷ but this must be an express arrangement (or clearly evidenced from the facts) as the parent subsidiary relationship alone does not give rise to such presumptions. More often than not, the parent subsidiary relationship can be used to avoid the need for agency or partnership, thus further limiting modes of recourse available to creditors.

Parent as a Shareholder

Groups of companies could not exist were it not legal for one company to own shares in another. Historically, in the United States, the courts had expressed a reluctance to allow a corporation the right to acquire and hold shares in other companies without express legislation or charter.¹²⁸ The possibility of intercorporate ownership was perceived as an abuse because of legislative silence on the matter. In England, a much more liberal view saw better exploitation of the corporate form. Despite legislative silence, if the power of intercorporate ownership was specified in the memorandum of association then it was not *ultra vires*.

The US soon overcame the legislative restrictions. In *Berkley v. Third Ave. Ry*¹²⁹ Chief Judge Cardozo opined that the legal position of a parent was that of a shareholder and no different to that of the conventional shareholder. This is a fundamental notion as 'limited liability is the rule, not the exception: and on that assumption large undertakings are rested, vast enterprises are launched, and large sums of capital

¹²⁷ The general rule is that the relationship between parent and subsidiary is not a partnership. See for example, *Re Rogers, Ex parte CMV Parts Distributors Pty Ltd* (1989) 20 FSR 561.

¹²⁸ See for example the use of the ultra vires argument to prohibit corporate ownership of shares. *First National Bank v. National Exchange Bank* 92 US 122, 128 (1875); *Louisville and N.R.R. v. Kentucky* 161 US 667, 689, 698 (1896) *De La Vergne Refrigerating Machine. Co. v. German Savings. Institute* 175 US 40, 55 (1899).

¹²⁹ 224 N.Y. 84, 155 N.E. 58 (1926).

attracted.¹³⁰ The establishment of the parent - subsidiary structure necessitates observance of corporate norms because this allows a relatively accurate assessment of risk and liability to be made by business. The economic and normative force of limited liability and separate personality ensures a parent is construed as a shareholder.

In England, a parent in normal circumstances is no more than a shareholder.¹³¹ To be sure, a parent company may take on a role in the affairs of its subsidiary that goes beyond mere shareholding. But, absent *special circumstances*, a parent will not incur any liability to creditors of its subsidiary by only exercising the prerogatives of control.

The Court of Appeal decision in *Multinational Gas Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd & Ors*¹³² bears witness to the nature of the power relationship between shareholders, directors, and subsidiary companies. Three oil companies ('the shareholders') decided to join together using a joint venture company ('Multinational') incorporated in Liberia to carry on an enterprise relating to the purchase, storage, transportation, and sale of petroleum products. A second company incorporated in England ('Services') was formed to act as an advisor and agent for Multinational. The three oil companies were the sole shareholders in both Multinational and Services. The shareholders, with a view to ensuring the companies were run in their interests, appointed their employees and nominees as directors of both. After a period of lacklustre operation the directors changed their trading policy entering much more speculative and risky ventures. The market eventually turned against

¹³⁰ *Anderson v. Abbott* 321 US 349, 362(1944).

¹³¹ *Multinational Gas Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd & Ors* [1983] 1 Ch 259.

¹³² [1983] 1 Ch 259.

Multinational and the financial problems were immense.¹³³ As both Multinational and Services were in liquidation and had very few assets to satisfy creditors, some of its creditors, acting through the liquidator, wanted to make the oil companies discharge at least some of [Multinational's] liabilities. Knowing that the oil companies, in their capacity as shareholders, owed no duty to the creditors, it was necessary to argue that liability attached to the oil companies in an alternative capacity. This was done by alleging that the nominee directors had failed to perform the duty of care they owed to Multinational.

It was alleged that Services, as Multinational's agent, had acted negligently in providing financial information. Further, that the directors and the shareholders had negligently failed to appreciate that Services was giving inadequate financial information. In this way, the liquidator sought to position himself to sue the directors and shareholders that were outside the jurisdiction. In the end, the decision turned not on the question of jurisdiction, but on whether the three shareholders could be held liable for the debts of their company. Importantly, there were neither allegations that the directors nor shareholders of Multinational at any material time knew or suspected that Multinational was insolvent, nor were there allegations of ultra vires or bad faith.

The starting point for consideration had two essential aspects. First, separate personality and second, that a director of a limited company owes such degree of care to the company as a reasonable man might be expected to take in the circumstances on his own behalf. Insofar as separate personality is concerned, Multinational existed for the benefit of the shareholders, who provided they acted intra vires and in good faith could manage its affairs as they wished. The shareholders could lawfully take risks that no

¹³³ The estimated deficiency to creditors was nearly US\$114 million.

prudent man would take if they wished. Just as an individual can act like a fool, so too can a company.¹³⁴ The shareholders owed no duty to those who did business with Multinational. This was a risk creditors had to assess for themselves. In summary, shareholders are not liable to anyone except to the extent and manner provided in the Companies Act 1985.¹³⁵ In *Kuwait Asia Bank E.C. v. National Mutual Life Nominees Ltd*,¹³⁶ the Privy Council held that even as a majority shareholder in a subsidiary, a parent is not liable to creditors.¹³⁷ Therefore, to reaffirm *Salomon*, a parent in its capacity as shareholder is not liable for the obligations of a subsidiary in which it owns shares.

Parent as a Controller: The Prerogatives of Ownership

Power is used by a parent in a group of companies to ensure that each subsidiary conforms to its predetermined purposes and objectives. In law and in reality, there are legal and extra-legal (respectively) control devices a parent may use to ensure that their directives are followed by a subsidiary. In law, the control of a parent is something wholly different from the management by directors of a subsidiary. In its capacity as a shareholder, a parent has no power to direct the actions of the directors or employees of a subsidiary.¹³⁸ The directors and employees of a subsidiary are not agents of the parent-shareholder. All powers of management in a subsidiary derive from its articles of association and are invariably given to the directors. Employees of the subsidiary owe allegiance to the subsidiary through their contract of employment. A parent-

¹³⁴ *Ibid.*, at 268 f h per Lawton L.J.

¹³⁵ *Ibid.*, at 501 per Lawton L.J. and at 519 per Dillon L.J.

¹³⁶ [1991] 1 A.C 187, (PC).

¹³⁷ *Ibid.*, 223 e f.

¹³⁸ *Automatic Self-Cleansing Filter Syndicate Co. Ltd v. Cunningham* (1906) 2 Ch 34 (CA), *Quin & Axten Ltd v. Salmon* [1909] AC 442 (HL), *Shaw & Sons (Salford) Ltd v. Shaw* [1935] 2 KB 113 (CA), *Breckland Group Holdings Ltd v. London & Suffolk Properties Ltd*

shareholder can only interfere with the exercise of a director's powers by having him removed under section 303 of the Companies Act 1985 or according to the articles of association¹³⁹ and has no legal right to interfere with an employee. In law, the directors of a subsidiary owe fiduciary duties to the subsidiary and the duty of loyalty means they must act for the benefit of the subsidiary and not merely in the interests of the dominant shareholder.

In reality, the business of a subsidiary can be controlled by a parent in many ways. The cases demonstrate that the ownership of shares is not the only key to factual control.¹⁴⁰ However, the ownership of shares in a subsidiary offers a parent certain prerogatives of ownership that facilitate *extra-legal incidents of control*. The result is a hybrid form of control that fluctuates between control with a legal basis such as majority voting power and 'extra-legal' control that depends on the influence the parent has over those fulfilling formal management roles in the company.¹⁴¹ The two classical methods of extra-legal control are the election or appointment of directors and the use of sophisticated contractual techniques such as management agreements and loan agreements.¹⁴² Often extra-legal control ensures titular directors fulfil management roles within the subsidiary as the 'puppets' of the parent. In reality, all direction is derived from the board of the parent and the subsidiary's directors have little say in

[1989] BCLC 100.

¹³⁹ See generally in relation to this discussion, *Gramophone and Typewriter Ltd. v. Stanley* (1908) 2 KB 89, at 98 *per* Fletcher Moulton L.J. and cited with approval in the High Court of Australia decision of *Federal Commissioner of Taxation v. Commonwealth Aluminium Corporation Ltd* (1980) 143 CLR 646 at 661 *per* Stephen, Mason and Wilson JJ.

¹⁴⁰ The courts willingly acknowledge that control, in commercial reality, is a much wider notion than mere legal control. See *Bermuda Cablevision Ltd v. Colica Trust Co Ltd* [1998] 1 BCLC 1, (PC) at 10 *per* Lord Steyn.

¹⁴¹ Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* Revised ed. (New York: Harcourt, Brace & World Inc, 1968) at 67.

¹⁴² *Federal Commissioner of Taxation v. Commonwealth Aluminium Corporation Ltd* (1980)

management of the subsidiary. A common method used to ensure allegiance to a parent is for the parent to appoint its own employees as directors of a subsidiary. The power of the parent to select the subsidiary's board of directors derives from its capacity as a shareholder. Consequently, the parent has the power to terminate the employee-director's employment and remove them from office. This lever, despite the strict legal view that the director owes allegiance to the subsidiary, enables the parent to dictate the director's choice. In addition, a parent may exert power as a creditor and financier of the subsidiary¹⁴³ such as withholding or agreeing to pay money as debt or capital is an effective means of control.¹⁴⁴

Multinational Gas shows how the decisions of shareholders can be 'channelled' to effect action in a subsidiary. The shareholders from time to time nominated their employees to act as the directors of Multinational. As employees of the shareholders, the directors complied with the wishes of their employers. However, the directors owed a dominant duty of care to Multinational. When the shareholders resolved the policy of Multinational for the directors to implement, their acts became the actions of Multinational and were binding on it. Consequently, Multinational was bound by what was done when it was a going concern because the shareholders owed no duty to the company. Director's actions were ratified because their decisions were made with the full assent of the shareholders. Even if the director's conduct is misfeasance, provided

143 CLR 646 at 668 *per* Murphy J.

¹⁴³ See generally Berle & Means *op. cit.*, note 141 at 66.

¹⁴⁴ Michael Brooke and H. Lee Remmers, The Strategy of Multinational Enterprise (London: Longman, 1970) at 11.

it is *intra vires* and authorised by the shareholders no action for breach of duty accrues to the company.¹⁴⁵

Multinational Gas enables us to summarise the almost ‘seamless’ boundaries to the control a parent can exercise over a subsidiary. First, a parent may in its capacity as either employer or as a financier, influence or induce how a director exercises the powers of the corporation. Second, a parent may exercise its formal legal right of majority voting control by amending the articles of association, defining the constitution of the board and ratifying the actions of directors.¹⁴⁶ The law is clear in England that the parent is always treated as a shareholder. By virtue of this, a parent owes no duty to a subsidiary. This is a problem in a group of companies. Whilst a parent has control of a subsidiary, the law has been loathe to provide those who suffer from abuse of this power – creditors – with a mechanism to make the parent accountable. This proposition raises two further questions. First, what parental conduct is sufficient to justify departure from the general law principle that a parent is no more than a shareholder? Second, are there any other principles outside general company law that can visit a parent with liability for its immoderate use of power?

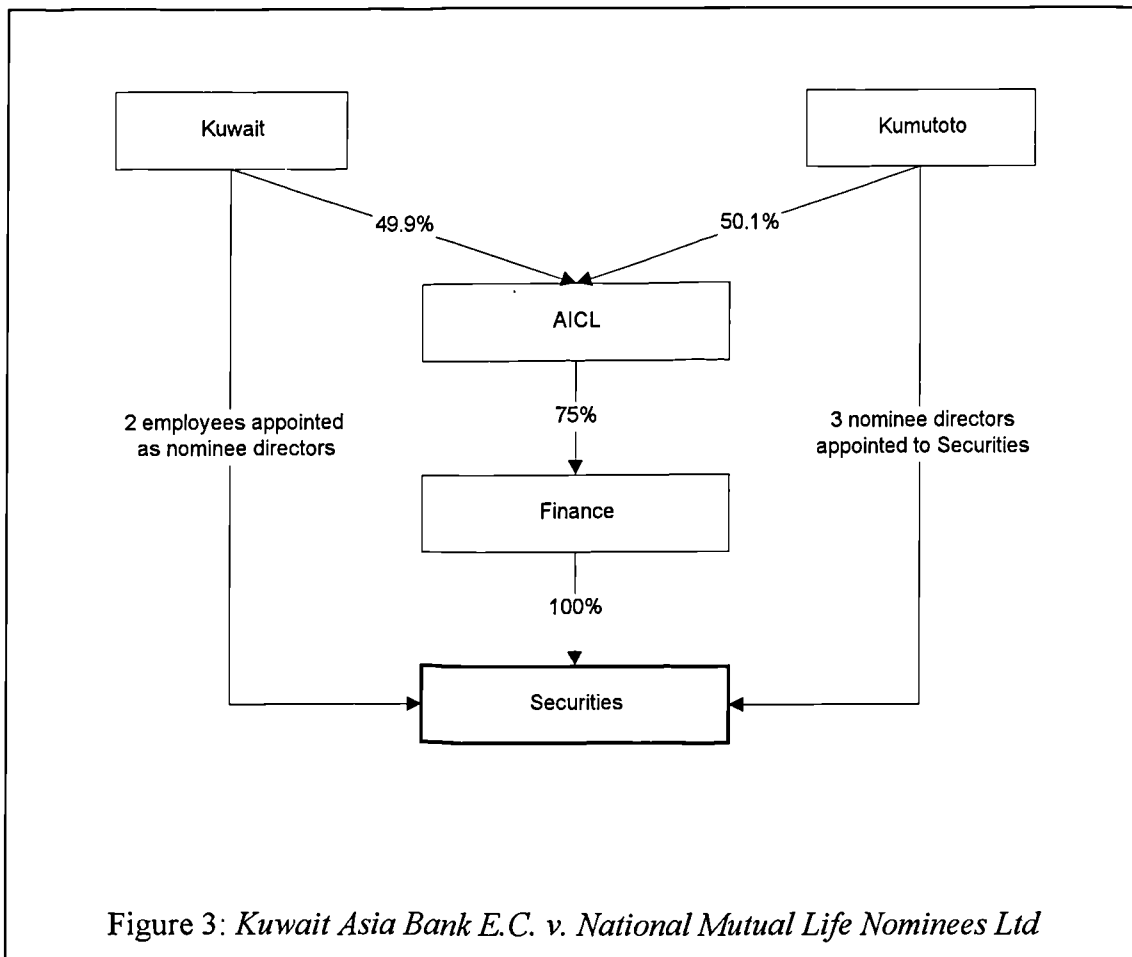
Parental ‘Influence’ or ‘Interference’ in the Management of a Subsidiary

In answer to the first question, the courts have differentiated between the exercise of legitimate ‘influence’ of management and ‘interference’ in management that gives rise to a cause of action. The conception of parental ‘influence’ and ‘interference’ in the management of a subsidiary was considered, in *Kuwait Asia Bank E.C. v. National*

¹⁴⁵ *Re Horsley & Weight* [1982] Ch 442.

¹⁴⁶ See generally Berle & Means *op. cit.*, n 141 at 212.

*Mutual Life Nominees Ltd.*¹⁴⁷ Kuwait Asia Bank E.C. (“Kuwait”) and Kumutoto Holdings Limited (“Kumutoto”) organised their corporate structure according to the following diagram.



Thus, Kuwait was beneficially interested in about 40 per cent of the shares in Securities. Kumutoto and Kuwait agreed that Securities would have five directors, three nominated by Kumutoto and two by Kuwait. Kuwait nominated two of its employees as directors. National Mutual was appointed as trustee for depositors with Securities. Securities covenanted with National Mutual to provide monthly and quarterly financial certificates on behalf of the directors. Securities went into liquidation and its unsecured depositors

¹⁴⁷ *Supra*, n 136.

were unable to recover fully their deposits and interest. National Mutual as trustee settled part of these debts and then sought contribution from, amongst others, the directors of Securities and Kuwait. The arguments raised against Kuwait were (1) its nominee directors were employees and their breaches of duty to the company were acts committed or omitted during the course of employment. Accordingly, Kuwait was vicariously liable for the acts and omissions of the employee-directors appointed to Securities. (2) The relationship between Kuwait and the employee directors was sufficient to constitute an agency. This argument was rejected completely.¹⁴⁸ (3) As Kuwait was a 'substantial shareholder' in AICL, which was the parent company that exercised power of ownership and control over Securities, it owed a duty of care to the National Mutual as trustee and to the depositors. The duty was to ensure that the business of Securities was not conducted negligently or recklessly or in such a manner as to disadvantage materially the interests of the unsecured creditors. (4) As the employee directors were accustomed to acting in accordance with Kuwait's directions, Kuwait was a 'director' under section 2 of the Companies Act 1955 (NZ). This argument was also subsequently rejected as groundless.¹⁴⁹

The Privy Council made a number of statements of principle. 'A director does not by reason only of his position as a director owe any duty to creditors or to trustees for creditors of the company. [Further,] a shareholder does not by reason only of his position as shareholder owe any duty to anybody.'¹⁵⁰ However, a director or a shareholder could accept or assume a duty of care by supplying information to a

¹⁴⁸ *Ibid.*, at 222 F H.

¹⁴⁹ *Ibid.*, at 223 F - 224 C. Cf *Re Hydrodam (Corby) Ltd* (1994) 2 BCLC 180 where Millet J. has recently acknowledged that a parent may be a 'shadow director'. See also *Standard Chartered Bank of Australia v. Antico* (1995) 18 ACSR 1.

¹⁵⁰ *Ibid.*, at 217 F G.

creditor analogous to the principle in *Hedley Byrne & Co Ltd v. Heller & Partner Ltd*.¹⁵¹ In relation to (1) and (3), the Privy Council firstly considered the power of a shareholder *qua* shareholder holding that,

the power of appointing a director of a company may be exercised by a shareholder or a person who is not a shareholder by virtue of the articles of association of the company, or by virtue of the control of the majority of the voting shares of the company, or by virtue of the agreement or acquiescence of other shareholders. ... In the absence of fraud or bad faith (which are not alleged here), a shareholder or other person who controls the appointment of a director owes no duty to creditors of the company to take reasonable care to see that directors so appointed discharge their duties as directors with due diligence and competence.¹⁵²

The role of a shareholder exemplified another boundary in which *Salomon* operated because,

[t]he liability of a shareholder would be unlimited if he were accountable to a creditor for the exercise of his power to appoint a director and for the conduct of the director so appointed. It is in the interests of a shareholder to see that directors are wise and that the actions of the company are not foolish; but this concern of the shareholder stems from self-interests and not duty.¹⁵³

The Privy Council then considered the power of a shareholder *qua* employer. If Kuwait had exploited its influence over the directors as employees and taken improper advantage for itself or harmed Securities then it would be liable for the loss suffered as a consequence of its misconduct. Where there was no evidence of impropriety there were no grounds for such allegations. Kuwait's duty not to exploit its influence as employer, in this instance, was the same as a father's influence over a son who is a director or a businessman's influence over an associate who is a director. The mere existence of the opportunity for abuse by Kuwait did not warrant imposing

¹⁵¹ [1964] AC 465. See also *Williams v. Natural Life Foods Ltd* [1998] 2 All ER 577 (HL) for a recent discussion of the notion of "assumed responsibility".

¹⁵² [1991] 1 A.C. 187, (PC) at 220 H - 221B.

responsibility for the directors' negligence.¹⁵⁴ The Privy Council considered the duty the directors owed Securities had priority over the duty of the director's to obey their employer-parent. The directors even as employees were bound to ignore the interests of Kuwait. The directors could not plead instructions from their employer as a defence or excuse for breach of their duties to Securities.¹⁵⁵

An employer who is also a shareholder who nominates a director owes no duty to the company unless the employer *interferes* with the affairs of the company. A duty does not arise because the employee may be dismissed from his employment by the employer or from his directorship by the shareholder or because the employer does not provide sufficient time or facilities to enable the director to carry out his duties. It will be in the interests of the employer to see that the director discharges his duty to the company but again this stems from self interest and not from duty on the part of the employer.¹⁵⁶

We can conclude from *Kuwait* that 'interference' must have sufficient causality to give rise to any claim for damages for loss arising from a breach of duty. This matter received extensive treatment by Thomas J. in the New Zealand High Court decision of *Dairy Containers Ltd v. N.Z.I. Bank Ltd.*¹⁵⁷ The facts of the case were very complex. DCL was a wholly owned subsidiary of NZDB. All the directors of DCL were senior executives of NZDB. The three executives who were directors had their employment with NZDB terminated on discovery that they had misappropriated DCL's funds. DCL claimed approximately NZ\$ 12 million for breach of contract against its auditor for the loss suffered from the undetected misappropriated funds. In response to this, the auditor joined the parent, NZDB as a third party alleging that NZDB was a *joint tortfeasor* on the basis that it had breached its duty of care owed to DCL as subsidiary. Further, that NZDB as parent was a 'director' of DCL under the extended definition

¹⁵³ *Ibid.*, at 221F.

¹⁵⁴ *Ibid.*, at 222 D F.

¹⁵⁵ *Ibid.*, at 222 B C.

¹⁵⁶ *Ibid.*, at 223 C D.

found in section 2 Companies Act 1955 (NZ) and it was vicariously liable for the acts and omissions of its employee senior executives whilst on the board of DCL.

The auditor alleged the parent's liability derived from its 'symbiotic' relationship with its subsidiary such that the subsidiary had no life of its own. The features of this relationship included: the parent's complete control of the manufacture of products by the subsidiary. The subsidiary was not permitted to make a profit. The parent provided all funding. The directors of the parent were the direct superiors of the director-employees of the subsidiary. Even with this level of intervention, Thomas J. was wary of any easy finding of parental 'interference'.¹⁵⁸

The scope of the conduct constituting 'interference' lead to argument concerning the interpretation of the word and the meaning suggested by the Privy Council in *Kuwait*. Counsel for NZDB argued that the word was used in a pejorative sense, requiring the Court to identify a particular act sufficient to constitute a cause of action. The contrary argument was that the word was not used in a pejorative or deprecatory manner. Thomas J. stated:

I do not think, therefore, that the Privy Council intended to use the word 'interfered' in a pejorative sense. Rather, the interference referred to is simply interference of a kind that would be sufficient to give rise to a direct duty of care.¹⁵⁹

This is an important conclusion because it may enable the court to make a global assessment of conduct that taken in its separate parts is not actionable but collectively

¹⁵⁷ [1995] 2 NZLR 30.

¹⁵⁸ *Ibid.*, at 87. Where his Honour stated 'If Counsel's argument is any guide, it may not be entirely clear what Their Lordships [in *Kuwait*] meant. But it is, perhaps, unwise too make too much of an observation which was almost in the nature of an aside.'

¹⁵⁹ *Ibid.*, at 88.

comprises a cause of action.¹⁶⁰ Thomas J. specifically pointed to a number of circumstances that were not ‘interference’. First, it was argued that failure of the parent to deal adequately with the intercompany accounts and balances was ‘interference’.

There is no doubt that the intercompany accounting between [parent] and [subsidiary] was very casual. Although I would not go so far as to say that [the parent] was negligent, its systems and records were inadequate, and [fraud was] ... made possible because of these shortcomings. But I do not think these failings give rise to a duty of care to the subsidiary companies. All companies are required to prepare group accounts and leading the role in reconciling the accounts will almost certainly be taken by the officers of the company. ... In the absence of any special circumstances, that obligation falls on the directors and management of the subsidiary itself.¹⁶¹

Further, it was alleged that the tardiness of the parent in implementing internal audits gave rise to a duty. Thomas J. held that if the parent had undertaken the audit and not taken reasonable care then a duty would arise. However, where no audit was conducted no duty could possibly arise. Finally, it was alleged that the parent’s total control of the subsidiary was ‘interference. Thomas J. also rejected this proposition,

I acknowledge that, if specific acts of interference can give rise to a duty to the subsidiary, it would appear logical to accept that total control could have the same effect. Indeed, the total control might be said to be continuing interference. But control of this kind, exercised through employees who have been appointed directors to the subsidiary’s board, does not negate the duty of those directors to the company. The interference, and action on the part of NZDB which would give rise to a duty, is not its ability to control the company, but the actual act or acts which override the director’s duty to their company so that the parent can be said to have interfered in the affairs of the company.¹⁶²

¹⁶⁰ This shows that the courts may be ready to accept the ‘laundry list’ approach to analysis of the parent subsidiary relationship as found in the US. *Infra.*, Chapter 8, Excessive Control – Unity of Interest on page 315.

¹⁶¹ *Ibid.* Cf. Australian group trading provisions. Part 5.7B Division 5 of the Corporations Law. *Infra.*, Chapter 6, Liability of a Holding Company for the Debts of its Subsidiaries on page 264.

¹⁶² [1995] 2 NZLR 30 at 89.

The possibility of a duty arising between parent and subsidiary becomes even more remote if the subsidiary has independent directors that are not accustomed to acting on the instructions or directions of the parent.¹⁶³

Interference and Its Relationship with Tort

Adams, Multinational, Kuwait, and Dairy Containers demonstrate that a parent's control over a subsidiary can be complete and comprise components of legitimate legal and extra-legal control. Crucially, the mere ability of a parent to control totally a subsidiary does not give rise to any duty whatsoever between the parent and subsidiary. Strictly, the law provides a parent, as a shareholder, is not permitted to interfere in the management of the subsidiary by a director even in general meeting.¹⁶⁴ No duty arises in favour of a subsidiary because a parent has the power to dismiss the director employee or remove the director from office.¹⁶⁵ The roles of appointor, employer, or shareholder are self-interested – without duty to the subsidiary. All duty, at common law, resides in the office of director. A parent can validly exercise 'influence' through extra-legal measures – one of the prerogatives of share ownership – whereas parental power exercised by 'interference' should entitle the aggrieved (such as a creditor) to a cause of action such that the parent is a tortfeasor. The difference between influence and interference is that 'influence' may be legally exercised in the absence of impropriety. If the 'influence' has indicia of impropriety and knowingly violates a legal right founding a cause of action then there is 'interference'. 'Interference' is conduct that breaches a threshold sufficient to demonstrate a direct causal connection of

¹⁶³ *Ibid.*, and *Kuwait Asia Bank E.C. v. National Mutual Life Nominees Ltd*, [1991] 1 A.C. 187 (PC) at 233.

¹⁶⁴ *Automatic Self-Cleansing Filter Syndicate Co. Ltd v. Cunningham* [1906] 2 Ch 34.

¹⁶⁵ *Kuwait Asia Bank E.C. v. National Mutual Life Nominees Ltd*, [1991] 1 A.C. 187 at 223 c d.

the parent's actions to loss incurred by the subsidiary. Thus, it can be said that 'interference' is a direct action by a parent outside the 'four corners' of its role as a shareholder or as an employer of the subsidiary's directors. This provides three avenues of recourse to a subsidiary and in turn the liquidator and the creditors.

First, interference of the parent may impose a direct duty to the subsidiary that is actionable in tort. Such interference can occur independently of the parent having a nominee employee-director on the board of a subsidiary. Second, interference may implicate a parent as a joint tortfeasor with a director's commission of a tort. A director can be personally liable for torts committed during the execution of their duties,¹⁶⁶ though care must be taken to determine whether the director's actions are his own or correctly attributable to the subsidiary.¹⁶⁷ Third, the parent may be vicariously liable for the actions of its employee director. In this regard it is only when the parent's actions override the director's duties to the subsidiary can it be said that the parent has 'interfered' with the affairs of the company to the extent that a duty is owed by a parent to the subsidiary.¹⁶⁸ Vicariously liability also attaches to the parent where the tortious conduct of the director is performed in the director's capacity as an employee and is not attributable to the subsidiary.¹⁶⁹

¹⁶⁶ *New Zealand Guardian Trust Co Ltd v. Brooks* [1995] 2 BCLC 242 (PC).

¹⁶⁷ Ross Grantham, 'Liability of parent companies for the actions of the directors of their subsidiaries' (1997) 18 *Company Lawyer* 138 at 142. See also *Williams v. Natural Life Foods Ltd* [1998] 2 All ER 577 (HL) for a recent discussion of the notion of "assumed responsibility".

¹⁶⁸ *Dairy Containers Ltd v. N.Z.I. Bank Ltd* [1995] 2 NZLR 30 at 87-90 *per* Thomas J. and *Kuwait Asia Bank E.C. v. National Mutual Life Nominees Ltd*, [1991] 1 A.C. 187 (PC) at 223-224 for a discussion of the notion of a parent's 'interference' with a subsidiary. For example, in *Ryde Holdings Ltd v. Sorrenson* [1988] 2 NZLR 157 a director's employer instructed the director to sell the assets of a company to a subsidiary at undervalue.

¹⁶⁹ Grantham, *op. cit.*, n 167 at 141.

Legitimacy of Control in the Parent Subsidiary Relationship

One dimension of the parent subsidiary relationship is what we can term the *legitimate control model*, which operates in ordinary commercial circumstances. A parent fulfils two primary roles in relation to a subsidiary. First, as a shareholder and second, as a controller. The parent's accountability to the subsidiary is construed with respect to its capacity as a shareholder: no discrete duties arise from the fact that a parent is a controller. Thus, a parent owes no duty to a subsidiary except in the exceptional circumstances that may constitute 'interference'. As a controller, for example, a parent can make a decision that is conveyed, via a directive either from an employer or through the director being on the board of both parent and subsidiary, to the directors of the subsidiary. The director complies with the parent's wishes because of a number of reasons. First, the parent may employ the person filling the role of director and failure to comply may result in disciplinary action. Second, it is implied that if the director complies with the wishes of the parent his actions will be ratified in the parent's capacity as a shareholder. The directors can then put the decision of the parent into place.

Close association between the parent and subsidiary should not deprive the companies of legitimate privileges.¹⁷⁰ In summary, *the legitimate control model* is evidenced by a number of features demonstrating conduct that is a legitimate use of control by a parent over a subsidiary.

1. Conducting business through a subsidiary is not an abuse and a parent may have complete control of a subsidiary's board.

¹⁷⁰ C. E. Brooks, 'Parent and Subsidiary, right of parent or subsidiary to share with other

2. The desire to limit liability using a subsidiary is not a fraud.¹⁷¹ It is often the very reason for incorporating a subsidiary because the business of the subsidiary is separate and different.
3. Domination of the subsidiary by a parent is not a badge of impropriety. Only when the influence of the parent, either directly or via its employee directors on the board of the subsidiary is sufficient to comprise a cause of action will the parent's conduct comprise interference.
4. A parent may exploit the limited liability and separate personality of a subsidiary subject to very few limits. A subsidiary may exist purely for the parent's benefit. The parent may manage the subsidiary's affairs as it wishes.¹⁷² Any act performed by a subsidiary falling within the express or implied powers conferred by its memorandum of association, whether or not a breach of duty by directors, will be binding on the subsidiary if approved or ratified by the shareholders – parent or otherwise.¹⁷³
5. The motives of the parent influencing management of the subsidiary need not be commercial; they can be whatever the parent wishes provided they are legal.¹⁷⁴ The legality qualification includes factors such as the duty of directors to preserve the

creditors in assets of associated corporation on the latter's insolvency' (1939) 37 *Michigan Law Review* 440 at 448.

¹⁷¹ *Adams v. Cape Industries Plc* [1990] 1 Ch 433.

¹⁷² *Multinational Gas Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd & Ors* [1983] Ch 258.

¹⁷³ *Aveling Barford Ltd v. Perion Ltd* [1989] BCLC 626 at 631 *per* Hoffman J.; *Rolled Steel Products (Holdings) Ltd v. British Steel Corporation* [1986] Ch 246 at 296 *per* Slade L.J.

¹⁷⁴ *Re Horsley and Weight Ltd* [1982] 1 Ch 442 at 450 *per* Buckley L.J.

capital fund of the subsidiary. However, a subsidiary and the directors acting on its behalf can expend the contributed capital for any purpose that is *intra vires*.¹⁷⁵

The shareholding of a parent in a subsidiary is the source of legal control. Extra-legal control comes from the prerogatives of legal ownership. This type of control is latent, but increases as the level of shareholding in a subsidiary increases. Where there is a minority shareholding, the use of extra-legal control is circumscribed by the duty of the majority to the minority. However, where a subsidiary is wholly owned, the prerogatives of ownership are largely unfettered. This means that a parent regularly controls how a subsidiary is funded.

Parent as a Creditor

Funding for a subsidiary is usually comprised of debt and equity. Debt finance is commonly obtained from parent companies or banks in exchange for commercial paper with varying degrees of security. The issue of shares raises equity finance. The shares have varying rights and usually confer some degree of control to the holder. The proportions of debt and equity necessary are dependent on factors such as the nature of the enterprise. Parents via the *legitimate control model* have the liberty to choose the kind of funding they will use to establish a subsidiary. A rational financial structure emphasises maximising return for the minimum of risk. If the business risk is uncertain, the inherent advantages to the lender of debt over equity are obvious.

A parent shareholder and creditors each bear some risk of a subsidiary's failure. Parent shareholders assume greater risk than creditors because their interests receive the lowest priority on insolvency. The compensation for assuming this risk is receiving a share in

¹⁷⁵ *Ibid.*, at 454 *per* Buckley L.J.

the profits whereas creditors are confined to interest and the benefit of priority of payment over shareholders. However, a parent or other group shareholders may assume the position of both creditor and shareholder.¹⁷⁶ Therefore, if the subsidiary is a success profit will be forthcoming to the parent but if it fails the parent is allowed to prove its debts and be treated *pari passu* with other creditors. Notwithstanding this, a parent may have a valid security interest that ensures that all its debt is paid before any of the unsecured creditors.

This reality demonstrates how unrealistic it is to say that corporate structures confer a separation of control and investment. This causes a diametric opposition in views regarding how the claims of affiliated companies should be treated on insolvency.¹⁷⁷

Views concerning the ability of a controller or parent company to spread risk in this fashion range from it being purely unfair to a legitimate commercial device. Some argue that the device is unfair because a creditor's assessment of risk is based on the collective claims of other creditors who have the same minimal influence over the destiny of the enterprise. Moreover, because any loan to the subsidiary by parent company is designed to maximise profits it follows that the character of such funds is akin to risk capital. Such financial structuring biases the exercise of control in favour of the best interests of the parent and not the subsidiary.¹⁷⁸

¹⁷⁶ Insofar as liquidation is concerned the general legislative purpose of the rule that 'members come last' (see section 74 Insolvency Act 1986) is subject to strict rules of delineation. For example, *Soden v. British Commonwealth Holdings Plc* [1997] 2 BCLC 501, (HL) at 505 *per* Lord Brown Wilkinson.

¹⁷⁷ See generally the exchange between Professors Landers and Posner. Jonathan M. Landers, 'A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy' (1975) 43 *University of Chicago Law Review* 589 (hereinafter cited as 'Landers '75'); Richard A. Posner, 'The Right of Creditors of Affiliated Corporations' (1976) 43 *University of Chicago Law Review* 499; Jonathan M. Landers, 'Another Word on Parent, Subsidiaries and Affiliates in Bankruptcy' (1976) 43 *University of Chicago Law Review* 527.

¹⁷⁸ Landers '75, *op. cit.*, at 559.

Alternatively, it is argued that the existence of funding devices that favour parental interest need not condemn the present law. The externalisation of the risk of business failure to creditors is a legitimate business strategy available to all who use the corporate form.¹⁷⁹ The existence of the *Salomon* doctrine and the financing structure mentioned should not be expected to conflict with the credit system to the extent that they are turned in on themselves to balance advantage between debtor and creditor.¹⁸⁰ Posner epitomises the views of the Chicago School in this area stating: 'An efficient corporations law is not one that maximises creditor protection on the one hand or corporate freedom on the other, but one that mediates between these goals in a fashion that minimises the costs of raising money for investment.'¹⁸¹

Does this mean the 'creditor proof corporation'¹⁸² is an evil that must be scotched from commerce? It depends entirely who the creditors are. A parent has no duty adequately to capitalise a subsidiary and may provide debt finance for a subsidiary to function. Most importantly, the minimal capitalisation of a company is sanctioned legislatively.¹⁸³ Despite this clear expression of legislative intention, some are reluctant to accept that the bedfellows of credit and the parent - subsidiary relationship are a legitimate commercial device.¹⁸⁴

¹⁷⁹ Posner, *op. cit.*, at 503.

¹⁸⁰ Posner, *op. cit.*, at 505.

¹⁸¹ Posner, *op. cit.*, at 509.

¹⁸² Elvin R. Latty, 'Corporation Statutes as the Answer to Parent - Subsidiary Liability' (1937) 35 *Michigan Law Review* 794 at 795.

¹⁸³ See sections 117 and 118 Companies Act 1985. A public company must have a minimum capitalisation of £50,000. However, a private company has no such requirement.

¹⁸⁴ In *Atlas Maritime Co SA v. Avalon Maritime Ltd, The Coral Rose (No.1)* [1991] 1 *Lloyds Rep* 563 (CA). Staughton L.J. summarised the essence of this position saying: 'The creation or purchase of a subsidiary with minimal liability which will operate with the parent's funds and on the parent's directions but not expose the parent to liability may not seem to some the most honest way of trading' at 571.

The law does recognise that this device is open to abuse and has adopted protective measures which recognise the market reality that a creditor may not have access to important management *information* and in most circumstances cannot *supervise* the subsequent use of the credit. For example, if we accept a parent is a ‘shadow director’ of a subsidiary, wrongful trading¹⁸⁵ to an extent may counter an *information* deficit. This is evident from the fact that a corporation can incur credit without a creditor knowing that the debt will not be repaid. *Supervisory* remedies such as transactions at under value, voidable preferences and the capital maintenance rule seek to counter conduct that unduly adds to the risk of a creditor’s investment. If a remedy reduces a creditor’s cost of obtaining information or monitoring management yet does not stifle the controllers entrepreneurial choices then the measure is justified. Though we cannot regulate to protect the foolhardy from themselves, we can regulate to protect creditors from unconscionable use of the corporate form.

COMMENTS

Whilst the courts are bound to comply with *Salomon*, it is not without reservation - ‘It is perhaps permissible under modern commercial conditions to regret the existence of these principles. But it is impossible to deny, ignore or disobey them.’¹⁸⁶ The primary criticism of the application of *Salomon* to the parent subsidiary relationship is that it fails to recognise the economic reality. Concern is often expressed for the plight of the creditor because of the use and abuse of power by parent companies. The often quoted paragraph from Templeman L.J. in *Re Southard & Co Ltd*¹⁸⁷ shows a judicial

¹⁸⁵ See section 214 Insolvency Act 1986.

¹⁸⁶ *Ibid.*, *Albacruz v. Albazero, The Albazero* [1977] AC 774, (CA) at 807 d g per Roskill L.J.

¹⁸⁷ [1979] 1 WLR 1198.

understanding of the problems posed by superimposing *Salomon* onto a group of companies.¹⁸⁸

For Staughton L.J. in *Atlas Maritime Co SA v. Avalon Maritime Ltd, The Coral Rose (No.1)*¹⁸⁹ the power of a parent to undercapitalise a subsidiary to the detriment of creditors verged on venality:

The creation or purchase of a subsidiary company with minimal liability, which will operate with the parent's funds and on the parent's directions but not expose the parent to liability, may not seem to some the most honest way of trading.¹⁹⁰

Even so, Staughton L.J. considered to change the status quo by making an agency relationship between parent and subsidiary a revolutionary exercise. In *Briggs v. James Hardie & Co Ltd*¹⁹¹ Rogers A.J.A. (as he then was) somewhat poignantly stated,

This undoubtedly afflicted seventy-one year old man was therefore confronted with the barriers of the entrenched principles of limited liability, firmly enshrined in the law since [*Salomon*]. With all due humility, I am bound to say that there seems to be something wrong with the state of the law when, in order to recover compensation for his apparent asbestosis, a person in the position of this plaintiff has to mount a challenge to fundamental principles of company law.¹⁹²

Whilst these criticisms are perhaps justified, the judiciary is reluctant to offer an alternative. Can stated instances that demonstrate the harsh operation of *Salomon* justify the use of an alternative liability rule such as economic unity when operation of the current orthodoxy arguably encourages business start-ups and produces greater wealth overall.

¹⁸⁸ *Ibid.*, at 1208 F H. *Supra* p 24.

¹⁸⁹ [1991] 4 All ER 769, (CA).

¹⁹⁰ *Ibid.*, at 779 e f.

¹⁹¹ (1989) 16 NSWLR 549.

¹⁹² *Ibid.*, at 559 A B.

In summary, the relationship between parent and subsidiary can be described with reference to the *legitimate control model*. This model permits a parent to control completely every aspect of a subsidiary's purpose, finance, and management structure. The source of such complete control derives from share ownership. Legal control derives from the ability to control the company in general meeting. Whereas the more pervasive notion of extra-legal control enables the parent to transcend legal controls and use influence upon directors and employees of the subsidiary. Extra-legal control derives from the prerogatives of ownership that attach to shares particularly where there is a majority shareholding.

A subsidiary which speaks with the voice of the parent who controls it and which acts as the parent directs is not of itself a façade nor is it a sham. A subsidiary's existence as a separate entity is not incompatible with its obedience to orders.¹⁹³ If a parent uses the group structure to ensure that legal liability for a particular activity falls on a subsidiary rather than the parent then it is not an abuse.¹⁹⁴ However, where there is an express or implied contractual term that includes the parent or subsidiary within its scope, the presumption may be rebutted.¹⁹⁵ It is presumed, in the absence of evidence to the contrary, that a director of a subsidiary is neither a principal of the parent¹⁹⁶ nor an agent of the company's controlling members.¹⁹⁷ The sheer weight of authority and fortification of these principles has dispatched any likelihood of the parent subsidiary

¹⁹³ *Federal Commissioner of Taxation v. Casuarina Pty Ltd* (1971) 127 CLR 62 at 78 per Windeyer J.

¹⁹⁴ *Adams v. Cape Industries Plc* [1990] Ch 433 at 544 per Slade L.J.

¹⁹⁵ *Pioneer Concrete Services Ltd v. Yelnah Pty Ltd* (1986) 5 NSWLR 254 at 264 per Young J., SC(NSW).

¹⁹⁶ *Rainham Chemical Works Ltd v. Belvedere Fish Guano Company Ltd* [1921] 2 AC 465 at 488 per Lord Parmoor, (HL).

¹⁹⁷ *Gramophone & Typewriter Ltd. v. Stanley* [1908] 2 KB 89 at 99 per Fletcher-Moulton L.J., at 105-6 per Buckley L.J.

relationship being viewed as a economic entity in ordinary commercial circumstances. Despite the existence of the *legitimate control model* the use of complete control over a subsidiary does not go unfettered. The law offers two avenues to pierce the corporate veil and expose a parent to the liability and responsibilities of a subsidiary. The first of these is explored in Part II and concerns the jurisprudential approach to veil piercing. The second is considered in Part III and concerns the statutory remedies available to creditors.

**Part II: The General Law and the Judicial Limits
of *Salomon***

Chapter 2

Agency and the Sham as Applied to Groups of Companies

INTRODUCTION

In *Adams v. Cape Industries Plc*,¹ the Court of Appeal attempted to reconcile some of the inadequacy of veil piercing jurisprudence by categorising the circumstances that may permit the rejection of entity. First, the court considered the ‘single economic unit’ arguments discussed in Chapter 1. Until *Adams* there had been an emerging jurisprudence on the permissibility of disregarding separate personality in circumstances where there was a group of companies. Professor Gower seems to have been the primary academic force² with Lord Denning providing the judicial impetus.³ As we have already discussed, this is not a valid ground for rejecting *Salomon* in the context of creditor’s claims. Second, concerns the circumstances described by

¹ [1990] Ch 433.

² Professor Gower stated in his 4th edition ‘that the courts have supplemented the action of the legislature in affording recognition of ‘enterprise entity’ rather than ‘corporate entity’ and in lifting the veil of incorporation in relation to associated companies rather more readily’ at 133. Whereas in his 5th edition in the light of *Adams v. Cape Industries Plc*, Professor Gower states ‘It seems therefore that in aid of interpretation [of a statute contract or other document] the court may (and indeed should) have regard to the economic realities in relation to the companies concerned. But that now seems to be the extent to which the ‘single economic unit’ argument can succeed.’ at 129.

³ The views of Lord Denning have been discredited and strongly criticised. *Supra*, Economic Unity Where Justice So Demands? on page 83. See also F. G. Rixon, ‘Lifting the Veil between Holding and Subsidiary Companies’ (1986) 102 *Law Quarterly Review* 415 at 416-417.

Professor Gower as the ‘interpretation’ cases.⁴ That is, those situations where the court must consider the parent subsidiary relationship in terms of construing a statute, contract or other document. In this context, we can also consider the notion of parent subsidiary agency. *Salomon* rules out the possibility of a parent being the principal of a subsidiary *per se*, but as we shall see, historical confusion resulted in the development of a number of exceptions. *Adams* now effectively excludes these exceptions and the presumption of any contractual agency relationship except where there is an express or implied agreement between subsidiary and parent. Third, is the notion of ‘a façade concealing the true facts’ or sham acknowledged by the House of Lords in *Woolfson v. Strathclyde Regional Council*.⁵ In this chapter, we will consider the notion of parent subsidiary agency and then go on to discuss the façade or sham as a means of veil piercing. It will be demonstrated that there are three means of veil piercing using the doctrine of the sham. First, the transactional sham, second the corporate sham, and third the corporate – transactional sham hybrid.

SUBSIDIARY AS THE AGENT OF A PARENT

Early after the House of Lords decision in *Salomon*, the courts began to grapple with the problem of agency and the parent subsidiary relationship.⁶ Initially, the courts were readier to perceive the relationship as one of agency. This misunderstanding was resolved in *Gramophone & Typewriter Ltd. v. Stanley*.⁷ The starting assumption became that each company was a separate entity and no relationship of agency existed.⁸

⁴ Davies, *op. cit.*, at 174.

⁵ [1978] SLT 159.

⁶ For example, *Apthorpe v. Peter Schoenhofen Brewing Co* (1899) 4 TC 41; 80 LT 395, (CA). (Smith, Collins and Romer L.J.J), *Kodak Ltd v. Clark* [1903] 1 KB 505, (CA).

⁷ [1908] 2 K.B. 89, (CA).

⁸ *Ibid.*, at 95-96.

This lead to a number of statements of principle concerning the relationship between parent and subsidiary. Just as the parent subsidiary relationship was not automatically one of agency, it was not one of debtor and creditor.⁹ It follows that the allocation of roles ensures that a director is not considered a principal of a company.¹⁰ On the other hand, where it is clear there is an agency agreement between a corporator and company, the court willingly accepts such proposals.¹¹ Similarly, if there are indicia that justify an inference of an agency relationship then the courts are willing to impose the consequences on the parent subsidiary relationship.

In *Smith, Stone and Knight Ltd. v. City of Birmingham*¹² Atkinson J. concluded that the test of whether the businesses of parent and subsidiary are sufficiently entwined to establish an agency was a question of fact. Matters that need to be considered include (1) how were the profits treated. Were the subsidiary's profits are treated as that of the parent?¹³ (2) Who appointed the officers? Were the officers of the subsidiary appointed by the parent?¹⁴ (3) Was the parent in effectual and constant control of the subsidiary?¹⁵

⁹ *I. R C. v. Sansom* [1921] 2 KB 492, (CA).

¹⁰ *Rainham Chemical Works Ltd v. Belvedere Fish Guano Company Ltd* [1921] 2 AC 465.

¹¹ *The Roberta* (1937) 58 Lloyds LR 159. Like *The Roberta*, in *Southern v. Watson* [1940] 3 All ER 439 it was clear that upon sale of a trader's business to a company and agency agreement existed for the purpose of the company completing unfulfilled orders on the trader's behalf.

¹² (1939) 4 All ER 116.

¹³ *Smith, Stone and Knight Ltd. v. City of Birmingham* [1939] 4 All ER 116, (KB) at 121 *per* Atkinson J. *Firestone Tyre and Rubber Co Ltd v. Lewellin* [1956] 1 All ER 693, (CA) at 700 *per* Evershed M.R. and more recently *Adams v. Cape Industries Plc* [1990] Ch 433, (CA) at 546 *per* Slade L.J.

¹⁴ *Smith, Stone and Knight Ltd. v. City of Birmingham* [1939] 4 All ER 116, (KB) at 120-1 *per* Atkinson J. See also, *Spreag v. Paeson Pty Ltd* (1990) 94 ALR 679 at 711 *per* Sheppard J., (F C Aust).

¹⁵ *Smith, Stone and Knight Ltd. v. City of Birmingham supra*, *Firestone Tyre and Rubber Co Ltd v. Lewellin supra*, *DHN Food Distributors Ltd v. London Borough of Tower Hamlets* [1976] 3 All ER 462 (CA) at 467 *per* Lord Denning M.R. See also, *Spreag v. Paeson Pty Ltd supra*, *J R McKenzie Ltd v. Gianoutsos* [1957] NZLR 309 at 324-325 *per* Barrowclough C.J., (CA)(NZ).

(4) Did the parent and subsidiary have separate business operations?¹⁶ The high degree of control of the subsidiary by the parent and the treatment of the profits of the business as profits of the parent demonstrated that the business was the business of the parent, in the conduct of which business the subsidiary acted as the agent of the parent.

There is inadequacies in the regime laid down in *Smith Stone & Knight*. As Professor Gower pointed out, the attempt at a methodology in *Smith Stone & Knight* is problematic because it leads to the counter-intuitive conclusion that where ever there is a controlling shareholder who is a managing director a determination of agency is almost inevitable.¹⁷

Cases after *Smith Stone & Knight* continued to demonstrate the nebulous corporate law notion of agency necessary to establish the principal agent relationship between parent and subsidiary.¹⁸ In *Littlewoods Mail Order Stores Ltd v. Mc Gregor (Inspector of Taxes)*,¹⁹ Lord Denning M.R. went so far as to treat the mere relationship of parent and

¹⁶ *DHN Food Distributors Ltd v. London Borough of Tower Hamlets* [1976] 3 All ER 462 at 468-9 per Goff L.J., *Adams v. Cape Industries Plc supra*, at 548. In addition, a number of other matters have been used in this context, such as: (a) did the subsidiary have its own bank accounts? *Spreag v. Paeson Pty Ltd supra*. (b) Did the subsidiary own or rent its own business premises? *Adams v. Cape Industries Plc supra*, at 545-6. See also *J R McKenzie Ltd v. Gianoutsos supra*, *Mario Piraino Pty Ltd v. Roads Corporation (No 2)* [1993] 1 VR 130 at 148 per Gobbo J. (Supreme Court of Victoria). (c) Did the subsidiary have its own employees and employees' superannuation or pension scheme? *Adams v. Cape Industries Plc op. cit.*, at 545. See also *Mario Piraino Pty Ltd v. Roads Corporation (No 2) supra*.

¹⁷ L. C. B. Gower, *The Principles of Modern Company Law* 2nd ed (London: Stevens & Sons, 1957) at 196. Even so, *Smith Stone & Knight* offers some degree of rigour that has gained limited use in Australia. See *Hotel Terrigal Pty Ltd v. Latec Investments Ltd (No. 2)* [1969] 1 NSWLR 676 at 680 and *Spreag v. Paeson Pty Ltd* (1990) 94 ALR 679 at 771.

¹⁸ *Pegler v. Craven* [1952] 2 QB 69, (CA). See also *Re F.G. (Films) Ltd* [1953] 1 WLR 483 and *Firestone Tyre and Rubber Co Ltd v. Lewellin* [1956] 1 All ER 693, (CA).

¹⁹ [1969] 3 All ER 855, (CA).

subsidiary as making disregard of entity available.²⁰ The emphasis moved away from agency to the equally compatible notion of 'single economic entity' analysis.

The current trend of cases is contrary to these developments and the mode of analysis is now conventional. For example, in *Briggs v. James Hardie & Co Ltd*²¹ the mere fact that the subsidiary complied diligently and accurately with the parent's wishes²² did not establish agency. Rather, the exercise of complete dominion or control was seen as merely a dimension to the parent subsidiary relationship.²³ The decisions in *Adams v. Cape Industries Plc*²⁴ and *Atlas Maritime Co SA v. Avalon Maritime Ltd, The Coral Rose (No.1)*²⁵ make it very clear that a high level of control is a legitimate aspect of the parent subsidiary relationship. It is not an immediate ground for the presumption of agency.²⁶ This suggests that there is difference in the notion of agency used in these earlier veil piercing cases and the notion found in agency law. Indeed, there has been a significant transitional development of the agency aspect of rejecting separate personality. For the purpose of comparison, it is worthwhile dwelling on the definition of 'agency'.

Agency is the fiduciary relationship which exists between two persons, one of whom expressly or impliedly consents that the other should act on his behalf, so as to affect his relations with third parties and the other of whom similarly consents so to act or so acts.²⁷

²⁰ *Ibid.*, at 860.

²¹ [1989] 16 NSWLR 549.

²² *Ibid.*, at 556.

²³ *Ibid.*, at 567 *per* Rogers AJA.

²⁴ [1990] Ch 433, Scott J. and Court of Appeal.

²⁵ [1991] 4 All ER 769, (CA).

²⁶ *Yukong Lines Ltd v. Rendsberg Investments Corporation (No. 2)* [1998] 1 WLR 294, (QB).

²⁷ F. M. B. Reynolds, *Bowstead and Reynolds on Agency* 16th ed (London: Sweet & Maxwell, 1996) Number 7 of *The Common Law Library* at 1.

The essence of agency is consent not close control.²⁸ This was made clear by Neil L.J. in *Atlas Maritime* where he stated ‘the fundamental principle [is] that the relationship of principal and agent can only be established by the consent of the principal and agent.’²⁹ Consequently, the use of the term ‘agency’ in the context of cases such as *Apthorpe v. Peter Schoenhofen Brewing Co.*,³⁰ *Smith Stone & Knight*, and *Firestone Tyre and Rubber Co Ltd v. Lewellin*³¹ where it has been used to reject entity between parent and subsidiary is misleading. Consequently, in the light of recent authority these cases should not be considered good authority any longer.

Further, it is arguable that the *Smith Stone & Knight* regime has been superseded in light of *Woolfson* and *Adams* suggesting that the veil should only be pierced when there are ‘special circumstances’ and *Adams* because reference should be made to the formality of agency law and not a hybridised company law concoction. In any event, a finding of an agency between parent and subsidiary on traditional agency law is not veil piercing because companies like individuals can be agents. The early historical use of a variant of agency in veil piercing jurisprudence demonstrated a fundamental misunderstanding of the nature of corporate personality.

THE SUBSIDIARY OR GROUP OF COMPANIES AS A SHAM OR FAÇADE

We are left with the final ‘true’ form of jurisprudential veil piercing that examines fundamental questions concerning the way in which a company is used. Again, our

²⁸ *Garnac Grain Company Inc v. HMF Faure and Fairclough Ltd* [1968] AC 1130 at 1137 per Lord Pearson.

²⁹ [1991] 4 All ER 769, (CA) at 774.

³⁰ (1899) 4 TC 41; 80 LT 395, (CA).

³¹ [1956] 1 All ER 693, (CA).

initial point of reference is *Salomon*. In *Tunstall v. Steigman*,³² Ormerod L.J. stated that ‘... any departure [from *Salomon*] ... has been made to deal with special circumstances when a limited company might well be a façade concealing the real facts’.³³ Danckwerts L.J. also confirmed that the personality of a company’s controllers is only to be regarded as relevant in ‘special circumstances’,

...as indicating the nature of the company without really departing from the principle that a limited liability company incorporated under the Companies Acts is a distinct legal entity, differing from the individuals who hold the shares in the company or control it through the mechanism of the Companies Acts’³⁴

This was confirmed by the House of Lords in *Woolfson v. Strathclyde Regional Council*³⁵ where Lord Keith of Kinkel considered ‘it is appropriate to pierce the corporate veil only where special circumstances exist indicating that it is a mere façade concealing the true facts’.³⁶ We will refer to this test as the *Woolfson formulation*. It is regrettable that we are left with little guidance after the mammoth decision of the Court of Appeal in *Adams* or the House of Lords decision in *Woolfson* as to the nature of either ‘special circumstances’ or a corporate sham / corporate façade. This raises three challenges. First, what are ‘special circumstances’? Second, what is a ‘mere façade concealing the true facts’? Finally and most importantly, is the *Woolfson formulation* a suitable and adequate test to interrogate the legitimacy of a group of companies and its associated transactional arrangements.

³² [1962] 2 QB 593.

³³ *Ibid.*, at 602.

³⁴ *Ibid.*, at 607. Interestingly, Lord Denning made no mention of *Tunstall v. Steigman* in *Littlewoods Mail Order Stores Ltd v. Mc Gregor (Inspector of Taxes)* [1969] 3 All ER 855.

³⁵ [1978] SLT 159.

³⁶ *Ibid.*, at 161. See also *Adams v. Cape Industries Plc supra* at 539 E F.

Special Circumstances

Lord Keith gave little detail in *Woolfson* as to the nature of ‘special circumstances’ and the courts have been reluctant to elucidate further.³⁷ Consequently, there is merit in examining other areas of the law that have dealt with similar principles. Arguably, the *Woolfson* formulation is merely a species of the general law ordering concerning the *doctrine of the sham*.³⁸ Thus, we can gain greater understanding of the *Woolfson* formulation through an examination of the general law.

If the notion of *special circumstances* is to have prescriptive merit then the analysis must be principled. This is often difficult because, universally, rejecting the separate personality of a company occurs where some circumstance shocks the conscience of the court. Veil piercing, as an equitable function of the court, has always been at risk of being unprincipled and a one dimensional entreaty to the canon of equitable justice. The notion of *special circumstances* offers a jurisprudential threshold that must be negotiated before the court is entitled to reject existence of the company or the transaction in which the company participates. The existence of *special circumstances* justifies a more critical objective examination of the facts, especially, the design of a company’s structure and transactional arrangements. Obviously, there is a significant difference between interrogating a transaction in order to elucidate its nature, function and role and the vagaries and variability inherent in a *search for justice*.³⁹ Any attempt

³⁷ In *Adams v. Cape Industries Plc* *supra* at 543 the Court of Appeal said, ‘From the authorities cited to us we are left with rather sparse guidance as to the principles which should guide the court in determining whether or not the arrangements of a corporate group involve a façade within the meaning of that word as used by the House of Lords in *Woolfson v. Strathclyde Regional Council*. We will not attempt a comprehensive definition of those principles.’

³⁸ The word ‘sham’ is used in its widest context.

³⁹ In *Adams v. Cape Industries Plc* [1990] 1 Ch 433, (CA), the Court of Appeal said, ‘... save in cases which turn on the wording of particular statutes or contracts the court is not free to

to do 'justice' will be in the eye of the beholder and not necessarily an objective description of the true position.

Negotiation of the *special circumstances* threshold is also dependent on the type of objectivity used. For instance, if a transaction is analysed in terms of a parent company's wishes we are using the parent's own perspective. If we look at an arrangement such as the restructuring in *Adams* and ask 'was the legitimate purpose of the arrangement the continuance of business?' we can reasonably justify the conclusion from the perspective of the parent. Such an analysis will be unlikely to produce *special circumstances*. Whereas if a 'fly on the wall' or 'global' objectivity is used the court can be better placed to assess whether special circumstances exist. As we shall see the courts regularly use 'the parental perspective' to determine the nature of a single company or transaction in the context of a complex structure or series of transactions. The problem is that the courts are too willing to accept the parent's version of the motive behind structural manipulation, as in *Adams*, with out further enquiry. Let us turn to nature of 'special circumstances'.

For the court to reach the conclusion that, '[there] may, of course, be cases where documents are not bona fide nor intended to be acted upon, but are only used as a cloak to conceal a different transaction'⁴⁰ there must be factual inconsistencies. These inconsistencies must enable the court to infer fairly that the real nature of the transaction between the parties is something quite different from that recorded in the

disregard the principle of [*Salomon*] merely because it considers that justice so requires.' at 536.

⁴⁰ *Inland Revenue Commissioners v. The Duke of Westminster* [1936] AC 1 at 21 *per* Lord Tomlin.

documents evidencing the transaction.⁴¹ The inconsistencies alert the court that all is not what it seems. The court is then entitled to look ‘without blinkers’ and examine the transaction in a wider contextual manner in order to elucidate the true purpose. Thus, the inconsistencies or ‘special circumstances’ are an indicator of some potential wrongdoing deserving greater attention and entitling the court to survey more evidence. Clearly, if the court determines that there are no inconsistencies then the purpose of the transaction or corporation are genuine. Need for further recourse to more evidence is unnecessary. Whereas, if the evidence produces inconsistencies then recourse must be made to further facts or ‘the substance’ to determine if the company or transaction is a sham or façade.

Before going further, we should note that a true *corporate sham* occurs where a company is formed for an illegitimate purpose. We can argue that the incorporation of the company is itself a sham. If this is not the case then the company *per se* can only be construed as a sham in the sense that its separate existence will be disregarded within the context of a particular transaction or a series of transactions. Of course, the accompanying transaction may be legitimate but the corporate entity may be disregarded in that context. Where a company is legitimately incorporated it cannot then become a sham *per se*. In these circumstances, separate personality of the company is usually rejected only to the extent of an associated sham transaction but the company continues to function for all other legitimate purposes. However, the extent of

⁴¹ *Re Securitibank Ltd (No. 2)* [1978] 2 NZLR 136 at 148 (20-25) *per* Richmond J., (NZ)(CA).

the illegitimate transactions may be so pervasive, such that, even perceptibly legitimate transactions are also tainted.⁴²

Mere Façade Concealing the True Facts

There are many metaphorical turns of phrase used to convey the notion of a mere façade concealing the facts. The words 'façade' or 'sham' are often used in this context. Both words are attended by considerable ambiguity concerning their meaning and application. Whilst the use of these principles is commonly employed in the equitable jurisdiction, it invariably 'hovers on the periphery' and rarely becomes the jurisprudential gravamen.⁴³ Rixon offers the best available definition of 'façade' drawing from the Concise Oxford Dictionary⁴⁴ when he states,

In its figurative sense, 'façade' denotes outward appearance, especially one that is false or deceptive and imports pretence and concealment. That the corporator has 'complete control of the company' is not enough to constitute the company a mere façade, rather that term suggests, in the context, the deliberate concealment of the identity and activities of the corporator.⁴⁵

Whereas the widely accepted definition of a 'sham' derives from the decision of Lord Diplock in *Snook v. London & West Riding Investments Limited*⁴⁶ stating:

I apprehend that, if it has any meaning in law, it means acts done or documents executed by the parties to the 'sham' which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create. But one thing, I think, is clear in legal principle, morality and the authorities ... that for acts or documents to be a 'sham', with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to

⁴² *Re H* [1996] 2 All ER 391 at 397 a b.

⁴³ *Sharrment Pty Ltd v. The Official Trustee in Bankruptcy* (1988) 82 ALR 530 at 536 per Lockhart J. (Full F C Aust).

⁴⁴ 7th Ed (1982).

⁴⁵ Rixon, *op. cit.*, n 3 at 423.

⁴⁶ (1967) 2 QB 276.

create the legal rights and obligations which they give the appearance of creating.⁴⁷

The difference between these definitions is that Rixon is concerned with the corporation as a façade whereas Lord Diplock is concerned with a transactional sham. Arguably, there is no more than a semantic difference between the notion of ‘corporate façade’ and the general law doctrine of the sham. Indeed, there is little to be gained from drawing any distinction between a ‘transactional sham’ and a ‘corporate façade’. Both principles draw from the law of fraud. That is, the motives of the architects of the sham or façade are highly material⁴⁸ and the ‘parties say one thing intending another’.⁴⁹

A sham transaction or sham company is:

A disguise as a real thing: it may be an elaborate and carefully prepared thing; but it is nevertheless a disguise. The difficult and debatable philosophic questions of the meaning and relationship of reality, substance and form are for the purposes of our law generally resolved by asking did the parties who entered into the ostensible transaction mean it to be, and in fact use it as, merely a disguise, a façade, a sham, a false front - all these words have been metaphorically used - concealing their real transaction.⁵⁰

⁴⁷ *Ibid.*, at 802.

⁴⁸ The Court of Appeal in *Adams* held that *Jones v. Lipman* [1962] 1 WLR 832 offered the only guidance on this point in the context of a corporate façade.

⁴⁹ *Antoniades v. Villiers* [1988] 2 All ER 296 at 147 D *per* Bingham LJ. For example, in other cases the courts have not discerned any significant distinction between a ‘sham device’, whose only object is to disguise the grant of a tenancy and to evade the Rent Acts, and an ‘artificial transaction’ having the same sole object: see *Hadjiloucas v. Crean* [1983] 3 All ER 1008 at 1022J *per* Mustill LJ. Each has the purpose of disguising what is granted and making it appear to be other than what it is. See *Gisborne v. Burton* [1989] 1 QB 390, (CA) at 405 CD *per* Ralph Gibson L.J. (dissenting).

⁵⁰ *Scott v. Federal Commissioner of Taxation (No. 2)* (1966) 40 ALJR 265 at 279 *per* Windeyer J. See also *Sharrment Pty Ltd v. The Official Trustee in Bankruptcy* (1988) 82 ALR 530 at 537 *per* Lockhart J. Federal Court of Australia where his Honour stated: ‘A ‘sham’ is therefore ... something that is intended to be mistaken for something else or that is not really what it purports to be. It is a spurious imitation, a counterfeit, a disguise or a false front. It is not genuine or true, but something made in imitation of something else or made to appear to be something which it is not. It is something which is false or deceptive.’

This common core of interpretation sees the doctrine of the sham regularly used in areas outside company law such as tax law, landlord and tenant, and contract. These areas of law can assist in the way company law copes with the notion of the sham in the context of a group of companies. As we shall see, company law has made limited use of the notion of a sham, whereas tax law, in particular, uses the idea in combination with the *Ramsay Principle*⁵¹ when interpreting complex transactions. It will be demonstrated that company law is presently hamstrung in its conception of what constitutes a sham in the context of corporate groups. Analysis is done on a discrete company by company and transaction by transaction basis which cannot deal with complex transactions spread over a group of companies. Tax law provides significant precedent for the introduction of a rule of interpretation in the case of complex transactions so that a contextual analysis is used to determine the overall purpose of an arrangement undeflected by the specifics of particular transactions. If we use a variant of the tax law *Ramsay Principle* in the context of the group of companies then we move away from the fixation with the notion of complete control of a subsidiary by a parent. The issue is much more fundamental. Is the group of companies and its associated transactional structure used for a legitimate purpose or is the claim to be motivated by that purpose a colourable sham?

The Transactional Sham

At the outset, when a transaction is analysed we must acknowledge that it has a *prima facie* legitimacy. Only when the context in which a contract or a company is placed demonstrates *inconsistencies* can the court look beyond this putative legitimacy. This necessitates the court to juggle issues concerning *substance* and *form*. Just as a

⁵¹ *W.T Ramsay v. IRC* [1982] AC 300, (HL).

transaction has an initial claim to legitimacy there must be a point of reference in the substance form debate. 'It is said we must go behind the form to look at the substance ... but, in order to ascertain the substance, [we] must look at the legal effect of the bargain which the parties have entered into.'⁵² Initially, 'the substance is, that which results from the legal rights and obligations of the parties ascertained upon ordinary legal principles'.⁵³ Indeed, the court must first look at the nature of the transaction which the parties have agreed.⁵⁴

Clear cases of sham occur because something is represented to be something it is not. *Ridge Securities Ltd v. IRC*⁵⁵ concerned the attempt of a solvent company to use a tax avoidance scheme. The company granted debentures to its parent and paid large uncommercial sums as 'interest'. Pennycuik J. held that the 'interest' payments were ultra vires because they were dressed up gifts of capital. In *Re Halt Garage (1964) Ltd*⁵⁶ the liquidator of a company challenged payments of £30 per week paid to a person who acted as both a shareholder and a director as remuneration. As the person offered no services to the company, Oliver J. decided that as far as the payments exceeded £10 per week they were *merely dressed up returns of capital* to a shareholder and therefore ultra vires. In *Alec Lobb (Garages) Ltd v Total Oil (Great Britain) Ltd*,⁵⁷ Total Oil after having purchased a fuel outlet from a company sought to lease the same property back to the company's former directors. The lease contained an onerous restraint of trade that was subsequently challenged. Total argued that the restraint was legal because the

⁵² *Re Hinckes, Dashwood v. Hinckes* [1921] 1 Ch 475 at 489 per Warrington L.J. Affirmed in *Inland Revenue Commissioners v. The Duke of Westminster* [1936] AC 1 at 20 per Lord Tomlin.

⁵³ *Ibid.*, at 20-21 per Lord Tomlin.

⁵⁴ *Chow Yoong Hong v. Choong Fah Rubber Manufactory* [1962] AC 209, (PC) at 216-217.

⁵⁵ [1964] 1 All ER 275.

⁵⁶ [1982] 3 All ER 1016.

individuals had no previous right whatsoever to trade at all on the land in question.⁵⁸

The court recognised that the leaseback was a device to evade the doctrine of restraint of trade. Dillon L.J. citing *Guildford Motor Co. Ltd v. Horne* stated:

The court has ample power to pierce the corporate veil, recognise a continued identity of occupation and hold, as it should, that Total can be in no better position quoad restraints of trade by granting the lease-back to Mr. and Mrs. Lobb than if it had granted the lease-back to the company.⁵⁹

In *Aveling Barford Ltd v. Perion Ltd*,⁶⁰ Aveling Barford Ltd ('Aveling') and Perion Ltd ('Perion') were both directly or indirectly owned or controlled by Dr Lee. As a going concern, Aveling's balance sheet showed that its assets exceeded its liabilities, but that it had an accumulated deficit on its profit and loss account. It was not in a position to make a distribution to its shareholders. Aveling sold a property independently valued at £650,000 to Perion for £350,000, which Perion later onsold for £1,526,000. The issue arose whether the sale to Perion was a breach of duty by Dr Lee toward Aveling and as such took on the qualities of a sham.

It follows that a transaction, which amounts to an unauthorised return of capital, is ultra vires and cannot be validated by shareholder ratification or approval. Whether or not the transaction is a distribution to the shareholders does not depend exclusively on what the parties choose to call it. The court looks at the substance rather than the outward appearance.⁶¹

Outside the company context, there are a number of examples of situations where transactions have been used to attempt avoidance of certain legislative provisions. In *Gisborne v. Burton*,⁶² the Court of Appeal was called on to determine the nature of an arrangement whereby a farmer had first leased a property to his wife which his wife

⁵⁷ [1985] 1 WLR 173, (CA).

⁵⁸ *Ibid.*, at 178 C.

⁵⁹ *Ibid.*, at 178 DE.

⁶⁰ [1989] BCLC 626.

⁶¹ *Ibid.*, at 631 a c.

then sub-let the property to a tenant for agricultural use. The sub-tenant alleged that the arrangement between the husband and wife was a sham entered to avoid the application of the security of tenure provisions in certain agricultural holdings legislation. The court noted a number of ‘inconsistencies’ concerning the arrangement. First, that around the same time, the wife who owned a separate property had leased the land on to her husband and he in turn sub-let the land to another tenant.⁶³ Second, there were two pre-ordained steps rather than one single step such that there was no commercial purpose for the husband to lease the land to the wife.⁶⁴ Third, the lease and the sub-lease were entered into contemporaneously.⁶⁵ Finally, the wife had admitted she thought the arrangement was between her husband and the tenant.⁶⁶ In light of this, the agreement between the husband and the wife was struck down and treated as if the tenant had leased the land directly from the husband, thus requiring the fulfilment of the protective statutory procedure.

In *Antonaides v. Villiers*⁶⁷ a landlord sought to let a property to an unmarried couple using separate, but exactly the same ‘licence’ agreements. The landlord’s intention was to avoid the operation of the Rent Acts, which imposed statutory periods of notice for termination of the let. The landlord later served a notice to quit on the ‘licensees’. The couple alleged that the arrangement sought to contract out of the Rent Acts. The House of Lords accepted that since parties to an agreement cannot contract out of the Rent Acts, a document expressed in the language of a licence must nevertheless be examined

⁶² [1989] 1 QB 390, (CA).

⁶³ *Ibid.*, at 396 *per* Dillon L.J.

⁶⁴ *Ibid.*, at 399 BD *per* Dillon L.J.

⁶⁵ *Ibid.*, at 399 F.

⁶⁶ *Ibid.*, at 402 F *per* Russell L.J.

⁶⁷ [1990] 1 AC 417, HL. [1988] 3 All ER 1058 (Reported as a joint judgement with *AG Securities v. Vaughn*).

and construed by the court in order to decide whether the rights and obligations enjoyed and imposed create a licence or a tenancy. Lord Templeman referring to his own comments in *Street v. Mountford*⁶⁸ stated:

Although the Rent Acts must not be allowed to alter or influence the construction of an agreement, the court should in my opinion be astute to detect and frustrate sham devices and artificial transactions whose only object is to disguise the grant of a tenancy and evade the Rent Acts⁶⁹

With this in mind, the courts have identified certain features of a transaction that may attribute the quality of a sham. Whilst it is possible to characterise certain transactions in their entirety there is some authority that assists in recognising the significance of particular elements of certain transactions as the ‘badges’ of a sham. First, where the dominant purpose or more particularly the sole purpose of a transaction is to evade liability or obligations, the courts are more willing to conceive a transaction as a sham.⁷⁰

Second, the inherent artificiality of a single transaction does not give rise to its characterisation as a sham *per se* or to the characterisation of the constituent documents as a sham. This is so long as each document ‘had the effect that it purported to have’, and so long as none of the documents purported ‘to do something different from what the parties had agreed to do’.⁷¹ For example, a transaction involving a round robin of cheques does not necessarily establish that the transaction is a sham, even when no

⁶⁸ [1985] 2 All ER 289.

⁶⁹ *Ibid.*, at 229.

⁷⁰ For example, where assets are deliberately transferred from A to B in the knowledge that to do so will defeat a creditor's claim or other potential claim. See *Creasey v. Breachwood Motors Ltd* [1992] BCC 638 and *The Tjaskemolen* [1997] 2 Lloyd's Rep 465, (QB). Alternatively, where an attempt is made to avoid statutory rights under certain legislation. See *Gisborne v. Burton* [1989] 1 QB 390, (CA); *Antonaidis v. Villiers* [1990] 1 AC 417, (HL).

⁷¹ *Inland Revenue Commissioners v. Littlewoods Mail Order Stores Limited* (1962) 2 All ER 279 at 285 *per* Lord Reid.

party has funds to meet the cheques.⁷² Further, inherent complexity does not characterise a transaction as a sham *per se*. For example, where a gift takes the form of redeemable preference shares instead of cash. The mere fact that the transaction became complex and elaborate rather than simple and straightforward did not affect its true nature.⁷³ If the transaction has the character it purports to have and the parties intended it to be so then it will have effect according to its tenor.⁷⁴ Further and importantly mere circumstances of suspicion do not establish a sham. At this point, it is appropriate to differentiate between the inherent complexity of a single transaction and the overall complexity of a series of transactions. In a series of transactions each transaction alone may be very simple, but the overall effect may be highly complex.

Third, it is a common feature of a sham that there is often no change in legal or beneficial ownership of the subject matter. For example, a purported disposal of property, and by analogy a purported creation of a debt, may be a sham where donor and donee (or lender and debtor) do not intend to give effect to the transaction, it being agreed between them that there will be no change in the legal and beneficial ownership of the property.⁷⁵ Finally, there is a public policy feature where certain transactions may be legally effective although intended to achieve an unacceptable purpose that attracts a sanction from the law.⁷⁶ For example, the courts have recognised the impropriety of a

⁷² *Re Barnett; Perpetual Trustee Co Limited v. Barnett* (1969) 2 NSW 721; *Sharrment Pty Ltd v. The Official Trustee in Bankruptcy* (1988) 82 ALR 530 at 537ff *per* Lockhart J.

⁷³ *Coppleson v. Federal Commissioner of Taxation* (1981) 34 ALR 377 (SC)NSW; See also *Sharrment Pty Ltd v. The Official Trustee in Bankruptcy supra*.

⁷⁴ *Miles v. Bull* [1969] 1 QB 258 at 264 *per* Megarry J.

⁷⁵ The fact that a taxpayer had continued to act as though he actually owned and controlled a particular parcel of real property gave rise to an inference that the transactions which led to its being purchased in the name of a group company with funds apparently the funds of the group company were a sham. See *Sharrment Pty Ltd v. The Official Trustee in Bankruptcy supra*.

⁷⁶ For example, a disposition that is subsequently struck down during the process of

company within group divesting its assets with the purpose and effect of ensuring that they will not be available to meet its existing liabilities. The courts will strike down such arrangements as a sham in particular, where the transfer is made to another member of the group at an undervalue⁷⁷ or to a company having the same shareholders and directors for no apparent commercial purpose.⁷⁸ To reiterate:

A transaction is no sham merely because it is carried out with a particular purpose or object. If what is done is genuinely done, it does not remain undone merely because there was an ulterior purpose in doing it ... mere circumstances of suspicion do not by themselves establish a transaction as a sham; it must be shown that the outward and visible form does not coincide with the inward and substantial truth.⁷⁹

The problem lies in the methodology used to determine what is 'genuinely done'.⁸⁰ Arguably, the transactional sham can occur in two circumstances. First, where the purpose of the transaction is illegitimate and second, where the form of the transaction is not an accurate reflection of its true and intended effect. Against this background, we can then consider situations where the use of a company in a certain context has resulted in it being treated as a sham.

The Corporate Sham

The corporation is a legal device designed for the advancement of societies greater good. Consequently, we must acknowledge the innately artificial nature of corporate personality. A company alone without any environmental influences cannot be a sham.

liquidation as a voidable preference is not a sham *per se*. See *Sharrment Pty Ltd v. The Official Trustee in Bankruptcy supra*.

⁷⁷ *The Tjaskemolen* [1997] 2 Lloyd's Rep 465, (QB).

⁷⁸ *Creasey v. Breachwood Motors Ltd* [1992] BCC 638. Though the recent Court of Appeal decision in *Ord v. Belhaven Pubs Ltd* The Times, 7 April 1998 expresses serious, yet arguably unnecessary, doubts about the decision in *Creasey*.

⁷⁹ *Miles v. Bull* (1969) 1 QB 258 at 264 *per* Megarry J. See also *Sharrment Pty Ltd v. The Official Trustee in Bankruptcy* (1988) 82 ALR 530 at 538ff *per* Lockhart J.

⁸⁰ We should recall the previous discussion concerning the type of objectivity used to

The basic aspect of the corporate form must be respected otherwise there is little rationale for the use of companies, let alone, the use of groups of companies. However, there is no rule of law, logic, or common sense requiring the courts to use and apply corporate personality as a whitewash for corporate wrongdoing.⁸¹ Only when the purpose for the use of a company is illegitimate does there need to be restriction.⁸² Even so, the rule's operation (e.g. separate personality) is only held in abeyance to the extent of the illegitimate purpose. As we shall see, there is a rather curious dichotomy in English Law between the circumstances where a corporate sham has been established by the courts and where the use of the corporation initially appears to be a sham but the courts up hold the use as legitimate.

Corporate Sham Cases

The consequence of a 'transactional' sham is that the court is permitted to view the 'real' effect of a transaction. For example, a sham transaction may not effectively transfer beneficial ownership of property.⁸³ Whereas, a corporate sham results in the corporate veil being removed to reveal the persons associated with the company. This may be individual controllers, a parent, or other group company. Legal personality is disregarded but only to defeat the illegitimate purpose. 'The fact that the court does lift the corporate veil for a specific purpose in no way destroys the recognition of the corporation as an independent and autonomous entity for all other purposes.'⁸⁴ The continued 'existence' of a company for other legitimate purposes even when the

determine what is genuine. *Supra*, Chapter 2, Special Circumstances on page 131 ff.

⁸¹ I. Maurice Wormser, Disregard of the Corporate Fiction and Allied Corporation Problems (New York: Baker, Voorhis and Co, 1929) at 36.

⁸² The use of the company in these circumstances is often described as an abuse of the corporate form. See Clive Schmitthoff, 'Salomon in the shadow' [1976] *Journal of Business Law* 305.

⁸³ *The Tjaskemolen* [1997] 2 Lloyd's Rep 465, (QB).

corporate veil is pierced is evidence of the notion that a company is no more than a collection of rules. If this collection of rules applies legitimately to a particular context then the company exists for that purpose. We will expand on this notion shortly.

In *Smith v. Hancock*,⁸⁵ a vendor trading under the name 'T.P. Hancock' sold his grocery shop to a purchaser with a ten year, five mile restraint of trade clause. Seven years later the vendor's wife commenced business nearby trading under the name 'Mrs T. P. Hancock'. The purchaser argued the restraint had been breached. Lindley L.J., obiter, stated:

If the evidence admitted of the conclusion that what was being done was a mere cloak or sham, and that in truth the business was being carried on by the wife ... for [the vendor], or by [the vendor] through his wife... I certainly should not hesitate to draw that conclusion, and to grant the plaintiff relief accordingly.⁸⁶

In *Guildford Motor Co. Ltd v. Horne*⁸⁷ the facts were similar but the restraint was circumvented by the husband procuring his wife to form a company and compete with a former employer. The court stated:

I am quite satisfied that this company was formed as a device, a stratagem, in order to mask the effective carrying on of a business of Mr E.B. Horne. The purpose of it was to try to enable him, under what is a cloak or a sham, to engage in business which, on consideration of the agreement which had been sent to him just about seven days before the company was incorporated, was a business in respect of which he had a fear that the plaintiffs might intervene and object.⁸⁸

⁸⁴ *Nedco Ltd v. Clark* (1973) 43 DLR (3d) 714 at 721. Saskatchewan Court of Appeal.

⁸⁵ [1894] 2 Ch 377, (CA). Whilst is not strictly a corporate sham case it is the seminal case upon which decisions like *Guildford Motor Co. Ltd v. Horne* [1933] Ch 935, (CA) relied.

⁸⁶ *Ibid.*, at 385

⁸⁷ [1933] Ch 935, (CA).

⁸⁸ *Ibid.*, at 936 *per* Lord Hanworth M.R.

Consequently, the purpose of the incorporation was tainted with the illegitimate intention of evading the operation of the restraint of trade.⁸⁹ In *Jones v. Lipman*,⁹⁰ the vendor Lipman sold a parcel of land to Jones. Before completion, Lipman and his nominee formed a company and Lipman then sold the land to it. In awarding an order for specific performance Russell J. stated: ‘The defendant company is the creature of the first defendant, a device and a sham, a mask which he holds before his face in an attempt to avoid recognition by the eye of equity.’⁹¹

In *Re Bugle Press Ltd*,⁹² two majority shareholders in Bugle Press Ltd (‘Bugle’) formed a company to acquire the shares of Bugle. The company then sought to compulsorily acquire the shares of the minority in Bugle using section 209 Companies Act 1948. Buckley J. accepted that,

...if individuals who themselves hold ninety per cent of the shares in a company constitute the transferee company in which they are the only shareholders, it would be contrary to the policy of the section to allow an offer by that transferee company to operate under the section, because the transferee company would be merely a screen for the ninety per cent shareholders, there would be no independent majority exercising any sort of disinterested choice in the question whether or not the offer should be accepted, and the device would be merely a device for enabling the ninety per cent majority to acquire, through the medium of the company form ad hoc, the shareholding of the minority.⁹³

A company will classically be treated as a sham where it is formed and used for a purpose the court perceives as illegitimate. In *Re H*,⁹⁴ four individuals owned all the

⁸⁹ It is also arguable that the company acquired property with actual notice of the fraud on a prior purchaser and as such the company takes the property subject to the latter’s equity. See *Yukong Lines Ltd v. Rendsberg Investments Corporation (No. 2)* [1998] 1 WLR 294, (QB) at 295 H *per* Toulson J.

⁹⁰ [1962] 1 WLR 832.

⁹¹ *Ibid.*, at 836 *per* Lord Russell J.

⁹² [1960] 1 All ER 768.

⁹³ *Ibid.*, at 771 AB.

⁹⁴ [1996] 2 All ER 391, (CA) decision of Rose L.J. with whom Aldous L.J. and Sir Iain Glidewell agreed.

shares in two family companies. It had been alleged that the individuals had committed excise fraud more than £100m through the companies. The Commissioner of Customs and Excise had had a receiver appointed over certain property⁹⁵ of three of the individuals including the shares they held in the family companies. The receiver sought to sell assets owned by the companies. The individuals argued that the receivership included only the shares in the companies. The assets of the company could not be the 'realisable property' of the receivership.⁹⁶ Only if the circumstances were appropriate to pierce the corporate veil could the assets of the company be regarded as the assets of the individuals.⁹⁷ This gave rise to a number of interesting submissions from counsel for the individuals. First, the companies had not been charged with any offences. Second, it was accepted that there were some legitimate parts to the companies business. Third, relying on *Adams v. Cape Industries Plc* control by the individuals was inadequate to justify an allegation of criminal activity by the companies. In the end, it was difficult for the court determine from the records of the companies which assets were part of the legitimate business and those that had been tainted by excise fraud. Rejecting the individuals' submissions, the court held that it was appropriate to pierce the veil of the companies, as the companies were no more than a sham, providing a façade for the individuals activities.⁹⁸ The court relied on:

a succession of cases throughout the twentieth century [to] show ... where the character of a company, or the nature of the persons who control it, is a relevant feature the court will go behind the mere status of the company as a legal entity, and will consider who are the persons as shareholders or even as agents who

⁹⁵ Pursuant to section 77 Criminal Justice Act 1988.

⁹⁶ [1996] 2 All ER 391 at 396c ff. See section 77 of the Criminal Justice Act 1988.

⁹⁷ *Ibid.*, at 396 g j.

⁹⁸ *Ibid.*, at 398 g.

direct and control the activities of a company which is incapable of doing anything without human assistance.⁹⁹

Moreover, the court in *Adams* accepted the statement that the court will lift the veil where a defendant by the device of a corporate structure attempts to evade limitations imposed on his conduct by law.¹⁰⁰ Thus, in *Re H* the companies were shams because the rule of separate personality could not be maintained in circumstances where the rule is used to achieve illegitimate purposes. Criminal activity and fraud are the worthiest of contexts in which to pierce the veil.

Comments

Despite the jurisdiction and willingness of the courts to disregard separate personality, we cannot conceive of the company *per se* as being a sham because it is an inherently artificial abstract notion designed to achieve a public good. It is inherent in the *Woolfson formulation* that, we must at least respect the form of the corporation and the legitimacy of the rules that comprise it until some evidential inconsistency or *special circumstances* permit us to look into the context that the company is proposed to be used. This draws out the importance of the context in which the use of the corporate entity is placed. The context of the entity's use is crucial for this purpose and may serve as the primary justification for retention or rejection of separate personality. For example, in *Salomon* or more recently *Williams v. Natural Life Foods Ltd*,¹⁰¹ if the court had not emphasised the strict allocation of the roles of shareholder or director and respected the notion of separate entity then the elementary principle of limited liability

⁹⁹ *Ibid.*, at 401 f h quoting *Merchandise Transport Ltd v. British Transport Commission* [1962] 2 QB 173 at 206-207 *per Danckwerts L.J.*

¹⁰⁰ *Ibid.*, at 401 j quoting *Adams v. Cape Industries Plc* [1990] Ch 433 at 544.

¹⁰¹ [1998] 2 All ER 577 (HL).

would have been thwarted. In *Pioneer Concrete Services Ltd v. Yelnah Pty Ltd*¹⁰² and *Adams v. Cape Industries Plc*¹⁰³ the courts prescribed that in the context of complicated commercial and corporate arrangements there was good commercial reason for having separate companies and subsidiaries performing different functions. The sense of context is important. For example, in *Guildford Motor Co. Ltd v. Horne*¹⁰⁴ the purpose was to try to enable the defendant using a company as a sham to engage in business contrary to a covenant in restraint of competition. As we have just seen, in *Re H* using a company as a front for criminal activity is good reason for a close examination of the context in which the rules that make up a company are available for application.

Cases Where the Corporate Entity is Sustained

There are a number of cases where the courts have refrained from declaring that the use of a corporation a sham. Using a process of comparison, these cases allow us to determine when an arrangement will be less susceptible to being treated as a sham. In *Re Polly Peck International plc (In Administration)*¹⁰⁵ the use of a single purpose financial company in a group of companies was seen as a legitimate commercial use for a company. When compared to the interposition of the Liechtenstein company AMC between Cape and CPC in *Adams* we can see the justification for its treatment as a façade - 'no more than a corporate name'. There was no commercial purpose for using the Liechtenstein company whereas a single legitimate commercial purpose is sufficient to separate one company from being a façade or sham.

¹⁰² (1986) 5 NSWLR 254. See also *Sharrment Pty Ltd v. The Official Trustee in Bankruptcy* (1988) 82 ALR 530.

¹⁰³ [1990] Ch 433.

¹⁰⁴ [1933] Ch 935, (CA).

¹⁰⁵ [1996] 2 All ER 433.

Influential in rejecting arguments alleging a sham is the existence of a form of contractual mutuality or consensuality between the parties and their use of a company. In *Hilton v. Plustile Ltd*,¹⁰⁶ Rose wished to rent a property from Hilton. It was Hilton's policy to only rent his properties to limited companies because there is a line of legal authority providing that such a tenant will not become a statutory tenant under section 2 of the Rent Act 1977 on termination of the tenancy.¹⁰⁷ The tenancy was arranged between Hilton and a shelf company, Plustile Ltd. Rose acted after obtaining legal advice. Rose paid the rent by personal cheques. Plustile never opened a bank account. The relationship between Hilton and Rose deteriorated and Hilton sought to obtain possession. Rose alleged that the tenancy to Plustile was a sham to evade the Rent Acts and that she should be treated as the tenant and was entitled to protection of the Rent Acts. Croom-Johnson L.J. considered the mere fact that the legal arrangements were to prevent the creation of the statutory tenancy insufficient alone.¹⁰⁸ The court noted that 'a sham exists where the parties say one thing intending another'¹⁰⁹ As Rose was fully aware of the situation she could not allege that the arrangement was a sham.

The Court of Appeal had a further opportunity to consider such a situation in *Kaye v. Massbetter Ltd*.¹¹⁰ In similar circumstances to *Plustile*, Kaye agreed to provide a 'company let' to Kanter using Massbetter Ltd. After a period Kaye served a notice to quit on the company and began an action for possession of the flat. In defence of the action it was alleged that the tenancy to Massbetter Ltd was a sham and that Kanter was the true tenant and entitled to the protection of the Rent Acts. The court asked if this

¹⁰⁶ [1988] 3 All ER 1051.

¹⁰⁷ *Hiller v. United Dairies (London) Ltd* [1934] 1 KB 57; *Firstcross Ltd v. East West (Export/Import) Ltd* (1980) 255 EG 355.

¹⁰⁸ [1988] 3 All ER 1051 at 1053-1054.

¹⁰⁹ *Ibid.*, 1054 h quoting *Donald v. Baldwin* [1953] NZLR 313 per F B Adams J. at 321.

was a case 'where the parties say one thing intending another' and in doing so focused on the contractual nature of the arrangement. It was the common intention of these parties that the agreement, as set out in the document, should be of a tenancy to Massbetter Ltd. Accordingly, his Honour could not find that the agreement was a sham.

Two points seem crucial to the decision; first, the offer of the tenancy was conditional on the tenant being a company. Second, if the agreement to the company was not conceived as a sham then it could not be transformed into a sham during the course of the arrangement. Counsel for Kanter was alive to the possibility of the arrangement being a sham on the grounds: first, the transaction – the tenancy agreement – could be construed as a sham. On this point it was recognised that there was nothing to stop the parties agreeing a company let provided it was a genuine one. The court accepted (as a company fell outside the ambit of the Rent Acts) that the parties were entitled so to arrange their affairs so as not to come within the Rent Acts. Second, the company itself could be construed as a sham. If the purpose for using a company was to avoid the application of the Rent Acts then such a purpose was not genuine and exposed the company as a sham. The court did not favour the latter. This position was justified by adopting the view that there is no special rule such that the facts take precedence to language except where the circumstances are not genuine. Note here the familiar ring of the *Woolfson* 'special circumstances' formulation though under a different guise and in a different legal context.

¹¹⁰ [1991] 62 P & CR 558, 24 HLR 28, [1991] 39 EG 129, [1991] 2 EGLR 97. (CA)

Comments

In *Hilton* and *Kaye*, the use of the company in the context of the Rent Acts had been legitimated by a line of legal authority. Consequently, using the *Hilton* line, to be a transactional sham both parties must intend it to be so. The individuals in both *Hilton* and *Kaye* (for example Kaye and Kanter) were not involved in the internal functioning of the company together. Thus, and as odd as it seems, there could be no intention between the two individuals that the company be a front for other activities. Whereas, in cases such as *Antoniades* and *Gisborne v. Burton* the individuals could not gain the same disassociation from their intention to avoid the operation of the legislation that a company offered in *Hilton* and *Kaye*. In *Antoniades*, both of the ‘licensees’ and the landlord had signed the licence seeking to contract out of the Rent Acts. Whereas in *Gisborne v. Burton* the lease agreement between the husband and the wife was intended to remove the statutory protection provided to a tenant where the tenancy was a sublease.

Cases such as *Hilton* and *Kaye* also have a dimension of mutuality when compared with a true corporate sham case such as *Re Bugle Press Ltd*.¹¹¹ The courts permit the parties via the right to freedom of contract to use a device that the courts had previously legitimated - the company let. Whereas, in *Re Bugle Press Ltd* there was no mutuality but rather a unilateral attempt to use a company to deprive a person of their shares.

The Corporate Sham / Transactional Sham – Where “Justice” so Requires

The courts have shown a willingness to use a wide scope analysis in conjunction with the sham that we can call ‘fly on the wall’ or ‘global’ objectivity. However, the court

¹¹¹ [1960] 1 All ER 768.

was only called on to consider a single company and a single transaction. The most significant case where a global context was used to determine the question of whether a corporation was being used for legitimate purposes is *Creasey v. Breachwood Motors Ltd.*¹¹² Creasey had obtained judgement against Breachwood (Welwyn) Ltd ('Welwyn') on 13 March 1991. Unknown to Creasey, Welwyn had ceased trading on 30 November 1988 and transferred its business to Breachwood Motors Ltd. ('Motors'). Motors already carrying on similar business elsewhere commenced trading on 1 December 1988 from the same premises using the same business name. Both directors and shareholders of Welwyn and Motors were the same. Welwyn was solvent at the time of the transfer and a director's report had been signed as recently as 6 September 1988 stating that the directors were encouraged by the way Welwyn's business was developing. The take over of Welwyn's business by Motors was entirely informal. Welwyn's assets were transferred to Motors and all creditors paid. No provision was made for the contingency of Creasey's claim being successful. *Guildford Motor Co. Ltd v. Horne*¹¹³ and *Jones v. Lipman*¹¹⁴ were distinguished because Motors was already in existence and carrying on its own business and any 'stratagem' involved the transfer of the business to Motors. Motors was not formed as a sham and Welwyn or Breachwood were not façades concealing the facts. Richard Southwell QC stated,

The facts of the present case are very different from those in *Woolfson* and *Adams*: and I do not read the judgement in *Adams* based on Lord Keith's statement of principle in *Woolfson* as barring the piercing of the corporate veil in this case, in which the transfer of assets from Welwyn to Motors would otherwise enable the Breachwood group owned by Mr Ford and Mr Seaman to evade responsibility for the contingent liabilities to Mr Creasey for breach of his contract of employment. The most important factor in this case is that Mr Ford and Mr Seaman, and through them Motors, themselves deliberately ignored the

¹¹² [1992] BCC 638.

¹¹³ [1933] Ch 935, (CA).

¹¹⁴ [1962] 1 WLR 832.

separate personalities of Welwyn and Motors, and did so with the benefit of advice of the solicitors acting for Welwyn and Motors. Nothing I have seen in the evidence could justify their conduct in deliberately shifting Welwyn's assets and business into Motors in total disregard of their duties as directors and shareholders, not least the duties created by Parliament as protection to *all* creditors of a company.¹¹⁵

The court faced a number of competing issues. First, the preponderance of authority indicated that it was only permissible to reject separate personality where special circumstances indicated that Motors was a sham or façade. It was clear that Motors had not been formed with the intention of avoiding Creasey's claim. It was the transaction involving the transfer of assets from Welwyn to Motors that was a sham not the company. The transfer of assets to Motors was made with the intention that both Creasey and the court be given the appearance that Welwyn had no assets and was insolvent. Whereas, at the time of the transfer the reality was that Welwyn had assets of over £70,000, a subsisting business and Creasey was the only unpaid creditor.

Second, the court drew from the context a clear breach of the director's duties owed to Welwyn and the director's duties owed to all creditors (even contingent creditors). This breach had been perpetrated by Ford and Seaman acting in their roles as directors of Motors to cause a breach of their duties in their capacity as Welwyn's directors. Messrs Ford and Seaman's conduct toward Welwyn in their roles as directors of Motors was attributed to Motors. Consequently, Motors became a party to the breach of the duty owed by the directors of Welwyn to both Welwyn and Creasey.

Third, the consequences for Creasey were (1) he had no claim in contract against Motors; (2) he could put Welwyn into liquidation and persuade the liquidator to bring misfeasance actions against the directors for the return of the assets; (3) he could bring

¹¹⁵ [1992] BCC 638 at 647 H - 648 A.

proceedings against the directors of Motors in one of the economic torts; and (4) as he was legally aided it was likely that the costs of pursuing one of these courses would be more than the sum recovered.¹¹⁶

Richard Southwell QC analysed the context in which the rule of Motors separate personality was set for application. The purpose derived was to assist in perpetration of a breach of duty and act as a shield protecting assets that had been received as a result of a sham transaction. This was an illegitimate purpose for the rule of separate personality to serve. Richard Southwell QC reached the correct conclusion but it was done under the guise of 'justice'.¹¹⁷

In *The Tjaskemolen*¹¹⁸ Clark J. also used the notion of 'justice' to pierce the corporate veil. Bayland Navigation Inc ('Bayland') was part of a group of companies known of the Fondel Group. Profer A.G. had chartered 'The Tjaskemolen' and it had later proven unseaworthy. Profer A.G. sued for damages and sought to arrest the ship as security in the action. It was alleged that Bayland had paid all its outstanding debts except Profer A.G. and then transferred the ship to a related Fondel Group company in order to avert the arrest of the vessel. Each company in the groups had been formed as a single purpose ship owning company and the court affirmed that such arrangements were not a sham.¹¹⁹ Further it was also recognised that the a parent or individual with the controlling or governing interest in each of the ship owning companies could

¹¹⁶ *Ibid.*, at 642 DH.

¹¹⁷ This reasoning has recently been severely criticised by the Court of Appeal in *Ord v. Belhaven Pubs Ltd* *The Times*, 7 April 1998, Hobhouse, Brook L.J.J. and Sir John Balcombe.

¹¹⁸ [1997] 2 Lloyd's Rep 465 (QB).

¹¹⁹ *Ibid.*, at 470, col 1. See also *The Evpo Agnic* [1988] 2 Lloyd's Rep 411 (CA) at 415, col 1 *per* Sir John Donaldson M.R.

legitimately cause the companies to use their individual assets to the mutual advantage of other members of the group. However, the situation was reprehensible where:

A group arranges its affairs in such a way as to divest a company with in the group of its assets with the purpose and effect of insuring that they will not be available to meet its existing liabilities, at any rate where the transfer is made to another member of the group at undervalue. Depending on the facts, such an agreement is likely to be held to be a sham or façade, as those expressions are used in the cases.¹²⁰

As in *Creasey*, the court had a situation where the company *per se* was not a sham but rather the transaction and the purpose for using the company was a sham. In *The Tjaskemolen*, we can also derive breaches of duty by the directors and the knowledge of the two group companies in the transaction, assenting to the removal of the major asset from a company at undervalue. Together, the breach of director's duty and the contract to transfer the ship at undervalue to the related group member to evade a liability entitled the court to treat the transaction as a sham. Beneficial ownership of the ship remained with Bayland.

It is submitted that the rationale of 'justice' in *Creasey* and *The Tjaskemolen* was achieved through a misunderstanding of the nature of corporate personality and its relationship with the transactional sham. The Court of Appeal has recently held that the reasoning in *Creasey* is wrong and not good authority.¹²¹ The unsatisfactory reasoning in *Creasey* may be true of the decision in *The Tjaskemolen* also, yet it is counter-intuitive to suggest that the results achieved in both cases were plain wrong. *Creasey* and *The Tjaskemolen* show that there are situations where the use of companies and transactions shock the conscience of the court. In such circumstances, if the court fails

¹²⁰ *Ibid.*, at 470, col 1.

¹²¹ *Ord v. Belhaven Pubs Ltd* The Times, 7 April 1998, (CA) Hobhouse, Brook L.J.J. and Sir John Balcombe.

to consider the 'cluster concept' of the company because of the absolutist approach to *Salomon* then to pierce the veil in other circumstances must be, to do 'justice'. The 'cluster concept' ensures that the rules of corporate personality: separate personality, limited liability, roles, attribution, duties etc. are considered in the context of the transaction concerned. Each rule when applied to the context must reveal a legitimate purpose. Failing this approach, the courts grapple with a one-dimensional appeal to an unstructured notion of 'justice' that uses flawed reasoning to justify what is essentially correct.

THE AGENCY AND SHAM CASES CONSIDERED AS A WHOLE

If we consider the parent subsidiary relationship in conjunction with the notions of agency and the sham, one situation stands out as the most susceptible to rejection of a subsidiary's separate personality. A non-trading subsidiary that acts as 'no more than a corporate name' with no commercial purpose in a group has questionable legitimacy after *Adams*. This combined with undercapitalisation, inability to meet existing and contingent creditor claims, and the unilateral nature of the arrangement are features contributing to the subsidiary being a façade or sham *per se*. *Re Polly Peck International plc (In Administration)*¹²² and *The Tjaskemolen* are arguable authority for the proposition that a single purpose company with a valid commercial purpose is legitimate. Further, there must be a respect for freedom of contract and mutuality where strict application of *Salomon* would defeat the bargain and the notion of consensuality. On the other hand if there is a unilateral attempt to evade liability such as that found in *Gilford, Creasey*, and *The Tjaskemolen* then the courts seem more

attune to the possibility of a sham company or transaction. Good evidence of this is where all creditors are paid except one and then steps taken to ensure that particular creditor is not paid. From the above we can distil a general legal proposition. Where there is a unilateral act combined with a transaction having no apparent commercial purpose, the courts should be alive to the potential for abuse. The courts should be prepared to examine carefully the nature of the transaction and the internal functioning of the company. Whereas if the transaction has consensuality or mutuality between the parties then rigid application of *Salomon* and compliance with the idea of freedom of contract is necessary.

¹²² [1996] 2 All ER 433.

Chapter 3

Jurisprudential Reform: Reconsidering the Group of Companies and the Doctrine of the Sham

INTRODUCTION

The juridical perception of companies needs to be recast if legislatures and the courts are to deal adequately with the phenomenon of the group of companies. The *Woolfson formulation*¹ remains the most authoritative statement of the extent of permitted departures from *Salomon* and also provides us with an avenue for reform. Such a reform calls for the recognition that a company is a collection of rules, rules to be interpreted in a manner that allow only legitimate corporate purposes to be advanced. Currently though, company law permits groups of companies almost complete immunity from findings of ‘puppet’ companies and that artficed, *intra* group transactions are to be regarded as shams. In a complex group structure, the removal of one or two companies and the connective transactions may have little or no effect on the overall purpose of a complex composite transaction. *Adams v. Cape Industries Plc*² demonstrates that the *Woolfson formulation* cannot cope with the complexity of a group of companies and the associated transactional arrangements. The courts are constrained by a formalist approach that perceives the company as a literal and real thing rather than the focal point of a cluster of rules. Accordingly, the analysis used by the courts to

¹ See *Woolfson v. Strathclyde Regional Council* [1978] SLT 159.

² [1990] Ch 433.

determine the legitimacy of a group and agreements involving group members is transactionally piecemeal in nature. Further, the sheer complexity of these transactions can simply overawe and benumb even the most meticulous and intelligent of the judiciary and counsel. The complexity of a series of transactions makes difficult the placement of adequate evidence before a court for consideration.³ For example, in *Adams*, the court failed to raise a number of issues even though the transition from NAAC to the new entity, CPC was considered a ‘composite arrangement designed to enable Cape asbestos to continue to be sold into the United States while reducing, if not eliminating, the appearance of any involvement therein of Cape or its subsidiaries.’⁴ The Court of Appeal looked at the ‘nature of the arrangements’ in terms of the rule of separate personality and accepted that the motives of each company were relevant in order to determine if there was a sham or façade.⁵ Thus, the motives of CPC and AMC were taken in isolation with consequent insensitivity to an emerging pattern. The court accepted the motives of each company in the Cape group structure as independently legitimate but failed to assess the overall legitimacy of the entire composite transaction. Why was it that only one part of the entire composite transaction was a sham while the legitimacy of the remainder was untainted? Understood as a composite transaction, the rearrangement of Cape's affairs had a duality of purposes. First, an arguably ill conceived ‘inherent’ legitimacy based on the aspiration of the parent to maintain business in the US. Second, a purpose of questionable legitimacy in light of the motive of evading further liability from the Tyler Two litigants.

³ See for example, the difficulty faced by the court in *Sharrment Pty Ltd v. The Official Trustee in Bankruptcy* (1988) 82 ALR 530.

⁴ *Adams v. Cape Industries Plc* [1990] Ch 433 at 478 F *per* Scott J.

⁵ *Ibid.*, 540 C D.

The doctrine of the sham as currently interpreted by English courts enables a transaction by transaction analysis but deals inadequately with a situation where a series of transactions and companies are used to avoid liability.⁶ The *Wolfson formulation* privileges an analysis which makes each single transaction sufficient unto itself. What is required instead is an approach which appraises the propriety of each transaction in light of any motive or purpose that emerges from considering a cluster of connected transactions in their totality. There should be a strong presumption that a purpose which would be found illegitimate if achieved directly does not attain legitimacy if done circuitously.⁷

There is significant precedent in UK law for the use of the notion of the sham in conjunction with a method of contextualising a series of transactions to determine their overall effect. UK tax law employs the doctrine of the sham in conjunction with the *Ramsay Principle*⁸ to deal with complex transactions where taxpayers have attempted to use companies and other structures and transactions unilaterally to evade tax liability. Company law can draw on this experience to deal more appropriately with step by step transactions whereby corporators in a corporate group seek to avoid liability to creditors.

In this next section, we will first call for a reconsideration of how the courts conceptualise companies. This is necessary if progress is to be made in improving fair dealing standards in groups of companies. Second, we will digress briefly to examine how tax law uses the sham and the *Ramsay Principle* in the context of complex

⁶ For example, *Creasey v. Breachwood Motors Ltd* [1992] BCC 638.

⁷ Support for this analysis that is found in *Re Bugle Press Ltd* [1960] 1 All ER 768. and *Acatos & Hutchinson v. Watson* [1995] 1 BCLC 218.

⁸ *W.T Ramsay v. IRC* [1982] AC 300, (HL).

transactions. We will then be in a position to address reasons why the judiciary may be reluctant to employ a variant of the *Ramsay Principle* in company law. Finally we will identify the features of a suitably adapted variant and consider what effect such an analysis would have had on *Adams*.

PERCEPTION OF THE COMPANY

Separate personality is the focus of many decisions in company law. There is little incursion of principles from other areas of law in this process. As we have seen in *Creasey v. Breachwood Motors Ltd*⁹ and *The Tjaskemolen*¹⁰ there is also a misunderstanding of the relationship between the transactional and corporate sham and a reluctance to venture from the *Wolfson formulation* in a manner that goes beyond invocation of the claims of 'justice'. The remedy for this jurisprudential deficiency is a reversion to what we can call 'first principles analysis'. Whereas, reasons must be given by a court for a decision to reject corporate personality, there is no corresponding obligation to justify why corporate personality has been retained.¹¹ A misunderstanding of corporate personality is the primary source of confusion producing a nebulous and undisciplined process for its rejection or retention. There is much academic argument as to the nature of corporate personality, theories ranging from denials that companies enjoy even a legal form of existence to those theories that insist that companies are as real as human entities.¹² Clearly, the English common law conception of the

⁹ [1992] BCC 638.

¹⁰ [1997] 2 Lloyd's Rep 465, (QB).

¹¹ Malcolm Anderson, 'Disregard of the Corporate Entity in an Intra-Corporate Dispute' (1939) 6 *University of Pittsburgh Law Review* 38 at 40.

¹² Wesley Newcomb Hohfeld, Fundamental legal conceptions, as applied in judicial reasoning edited by Walter Wheeler Cook /with a new foreword by Arthur L. Corbin (New Haven: Yale University Press, 1966), Otto von Gierke, Natural law and the theory of society, 1500 to 1800 with a lecture on the ideas of national law and humanity by Ernst Troeltsch ;

corporation is based on a legal entity with the ability to bear responsibility and enforce rights. The rationale for doing so is properly pragmatic. Limited liability companies are created and sustained for the organisational and economic benefits that they bring. Unlike human intrinsic rights which derive from their very nature. The 'right' to a separate personality is something that should always be vulnerable to a cost/benefit analysis.

The modern limited liability company - the ubiquitous vehicle of enterprise - is a creation of statute not recognition of a pre-existing 'naturally occurring' entity.¹³ A parent is permitted to have a subsidiary for no other reason than the organisational and commercial benefits which may ensue. Rules, such as limited liability, are used to escape the consequences of pre-existing rules such as joint and several liability. It was shown in *Salomon* that the purpose of the legal creation of separate personality produces the specific rule of limited liability. Nevertheless, in order for the modern limited liability company to operate effectively and fairly, the premise (separate personality) must be informed by notions of legitimacy arising from its pragmatic origins, as must the legal consequence (limited liability). For example, if there is no valid premise (legitimate commercial purposes) then the fiction (separate personality) and the rule (limited liability) have no justification. For this reason, the legal doctrine of corporate personality confers a defeasable legal privilege and not an absolute vested right.

translated, with an introduction by Ernest Barker (Cambridge: Cambridge University Press, 1934), H. L. A. Hart, 'Definition and Theory in Jurisprudence' (1954) 70 *Law Quarterly Review* 87, Frederick Hallis, *Corporate Personality: A Study in Jurisprudence* Reprint of 1930 Edition (London: Scientia Verlag Aalen, 1978)

¹³ Contrary to Taubner's hypothesis of autopoiesis or the self creating corporation. See Gunther Teubner, 'Enterprise Corporatism: New Industrial Policy and the 'Essence' of the Legal Person' (1988) 36 *American Journal of Comparative Law* 130.

Corporate personality exists so we may access advantages that would otherwise not exist. Arguably, a shelf company with no purpose has no 'existence'.

Little will be gained by seeking to ascertain what a corporation is. It is not a thing. It is a method. It defies definition when removed from the background of the purpose attempted to be accomplished and the manner of accomplishing it. When defined as a method the definition varies. The definition for one purpose may be totally different from the definition for another. So the utility in a definition is lacking. In the approach there is no room for theorizing in respect to the corporate entity. The sole concern need be only with the purpose and the means of attaining it.¹⁴

Only when the company uses a right or immunity afforded by corporate law in pursuit of legitimate concerns should the right or immunity be recognised. The company or more particularly, the rule in operation has no 'being' beyond the scope of its legitimate exercise. For example, corporate personality has as its most serious implication the notion that the company is separate from its members. *Salomon* made clear that the separate personality of a company was not dependent upon the will of its members but on the legislation (or rules) that created it. However, separate personality means nothing without interaction with other legal persons. The problem that has defeated the courts is how to create a body of principle that determines the legitimate ambit of separate personality.

Recently, the Privy Council in *Meridian Global Funds Management Asia Ltd v. Securities Commission*,¹⁵ was concerned the question of whether the conduct of certain employees could be attributed to a company for the purpose of imposing securities regulations on the company. In doing so, the court has offered an influential

¹⁴ William O. Douglas and Carrol M. Shanks, 'Insulation from Liability through Subsidiary Corporations' (1929) 39 *Yale Law Journal* 193 at 194.

¹⁵ [1995] 2 AC 500.

restatement of the nature of corporate personality in relation to the limited liability company. Lord Hoffmann considered:

Any statement about what a company has or has not done, or can or cannot do, is necessarily a reference to the rules of attribution (primary and general) as they apply to that company. Judges sometimes say that a company ‘as such’ cannot do anything; it must act by servants or agents. This may seem an unexceptional, even banal remark. And of course the meaning is usually perfectly clear. But a reference to a company ‘as such’ might suggest that there is something out there called the company of which one can meaningfully say that it can do or cannot do something. *There is in fact no such thing as the company as such, no ding and sich, only the applicable rules.* To say that a company cannot do something means only that there is no one whose doing of that act would, under the applicable rules of attribution, count as an act of the company.¹⁶ [emphasis added]

There is no Kantian *noumena* – nothing unknowable – just a cluster of rules that comprise the *phenomena* of the thing we call a company. Each of the rules is ‘a device for attaining desired legal consequences or avoiding undesired legal consequences’.¹⁷ The company's existence is conceived contextually rather than absolutely and recognition of corporate action depends on the application of the rules. It then becomes a question of whether the consequence that the rule entails in a particular context of application is a legitimate use of the corporate form.¹⁸ Central to any consideration of this nature is the tension between abuse and legitimacy. For instance, the utility of the corporation is high for some purposes but abusive for others, as when a company is merely a tax evasion device¹⁹ or a façade employed to evade pre-existing legal

¹⁶ *Ibid.*, 506 G - 507 B.

¹⁷ Oliver R. Mitchell, ‘The Fictions of the Law’ (1893) 7 *Harvard Law Review* 249 at 253.

¹⁸ Ross Grantham, ‘Corporate Knowledge: Identification or Attribution?’ (1996) 59 *Modern Law Review* 732.

¹⁹ *Littlewoods Mail Order Stores Ltd v. Mc Gregor (Inspector of Taxes)* (1962) 2 All ER 279

obligations.²⁰ Accordingly, our theory of corporate personality makes relevant a number of questions, in particular the issue of accountability for corporate actions.

Particular care is needed when analysing when the conduct of an individual associated with a company is to be attributed solely to the company or solely to the individual or, finally to be regarded, at one and the same time, as corporate conduct and individual conduct.²¹

The dogmatic application of the doctrine of separate personality has led to the reification of the corporation and its perception as a tangible immutable thing. We forget that it is like any other legal rule - designed to be used with common sense and applied to further justice and the greater good. It is not an idol for worship or a physical incarnation. It is a legal tool. Wormser, at the early stages of this century foresaw the difficulties of how we perceive the corporation when saying:

There is always danger, when a fiction (whether corporate or otherwise) becomes so deeply rooted in the case law, that judges no longer remember its object and purpose, and apply the fiction to an extent where they refuse to consider and to penetrate into the actual facts behind it.²²

²⁰ *Guildford Motor Co. Ltd v. Horne* [1933] Ch 935, (CA). See generally, Lon L. Fuller, Legal Fictions (Stanford: Stanford University Press, 1967) at 51-55 in relation to the use of fictions in law.

²¹ See *Williams v. Natural Life Foods Products Limited* [1998] 2 All ER 577. The tension between the independence of corporate action and the actions of the living corporators is further evident when *Salomon* is compared to the wartime decision in *The Continental Tyre and Rubber Co Ltd v. Daimler Co Ltd* [1915] 1 KB 893, (CA); [1916] 2 AC 307 (HL). If both cases are analysed, disregarding the latter as a wartime decision, they are irreconcilable. See Frederick Hallis, Corporate Personality: A Study in Jurisprudence Reprint of 1930 Edition (London: Scientia Verlag Aalen, 1978) at ii. The fiction theory derived from *Salomon* considered the substratum of the living corporators' actions irrelevant to the constitution of corporate personality because it was created by the legislature. Whereas, *Continental Tyre and Rubber* recognised that the personality of the corporators was an essential element of the corporation's legal personality. This was the catalyst the courts needed to seize upon the notion of accountability for corporate actions.

²² I. Maurice Wormser, Disregard of the Corporate Fiction and Allied Corporation Problems (New York: Baker, Voorhis and Co, 1929) at 24.

The status of the *Salomon* decision has influenced company law to focus on entity as its object and purpose. Whilst, there must be a presumption in favour of the separate entity of companies, it often conflicts with the primary social objective of ensuring legitimacy and fairness in commercial transactions. Thus, the way we think of the company and the group needs to acknowledge the separateness of each corporate entity as merely a legal presumption which applies to a legitimate corporate objective. When a corporate strategy involves a complex of transactions to which members of the same corporate group are parties, it is particularly important for courts to take a holistic approach when determining whether particular uses of the corporate form are legitimate or otherwise. If each transaction is taken individually on its merits and not linked to associated dealings, the true nature and purpose of a complex of transactions may not emerge. Company lawyers can usefully draw on the experience of tax law to develop a better more realistic, approach to divining the true motivation behind complex, linked transactions

THE SHAM AND THE RAMSAY PRINCIPLE

The datum for an analysis of complex transactions in tax law was the *Duke of Westminster Principle*. In the well-known observation of Lord Tomlin in *Inland Revenue Commissioners v. The Duke of Westminster*:²³

Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax. This so called doctrine of 'the substance' seems to me to be nothing more than an attempt to

²³ [1936] AC 1.

make a man pay notwithstanding that he has ordered his affairs that the amount of tax sought from him is not legally claimable.²⁴

Whilst *Duke of Westminster* was a revenue case dealing with the issue of whether ‘the Court may ignore the legal position and regard what is called ‘the substance of the matter’’,²⁵ it is submitted that the *Duke of Westminster Principle* derives from a rule of general legal application in that a person may use legal constructions to arrange their affairs to obtain whatever legitimate benefits may flow from the use of such constructions. For example, a variant of this principle is that an individual may use a company to arrange his affairs in such away as to limit his liability. *Salomon* is good authority for this proposition. The same issue also concerns the question how we can use *Salomon*; do we ignore the rules that make up the doctrine of corporate personality and pay direct heed to the underlying substance or do we respect the rules as reflecting a valid legal position. Thus, any appeal for a court to observe the wider context of a group of companies (or the ‘reality’) must initially recognise the company, the group, and any commercial dealings as legitimate. There should always be this strong presumption of legitimacy, a presumption only to be departed from in a principled manner, driven by cogent reasons.

The legal principles are well settled. First the true nature of a transaction can only be ascertained by careful consideration of the legal arrangements actually entered into and carried out. It is not to be determined by an assessment of the broad substance of the transaction measured by the overall economic consequences to the participants. The forms adopted cannot be dismissed as mere machinery for effecting other purposes. At common law there is no half way house between sham and characterisation according to the true nature of the legal arrangements actually entered into and carried out. A document may be brushed aside if and to the extent that it is a sham in two situations. The first is

²⁴ [1936] AC 1 at 19-20. See also the decision of Judge Learned Hand in the 2nd Circuit Court of Appeals *Helvering v. Gregory* 69 F (2d) 809, 810(1934), ‘Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the treasury...’

²⁵ [1936] AC 1 at 19.

where a document does not reflect the true agreement between the parties in which case the cloak is removed and recognition is given to common intentions. The second is where the document was bona fide in inception but the parties have departed from their initial agreement while leaving the original documentation to stand unaltered. Once it is established that the transaction is not a sham its legal effect will be respected.²⁶

A reliable version of the 'reality' can only be obtained by a structured and principled approach. Attempts to use an unstructured 'organic' approach have caused considerable confusion. For example, the view of Lord Denning in *Littlewoods, DHN* and *Wallersteiner* considered that the court could cut through the corporate form to view the 'reality' was a judicial discretion that should always be exercised in the interests of justice. The demand for justice by appealing to substance may trigger an appeal to treat the parent subsidiary relationship as one of unity and not separation, reflecting the economic reality. The problem with appealing to justice to declare that a group is economically one or that a number of different transactions is effectively one overarching scheme is the question of perspective.

The essence of the argument is that a court of equity will ignore such matters in order to do justice. A court of equity will certainly look at the true nature of a transaction, and will not be deterred by a sham. There is no principle of equity however, that empowers the court to ignore the true nature of a transaction and substitute some other concept. The appeal to 'justice' as a reason for such an approach is to a justice which is in the eye of the beholder, is unstructured and unprincipled.²⁷

Courts regularly respect limited liability and separate personality as rules fundamental to the legitimate use of a corporation for certain purposes. The Court of Appeal crystallised the position in *Adams* where it was said,

²⁶ *NZI Bank Ltd v. Euro-National Corporation Ltd* [1992] 3 NZLR 528 at 539 per Richardson J. See also *Attorney General v. Equiticorp Industries Group Ltd* [1996] 1 NZLR 528, at 538 where the statement was affirmed by the NZ Court of Appeal.

²⁷ *Attorney-General v. Equiticorp Industries Group Ltd* [1996] 1 NZLR 528. (NZ) (CA) (Richardson, McKay, and Henry JJ) at 538 (lines 1-7)

Our law for better or worse, recognises the creation of subsidiary companies which though in one sense the creatures of their parent companies, will nevertheless under the general law fall to be treated as separate legal entities with all the rights and liabilities which would normally attach to separate legal entities²⁸

Even on the strength of this statement there is scope for the employment of a form of analysis that assumes the legitimacy of each corporate vehicle and transaction but is prepared to take a holistic, unified approach to a series of transactions and related entities should there be evidence that they are linked and interdependent. Tax law during the height of *Duke of Westminster* was a formalist island of literal interpretation where:

[T]he courts regarded themselves as compelled to adopt a step by step analysis of [tax avoidance] schemes, treating each step as distinct transactions producing its own tax consequences. It was thought that if the steps were genuine, i.e. not sham or simulated documents or arrangements, the court was not entitled to go behind the form of the individual transactions. In combination those two features – literal interpretation of tax statutes and the formalistic insistence on examining steps in a composite scheme separately – allowed tax avoidance schemes to flourish.²⁹

The flourishing business in tax avoidance schemes was severely curbed by the decision of the House of Lords in *W.T Ramsay v. IRC*.³⁰ *Ramsay* concerned a complicated series of transactions that were genuinely carried through and exactly what they purported to be. The transactions considered together, from the outset, were designed to produce neither a gain nor a loss – they were self cancelling.³¹ The only reason for embarking on the scheme was to reduce tax. The court chose to adopt a realistic approach rather than a the *Duke of Westminster* atomistic analysis.

²⁸ [1990] 1 Ch 433, (CA) at 536 *per* Slade L.J.

²⁹ *IRC v. McGuckian* [1997] 3 All ER 817, (HL) at 824 *e g per* Lord Steyn.

³⁰ [1982] AC 300, (HL).

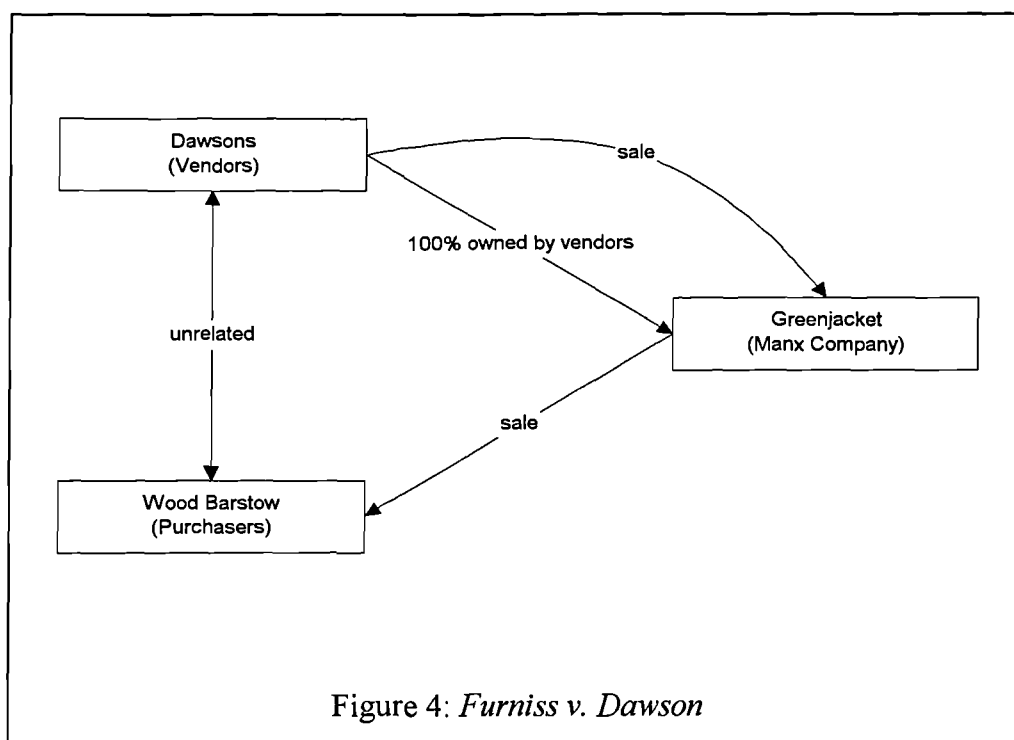
³¹ *Ibid.*, at 328 *per* Lord Wilberforce.

Given that a document or transaction is genuine, the court cannot go behind it to some supposed underlying substance. This is the well known principle [in *Duke of Westminster*] This is a cardinal principle but it must not be overstated or overextended. While obliging the court to accept documents or transactions, found to be genuine, as such, it does not compel the court to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs. If it can be seen that a document or transaction was intended to have effect as part of a nexus or series of transactions, or as an ingredient of a wider transaction intended as a whole, there is nothing in the doctrine to prevent it being so regarded: to do so is not to prefer form to substance, or substance to form.³²

Despite the fact that each transaction was legitimate the court questioned whether the entire arrangement was also legitimate. It was clear that the entire arrangement had the illegitimate purpose of tax avoidance. Whilst separately legitimate each transaction was co-dependent. If each transaction step was not completed then the scheme would not achieve its desired result. Consequently, the court changed the way it approached complex arrangements. Rather than test each transaction for legality, the court determined whether the motive behind the arrangement was legitimate. *Ramsay* ushered in a new realism for the analysis of complex tax avoidance schemes. In essence, the court looked to see if the overall transaction achieved a genuine result. For example, if an asset was genuinely divested for a loss then the court would permit a tax advantage. Whereas, the court advocated a scepticism toward self cancelling arrangements because the transactional co-dependency meant that the purpose was clearly aimed at tax avoidance. Another quality of the arrangement was that, as between the taxpayer and the State, the arrangement represented a unilateral attempt to avoid a future liability.

³² *Ibid.*, at 325 GH *per* Lord Wilberforce.

The *Ramsay principle* was developed further in *Furniss v. Dawson*³³ where it was demonstrated that the arrangement can also be relatively simple to attract the attention of the court. A father and two sons ('the Dawsons') wished to sell their shareholding in two small family companies to Wood Bastow Holdings Ltd ('Wood Bastow'). Before the sale took place the Dawsons entered into a scheme designed to defer any liability to pay capital gains tax on the sale of their shareholdings. To defer the CGT that would be otherwise payable the shares were first sold to a newly incorporated Isle of Man company ('Greenjacket') for the sum of £152 000, which was satisfied by an issue of shares. Greenjacket immediately on sold the shares to Wood Bastow for the same price. The scheme was advantageous because at no stage did any liability to CGT arise under the tax legislation of the time. Lord Brightman described it as 'a simple and honest scheme which merely seeks to defer payment of tax until the taxpayer has received into his hand the gain which he has made'.³⁴ Diagrammatically,



³³ [1984] 1 AC 474.

³⁴ *Ibid.*, at 518 G *per* Lord Bridge.

Furniss gave an elucidation of the methodology to be used in the *Ramsay principle*. The formulation involves two findings of fact, first, whether there was a preordained series of transactions, i.e. a single composite transaction, and secondly, whether that transaction contained steps which were inserted without any commercial or business purpose apart from tax advantage.³⁵ Thus, it was simply not enough to examine each transaction separately. The scope of the overall corporate and commercial arrangement is also in issue. Lord Bridge of Harwich developed this proposition in *Furniss v. Dawson*,³⁶

The strong dislike expressed by the majority in the *Westminster* case for what Lord Tomlin described, ... as 'a doctrine that the court may ignore the legal position and regard what is called 'the substance of the matter,' is not in the least surprising when one remembers that the only transaction in question was the Duke's covenant in favour of the gardener and the bona fides of that transaction was never for a moment impugned. When one moves, however, from a single transaction to a series of interdependent transactions designed to produce a given result, it is, in my opinion, perfectly legitimate to draw a distinction between the substance and the form of a composite transaction without in any way suggesting that any of the single transactions which make up the whole are other than genuine.³⁷

Another important feature from *Furniss* is the suggestion that even though a scheme may have some enduring legal consequences and is not a complete fiscal nullity; the *Ramsay Principle* is not rendered inapplicable.³⁸ In the recent House of Lords decision of *IRC v. McGuckian*,³⁹ the court was called to consider the nature of a late 1970's complex corporate and transactional structure that proposed to have the overall effect

³⁵ *Ibid.*, at 527 FH per Lord Brightman.

³⁶ *Ibid.*

³⁷ *Ibid.*, at 514 AB.

³⁸ *Ibid.*, at 512 EF per Lord Frazer. See also *Gisborne v. Burton* [1989] 1 QB 390, (CA) at 399 B per Dillon L.J.

³⁹ [1997] 3 All ER 817.

through a complex web of transactions of converting dividend income into capital. The tax effect being to avoid the payment of income tax on the dividend income. Independently each transaction and entity was legitimate but the entire scheme was struck down. In essence, the House of Lords confirmed that the *Ramsay Principle* was a ‘broad purposive interpretation ... asserting the power to examine the substance of a composite transaction ... simply rejecting formalism in fiscal matters and choosing a more realistic legal analysis’.⁴⁰

Comments

Tax law treatment of the sham question informs us that our initial analysis must respect the operation of rules and the validity of transactions. However, such analysis must be critical rather than accepting where there is a series of transactions spread over a number of entities. In particular, there must be a contextual analysis that examines the purpose of the overall arrangement. Where there is no commercial purpose to a scheme or arrangement other than avoiding tax then the entire structural arrangement can be removed.

Each transaction in a series of transactions or each company in a group of companies may each have a commercial or other purpose that relates to legitimate corporate objectives. A question that must be asked is ‘what is the commercial or other legitimate purpose of the entire composite transaction?’ Outside the context of tax evasion we must also be alive to variations in a corporate structure that have no apparent commercial purpose and produce no variation in the financial position overall – that is a fiscal nullity. For example, in *Adams* the court used a formalist transaction by

⁴⁰ *Ibid.*, at 825 f h.

transaction analysis analogous to literal approach found in the *Duke of Westminster*. We must at this point balance the general liberty of a person to arrange their affairs as they think fit using a group of companies and accompanying transactional arrangement with the need to have some jurisprudential test against which the purpose of the structure can be tested.

POSSIBLE DIFFICULTIES

There are a number of difficulties in a proposal to introduce a variant of the *Ramsay Principle* into the veil piercing jurisprudence relating to groups of companies. As already mentioned we must reconsider the way we think of the company. In doing so our jurisprudence can move away from the fixation with the question of control of a parent over a subsidiary and turn to a more fundamental analysis that asks whether observance of the corporate entity doctrine is legitimate in the prevailing circumstances. The more critical stance should be employed for all companies and particularly in respect of corporate groups. Thus, we must acknowledge the pre-eminence of *Salomon* but ensure we do not reify companies causing our analysis to ossify into a rigid acceptance of separate personality. A company and equally a group of companies are no more than a collection of rules. The existence of the entity is dependent upon the legitimate application of each rule in the context of its operation. Let us now address two possible difficulties with introducing the *Ramsay* approach to questions of liability arising in a corporate law context.

First, strictly speaking the *Ramsay Principle* is a tax law development that has largely been confined to the statutory interpretation of tax legislation and justified as giving

effect to the intention of Parliament.⁴¹ Nevertheless the courts have demonstrated a willingness to use the *Ramsay Principle* to construe legislation other than taxing statutes⁴² and the scope of application for the principle remains uncertain.⁴³ At this stage, no appellate court has rejected the application of the *Ramsay Principle* to other areas of the law.

Second, arguably, unless within the scope of the *Woolfson formulation*, there is no basis in law upon which a court can decline to give effect to a real transaction between the parties except on existing principles.⁴⁴ Accordingly, it is arguable that the *Ramsay Principle* is not applicable to the construction and enforcement of a private law transaction between private individuals. In the end though we are not asking for the tax law principle to be transposed to company law, but rather as a judicial response to forms of contrivance that can be modified to suit the needs of company law in particular circumstances where the law currently responds too rigidly to liability questions arising in the context of groups of companies.

ADAMS AND THE RAMSAY PRINCIPLE

In *Adams*, the Court of Appeal stated, ‘The question of law which we now have to consider is whether the arrangements regarding NAAC, AMC and CPC [the subsidiaries] made by Cape with the intentions we have inferred constitute a façade such as to justify the lifting of the corporate veil.’⁴⁵ The *Woolfson formulation* was applied with some success in *Adams*. We will recall that AMC was considered a sham

⁴¹ *IRC v. McGuckian* [1997] 3 All ER 817 (HL) at 825 fg per Lord Steyn.

⁴² *Gisborne v. Burton* [1989] 1 QB 390 (CA) at 398 G - 399 G per Dillon L.J.

⁴³ *Ingram v. IRC* (1997) 4 All ER 395 (CA) at 409 j per Nourse L.J.

⁴⁴ *Gisborne v. Burton* [1989] 1 QB 390 (CA) at 408 CD per Ralph Gibson L.J. (dissenting).

⁴⁵ *Adams v. Cape Industries Plc* [1990] Ch 433 at 542 A.

as 'no more than a corporate name': importantly, it served no commercial purpose. As there were a number of companies used in Cape's new group structure, the piercing of AMC's corporate veil had no effect for either Cape or the Tyler Two claimants. There were a number of factors that may have lead to a different result had the court adopted a variant of the *Ramsay Principle*. As mentioned above the court recognised that there was a composite transaction involved in the sale of asbestos into the US market. After the collapse of NAAC, the court while suspicious of the new configuration of companies⁴⁶ recognised that there was no real change in the way Cape did business in the US. We are faced with four factors that permit a *Ramsay* influenced analysis. First, there was a composite or series of transactions. Second, no real commercial effects; third, evidence of inconsistencies, and finally, there was no evidence of mutuality between Cape and the Tyler Two claimants. In the presence of these factors, the court should have left itself at liberty to consider, holistically, the entire composite transaction to determine whether the corporate form was being used for legitimate purposes across the entire structure. It was clear from the facts that the first, second and fourth factors were present. Let us consider the inconsistencies presented to the court.

Cape was selling a highly toxic substance that had proven potentially fatal to those who inhaled only minute quantities. Cape's business of selling asbestos had exposed large numbers of workers to the substance in excess of those participating in the original Tyler One litigation. Even so, the court accepted the veracity of Cape's intention to disassociate itself from the sale of asbestos and yet maintain a business that sold asbestos as legitimate and without further inquiry. In effect, the court permitted Cape to continue selling a toxic substance using the rule of separate personality without a

⁴⁶ It will be recalled that suspicion alone is not sufficient grounds for piercing the veil.

modicum of responsibility. At this point, we should ask whether this is a legitimate use of separate personality. This is not the only inconsistency presented to the court. The court recognised that a major participant (Morgan) in the composite transaction had been dishonest and was of questionable credibility. This did not alter the approach of the court to the composite transaction. Further, the court did not explore the possibility of agency between Morgan and Cape although Cape could effectively take control of CPC at any time. The question of agency between group companies was considered ‘on the footings, ... that NAAC [the subsidiary] must be regarded as a legal entity separate from Cape/Capasco.’⁴⁷ Such a conclusion was achieved after a detailed analysis of the ‘relevant purposes’. These were derived on the basis that there is neither a presumption of agency between parent and subsidiary nor a presumption of the subsidiary as the alter ego of the parent.⁴⁸ The flaw here is that these ‘presumptions’ were derived from the motive of Cape. Cape as we will recall was – according to a strict application of *Salomon* – a separate personality from the newly formed and apparently unrelated company formed by Morgan. Consequently, rather than look at the nature of the formation and genuineness of AMC, the court simply accepted its formation and the nature of the arrangements as a part of Cape’s plan. This is odd because on one hand the court is advocating the entity principle in relation to liability but permits the motive of Cape to be transposed to what is effectively an unrelated company.

This draws out the single most important deficiency in *Adams*. The court employs Cape’s own perspective to assess the situation rather than adopting, to borrow from contract law, ‘fly-on-the-wall objectivity’.⁴⁹ The Court of Appeal accepted the

⁴⁷ *Ibid.* at 545 AB.

⁴⁸ *Ibid.*, at 537 B.

⁴⁹ For example, see *Thake v. Maurice* [1984] 2 All ER 513, (HC) Peter Pain J. and [1986] 1

legitimacy of continuing the sale of asbestos in the US as Cape's dominant business purpose because, from Cape's point of view, this was the objective reason for putting the new arrangement in place. Despite the evidence of inconsistencies mentioned above the court had no alternative but to accept as subordinate Cape's intention to resist the enforcement of any default judgements by deploying a new and complicated corporate structure. If the Court of Appeal had reviewed these arrangements with appropriate objectivity, the overall arrangement may have been seen in a different light. A contextual analysis of the oddities of the case should have raised the suspicions of the court concerning the actual purpose of the entire arrangement: was it to evade a contingent liability rather than continue business? We can reach this conclusion, as the rearrangement of Cape's affairs in the form of the newly created companies left matters unchanged in commercial terms. However, the court's consideration was engrained with an absolute notion of the company rather than evaluating the legitimacy of separate personality across the range of facts which constituted the composite transaction. The consequence is that the rule of separate personality is used non-contextually to pre-empt arguments based on other areas of law such as agency. Thus, in the absence of a global analysis and the related question of legitimacy it is predictable that the court reaches the conclusion that the purposes of using a subsidiary permit it being a creature of the parent⁵⁰ and a parent can choose to arrange its affairs so that a business in a foreign country is carried on by a subsidiary.⁵¹

To recap, in *Adams* the court fragmented the transactions that took place during the transitional period from NAAC being the business vehicle in the United States to the

All ER 497 at 511 *per Nourse LJ* (CA). *Gibson v. Manchester City Council* [1979] 1 All ER 972, (HL) Diplock LJ.

⁵⁰ *Adams v. Cape Industries Plc op. cit.*, at 536 GH.

use of the new CPC. The court did not contemplate the motive of the entire scheme and the procedure adopted because it focused on each corporation being a separate personality and a transaction by transaction rather than global or schematic approach. The nature of Cape's unilateral action and the type of creditor involved had no influence on the willingness of the court to examine the context in greater detail using the *Woolfson formulation* as informed by the *Ramsay Principle*. It is submitted that the crux of the problem lies in how the court conceived the corporation as a tangible thing entitled to be utilised in absolute terms rather than an abstract concept – a cluster of rules that apply provided the context of their application is legitimate.

⁵¹ *Ibid.*, at 537 C.

**Part III: The Statutory Law: The Legislative
Limits to *Salomon***

Chapter 4

The Scope of the Current Legislative Remedy Regime for Creditors

INTRODUCTION

The remedies available to creditors of a group of companies, in the context of insolvency are dealt with in this chapter. We should, at this preliminary stage, recall the status of creditors in relation to a debtor during solvency. It is well established that unsecured creditors have no proprietary rights in the assets of a debtor. Accordingly, during solvency creditors lack locus standi to intervene in any part of a debtor's business¹ except for the equitable remedy of a Mareva injunction.² If the unsecured creditor obtains a judgement then execution may be an appropriate remedy, but on insolvency the remedies incumbent in official management or liquidation are the only recourse. Secured creditors are protected by the terms of their security document during solvency and, in addition, exclusion from the operation of *pari passu* in a liquidation. The primary remedy of realising a charged asset takes place independent of any insolvency proceedings. The security document may provide other advantages prior to liquidation such as, contractual remedies and access to information concerning management policy and decisions. By comparison an unsecured creditor is at a

¹ *Mills v Northern Railway of Buenos Ayres Co* (1870) LR 5 Ch App 621 at 628; I. C. F. Spry, The Principles of Equitable Remedies 5th ed (London: Sweet & Maxwell, 1997) at 515.

² Spry, *Ibid.* See also *Siskina (Cargo Owners) v. Distos Compania Naviera SA* [1979] AC

disadvantage, but is expected to have factored the risk of loss into the price of their credit as compensation.

The United Kingdom has certain legislative provisions with implications for the creditors of a group company but none that are specific to the needs of such creditors.³ If the legislation is to be effective then it must have the abuse of a parent's extra-legal control as one of its mischiefs. 'How can a creditor of a subsidiary use existing legislative remedies to impose liability on a parent?' Let us consider the available options.

TRANSACTION AT UNDERVALUE, PREFERENCES AND DEFECTIVE FLOATING CHARGES

Primarily, transactions at undervalue are those uncommercial, not arms-length transactions entered into by an insolvent company two years prior the liquidation date.⁴ A preference occurs when a company up to six months before the winding up puts a creditor or surety or guarantor for the company's debts into a better position than it would have been. The company must also desire to put the person in this better position.⁵ Defective floating charges are those created in favour of a person not connected with the company twelve months before the winding up date. The charge is only invalid if it had the corresponding effect of increasing the company's assets.⁶

210 (HL) at 260-1 *per* Lord Hailsham.

³ See Insolvency Act 1986: section 213 - fraudulent trading; section 214 - wrongful trading; section 238 - transactions at undervalue; section 239 - voidable preferences; section 244 - extortionate credit transactions; section 245 - defective floating charges.

⁴ Section 238 Insolvency Act 1986. Except where otherwise stated legislative references in Part III are to the Insolvency Act 1986.

⁵ Section 239.

⁶ Section 245.

These remedies are aimed at particular transactions that may be legitimate at the time but can be invalidated through the mechanism of liquidation. Further, the provisions do not regulate or set a standard of conduct for management during the life of the company. The primary criticism in the context of the group of companies is the fact that recovery from the 'preferred party' may well be impossible. As such, there is a real problem with the time that a creditor (through a liquidator) is able to seek recourse as the damage has been done. However, cases such as *Creasey v. Breachwood Motors Ltd*⁷ and *The Tjaskemolen*⁸ demonstrate a growing willingness of the courts to examine the nature of day to day transactions during solvency or where a transaction has the effect of causing insolvency.⁹

SUMMARY REMEDY AGAINST DELINQUENT DIRECTORS, LIQUIDATORS, ETC.

Section 212(1) and (3) Insolvency Act 1986 is in the following material terms:

(1) This section applies if *in the course of the winding up of a company* it appears that a person who-

(a) is or has been an *officer* of the company,

(b) has acted as liquidator, administrator or administrative receiver of the company, or

(c) not being a *person* falling within paragraph (a) or (b) *is or has been concerned or has taken part*, in the promotion, formation or *management of the company*,

has misapplied or retained, or become accountable for, any money or other property of the company, or been guilty of *any misfeasance* or breach of any fiduciary or *other duty* in relation to the company. ...

(3) The court may, *on the application of* the official receiver or the liquidator, or of *any creditor* or contributory, examine into the conduct of the person falling within subsection (1) and compel him-

(a) to repay, restore or account for the money or property or any part of it, with interest at such rate as the court thinks just, or

⁷ [1992] BCC 638.

⁸ [1997] 2 Lloyd's Rep 465, (QB).

⁹ Bearing recent criticism of *Creasey* in mind, it is unknown how the courts will treat it in future. See *Ord v. Belhaven Pubs Ltd* The Times, 7 April 1998, (CA).

(b) to contribute such sum to the company's assets by way of compensation in respect of the misfeasance or breach of fiduciary or other duty as the court thinks just. ...

(emphasis added)

The scope of section 212's application to the parent subsidiary relationship remains largely unexplored. Notably, it is a remedy that only applies during liquidation. Section 212(1) offers two avenues to draw a parent within its ambit. First, is the argument that a parent is an 'officer'. Second, is the argument that a parent is 'a person ... [who] is or has taken part, in the promotion, formation or management of the company'.

We will deal with the 'officer' point first. Pursuant to section 251 of the Insolvency Act 1986 if a word is undefined then it is permissible to use the definitions in Part XXVI of the Companies Act 1985. Section 744 provides that the definition of 'officer' includes a director, manager or secretary. This poses the question of whether a parent could fall into either the definition of a 'director' or a 'manager'. Section 741(1) provides that a 'director' includes any person occupying the position of director by whatever name called. The word 'manager' remains an undefined term in both the Companies Act 1985 and the Insolvency Act 1986.

We cannot assume that the definition of 'director' includes the notion of a 'shadow director'. We do this to allege that the parent is a person according to whose directions or instructions the directors of a subsidiary are accustomed to act. This belies a number of interpretative hurdles. A number of other sections in Part IV Chapter X of the Insolvency Act 1986 (Sections 206 - 219) refer to the term 'officer' or 'director' including the notion of a 'shadow director'.¹⁰ The implication being; Parliament did not

¹⁰ For example, sections 206(3), 208(3), 211(2) and 214(7).

intend the term 'officer' to extend to a 'shadow director'.¹¹ Thus, it is more appropriate because of its context to assume that Parliament would have indicated that 'officer' in section 212(1)(a) permitted transmutation to 'shadow director' specifically rather than inferentially.

Halsbury's, using everyday language, defines 'manager' as a person who has the management of the whole affairs of the company.¹² This is not an agent instructed to do a certain thing, or a servant who obeys orders, but a person entrusted with power to transact the whole of the affairs of the company.¹³ In *Re B Johnson & Co (Builders) Ltd*,¹⁴ Jenkins L.J. stated that the phrase 'manager of the company ... connotes a person holding, whether de jure or de facto, a post in or with the company of a nature charging him with the duty of managing the affairs of the company for the company's benefit.'¹⁵ We should recall that the courts readily accept that a parent customarily exercises complete dominion and control over a subsidiary.¹⁶ Accordingly, this provides support for the proposition that a parent, may, in certain circumstances, be regarded as a manager of its subsidiary. Nevertheless, such a step would present a significant threat to *Salomon*. The notion that a parent is merely a shareholder despite its complete dominion over a subsidiary and is neither a fiduciary nor a 'manager' limits any augmentation of the term 'manager'. Even so, there is still scope for section 212's application to the parent subsidiary relationship

¹¹ This is a contextual limitation of the word 'director' that equally applies to the term 'shadow director' as it does to the term 'de facto director'. *Re Lo-Line Electric Motors Ltd* [1988] Ch 477 at 489 AC per Browne-Wilkinson V.C.

¹² Lord Hailsham of St Marylebone, *Halsbury's Laws of England*, 4ed, 1996 reissue (London: Butterworths, 1996) vol 7(1) para. 641.

¹³ *Gibson v. Barton* (1895) LR 10 QB 329 per Blackburn J at 336.

¹⁴ [1955] Ch 634.

¹⁵ *Ibid.*, at 661.

¹⁶ *Briggs v. James Hardie & Co Ltd* (1989) 16 NSWLR 549 per Rogers AJA at 576 C F.

Section 212(1)(c) concerns persons not falling into the categories of subsections 212(a) or (b) and broadly applies to ‘a person ... [who] is or has taken part, in the promotion, formation or management of the company.’ The courts have recently demonstrated that this section is of wider import than subsection (1)(a).¹⁷ The words ‘*is or has been concerned or has taken part, in the promotion, formation or management of the company*’ is something lesser than the standard of involvement demanded of a *manager per se*.¹⁸ Arguably, the exercise of a parent’s complete dominion over a subsidiary may fall into this category. Again though, the parent’s supposed management function in a subsidiary can be clouded by a parent’s legitimate conduct in a different capacity. Such a dichotomy of the parent’s action toward a subsidiary is acceptable. The courts regularly illustrate their willingness to dissociate the actions of creditors, such as banks, or parents funding subsidiaries, to act legitimately in their interests from other action that usurps management of the company.¹⁹ The courts focus on the allocation of roles such as creditor and shareholder, attributing the predetermined standard of liability associated with the role. Presently, a parent’s position as the complete controller of a subsidiary is safe from the allegation that the parent falls within either section 212(1)(a) or (c). The section provides little support for the argument that a parent is a ‘shadow director’ or a person that has taken part in the management of a subsidiary.

Nevertheless, we will delve further into section 212 to demonstrate that should a parent be regarded as a director or shadow director by either a legislative amendment or a favourably wide treatment by the court,²⁰ section 212 offers an opportunity to improve

¹⁷ *Re Clasper Group Services Ltd* [1989] BCLC 143.

¹⁸ *Ibid.*, at 149 b d.

¹⁹ *Re Ayala Holdings Ltd* [1993] BCLC 256, ChD *per* Chadwick J at 262-263.

²⁰ It is difficult to judge from the few cases concerning section 212 whether this is a real possibility.

the ability of creditors to access the assets of a parent in respect of the debts of a subsidiary. Section 212(1) requires the wrong doing to be characterised in terms of its first and second limbs. The first limb provides, 'a person who ... has misapplied or retained, or become accountable for, any money or other property of the company.' This is uncontroversial and such allegations hinge on the veracity of evidence mustered against the parent. The second limb provides, 'or [a person who has] been guilty of any *misfeasance* or breach of any fiduciary or *other duty*' This limb involves more sophisticated legal issues and has both tortious and fiduciary dimensions. *Multinational Gas*²¹ established that directors owe no duty to creditors (tortious, fiduciary, or otherwise) during the period before insolvency.²² Further, a director neither owes a direct duty to an individual creditor nor is a creditor entitled to sue for breach of a director's fiduciary duty owed to the company outside the confines of liquidation.²³

From a tortious perspective, the words 'misfeasance or breach of any fiduciary or other duty' replaced the words 'misfeasance or breach of trust' in previous versions²⁴ to bring actionable negligence within the scope of the section.²⁵ The notion of misfeasance need

²¹ *Multinational Gas Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd & Ors* [1983] Ch 258.

²² *West Mercia Safetywear Ltd (in liq) v. Dodd* [1988] BCLC 250.

²³ *Yukong Lines Ltd v. Rendsberg Investments Corporation (No. 2)* [1998] 1 WLR 294, (QB) at 312 B C *per* Toulson J.

²⁴ See section 333 Companies Act 1948.

²⁵ *In Re B Johnson & Co (Builders) Ltd* [1955] Ch 634, where Evershed M.R. stated in relation to section 333 Companies Act 1948 at 648:

There is no such distinct wrongful act known to the law as 'misfeasance'. The acts which are covered by the section are acts which are wrongful, according to the established rules of law or equity, done by the person charged in his capacity as 'promoter, director,' etc. But it is clearly established that it is not every kind of wrongful act so done that is comprehended by the section. At one end of the scale it may, I think, be taken as *prima facie* clear that a wrongful act involving misapplication of property in the hands of the person charged would be covered by its terms. At the other end of the scale, a claim based exclusively on common law negligence, an ordinary claim for damages for negligence simply, would not be covered by the section. Nor is such a claim brought within the section by the mere expedient of adding epithets

not 'involve moral turpitude, but comprehends any breach of duty by an officer of the company, as such involving a misapplication or wrongful retention of the company's money'.²⁶ The standard of care required of a director, has until recently, been the primarily subjective standard set out in *Re City Equitable Fire Insurance Co. Ltd.*²⁷ Though Hoffmann J. (as he then was) has described the *other duty* of care applicable under section 212 in objective terms as the minimum common law duty reflected in section 214(4).²⁸ That is, a standard of the reasonably diligent person having both the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and the general knowledge, skill and experience that the director has.²⁹ Consequently, section 212 provides an avenue, if a liquidator can muster sufficient evidence, to sue a director for negligence.

If a parent falls within the definition of director or shadow director then there is also the fiduciary dimension. In *West Mercia Safetywear Ltd (in liq) v. Dodd*,³⁰ the liquidator

to the negligence charged, calling it 'gross' or 'deliberate'. Nor, by that expedient, without more, can what in truth is mere negligence be converted into something else, namely, breach of trust. But in between the two extremes that I have mentioned there is obviously a large range of conduct which may (or may not) be within the section.

As negligence was held to be outside the scope of section 333 Companies Act 1948, the Jenkins Committee recommended that it should be brought within the terms of the legislation. see Cmnd 1749 para. 503(d).

²⁶ *Selangor United Rubber Estates v. Craddock* [1967] 2 All ER 1255, (ChD) at 1258 G H per Goff J.

²⁷ [1925] Ch 407 at 428-9 per Romer J.

²⁸ See Hoffmann J. in *Re D'Jan of London* [1994] 1 BCLC 561, (ChD) and *Re Norman Theodore Goddard* [1991] BCLC 1028. It is unclear how these comments are to be reconciled with the long line of authority supporting the proposition that a director's duty of care is very limited. See *Re City Equitable Fire Insurance Co. Ltd* [1925] Ch 407 at 428-9 per Romer J. and *Re Brazilian Rubber Plantations & Estates Ltd* [1911] 1 Ch 425 at 437 per Neville J.

²⁹ See section 214(4). The definition of director includes shadow director under section 214(7).

³⁰ [1988] BCLC 250. The court was concerned with section 333 of the Companies Act 1948,

established that a transfer of funds from a subsidiary to a parent was clearly a fraudulent preference and such conduct constituted a breach of the fiduciary duty owed by the director of the subsidiary.³¹ The breach of this fiduciary duty, whilst owed to the company alone, was actionable by the liquidator for the benefit of creditors of the subsidiary. This is permitted because where a company is insolvent the interests of the creditors intrude and the process of liquidation displaces the rights of shareholders and directors to deal with assets of the company.³²

It remains uncertain whether the endeavours of the courts have enhanced or complimented the statutory developments.³³ In any event, we must be careful not to overstate the role of a director's duty to creditors. During the transition from solvency to insolvency it is arguable that a director's allegiance changes to that of the creditors. However, breach of such a duty is not actionable by the creditor until the company goes into liquidation and the liquidator decides to pursue the matter. No case has turned on the nature of the duty. Moreover, much of the jurisprudence represents *obiter dicta* as the duty arises in contexts where liability is clearly based on other grounds.³⁴

Section 212 provides ample scope for the recovery of a creditor's funds in conventional circumstances. It is acknowledged that the section is merely a reflection of the common law, expediting the procedure of actions to call directors to account for their

which was a forerunner to section 212 Insolvency Act 1986.

³¹ *Ibid.*, at 252 c d.

³² *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 711 at 730 *per* Street C.J.

³³ Vanessa Finch, 'Directors Duties: Insolvency and the Unsecured Creditor' in Alison Clarke ed, *Current Issues In Insolvency Law* (London: Stevens & Sons, 1991) 87-119 at 92. See Finch's article for a clear discussion of the nature of the duty at 100ff.

³⁴ L. S. Sealy, 'Personal Liability of Directors and Officers for Debts of Insolvent Corporations: A Jurisdictional Perspective (England)' in Jacob S. Zeigel ed, *Current Developments in International and Comparative Corporate Insolvency Law* (Oxford: Clarendon Press, 1994) 485-99 at 487.

impropriety provided it sounds in a cause of action.³⁵ Currently, it is arguable that the parent subsidiary relationship is outside the legislative intention of the section because there is no clear avenue to impose liability on a parent for abuse of extra-legal control.

FRAUDULENT TRADING

Section 213 Insolvency Act 1986 is in the following terms:

(1) If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, the following has effect.

(2) The court, on the application of the liquidator may declare that any persons who were knowingly parties to the carrying on of the business in the manner above-mentioned are to be liable to make such contributions (if any) to the company's assets as the court thinks proper.

Fraudulent Trading imposes liability on those who have controlled the company's enterprise with the intention to defraud creditors. On the successful application of a liquidator and for the benefit of all creditors, the court orders the defendant to contribute to the assets of the company. Use of the words 'any persons who were knowingly parties to the carrying on of the business' overcomes the definitional restrictions found in section 212 providing a very wide scope for the provision's operation.³⁶ However, fraudulent trading represents an extreme form of conduct because proof of an 'intention to defraud creditors' is a difficult evidentiary barrier to negotiate.³⁷ *R v. Grantham*³⁸ offered a relaxation of this problem by allowing the prosecution the concession of only proving an unlikelihood of receiving payment rather than proving there was no prospect of creditors being paid. However, the courts are reluctant to relax the notion of 'intention to defraud'.³⁹ The inadequacy of fraudulent

³⁵ *Re City Equitable Fire Insurance Co. Ltd* [1925] Ch 407.

³⁶ *Re Augustus Barnett & Son Ltd* [1986] BCLC 170 at 173 f g per Hoffmann J.

³⁷ *Ibid.*

³⁸ [1984] QB 675.

³⁹ Ian F. Fletcher, *The Law of Insolvency* 2nd ed (London: Sweet & Maxwell, 1996) at 660.

trading was made very clear in *Re Sarflax Ltd.*⁴⁰ The court held that where a debtor knew or had good grounds to suspect that he would not have sufficient assets to pay all his creditors in full, the mere preference of one creditor over another did not amount to an 'intention to defraud.' Accordingly such an allegation if pursued under section 213 would undoubtedly be struck out on the ground of not disclosing any cause of action. In view of wrongful trading's existence, regulation of a parent's extra-legal control of a subsidiary concerns corporate conduct that is a lesser evil than fraud. Appropriately, we will focus in detail on the efficacy of wrongful trading as a remedy and it is unnecessary to consider section 213 any further.

*Re Augustus Barnett & Son Ltd*⁴¹ demonstrated the inadequacy of fraudulent trading to respond effectively to the nuances of the parent subsidiary relationship. A parent induced the board of a subsidiary to continue trading and also induced suppliers and creditors to continue doing business with the subsidiary. Further, there was no evidence that the board of the subsidiary had any intention to defraud. It was clear the board honestly believed that the parent would continue to support the subsidiary and without such belief the board would not have caused the company to continue to trade.⁴² It was also clear that the parent was not carrying on the business of the subsidiary.

Hoffmann J. (as he then was), aware of the inadequacies of fraudulent trading, indicated its fallibility in the circumstances. The scope of the words 'person ... parties to' in section 213 was wide enough to cover those 'outsiders' not involved in the carrying on the business in anyway; but they must have participated in a fraudulent

⁴⁰ [1979] Ch 592.

⁴¹ [1986] BCLC 170.

⁴² *Ibid.* at 172i-173b.

act.⁴³ Hoffmann J. bound by the prevailing authority for the interpretation of ‘intention to defraud’ recognised a concession:

The circumstances in which parent companies should be liable for the debts of their subsidiaries is a matter of considerable public importance and debate. It may be that the law on this subject is inadequate. To form a view would require a much wider investigation of the issues of public policy than is open to a judge hearing an interlocutory application to strike out a pleading. The only point with which I am concerned is whether s 332 [former version of section 213 Insolvency Act 1986] can form the basis for imposing liability on a parent company otherwise than as accessory to fraudulent trading by the persons who actually carried on the business of the subsidiary. In my judgement it cannot. The language of the section is clear and unambiguous.⁴⁴

In *Multinational Gas Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd & Ors*,⁴⁵ the liquidator may have obtained greater leverage over the shareholders had wrongful trading been available on the basis that they were ‘shadow directors’. Wrongful trading is potentially the greatest threat to the protection *Salomon* provides to a parent, its directors, and related entities.

WRONGFUL TRADING

Section 214 Insolvency Act 1986 is in the following terms:

(1) Subject to subsection (3) below, if in the course of the winding up of a company it appears that subsection (2) of this section applies in relation to a person who is or has been a director of the company, the court, on the application of the liquidator, may declare that that person is to be liable to make such contribution (in any) to the company’s assets as the court thinks proper.

(2) This subsection applies in relation to a person if-

(a) the company has gone into insolvent liquidation,

(b) at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and

(c) that person was a director of the company at that time;

but the court shall not make a declaration under this section in any case where the time mentioned in paragraph (b) above was before 28th April 1986.

⁴³ *Ibid.*, at 173 f g.

⁴⁴ *Ibid.*, at 173h-174a.

⁴⁵ [1983] Ch 258.

(3) The court shall not make a declaration under this section with respect to any person if it is satisfied that after the condition specified in subsection (2) (b) was first satisfied in relation to him that person took every step with a view to minimising the potential loss to the company's creditors as (assuming him to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation) he ought to have taken.

(4) For the purposes of subsections (2) and (3), the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having both-

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and

(b) the general knowledge, skill and experience that that director has.

(5) The reference in subsection (4) to the functions carried out in relation to a company by a director of the company includes any functions which he does not carry out but which have been entrusted to him.

(6) For the purposes of this section a company goes into insolvent liquidation if it goes into liquidation at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding up.

(7) In this section 'director' includes a shadow director.

(8) This section is without prejudice to section 213.

Wrongful trading offers the opportunity to address a number of significant problems in company and insolvency law. In England, scope of the term 'shadow director' predominantly remains untested. The term arguably extends to the banker - company relationship⁴⁶ and the control of a subsidiary by a parent.⁴⁷ Wrongful trading and the term 'shadow director' have the potential to resolve the controversy of a parent's responsibility for the debts of its subsidiaries. In so doing, provide a way to deal with some of the problems met in *Re Augustus Barnett & Son Ltd*⁴⁸ and *Multinational Gas Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd & Ors.*⁴⁹ Before considering the scope of the term 'shadow director' it is necessary to consider the background to wrongful trading.

⁴⁶ *Re a Company (No 005009 of 1987), ex parte Copp* [1989] BCLC 13.

⁴⁷ D. D. Prentice, 'Group Indebtedness' in Clive M. Schmitthoff and Frank Wooldridge eds, *Groups of Companies* (London: Sweet & Maxwell, 1991) at 78. See also Millet J in *Re Hydrodam (Corby) Ltd* [1994] BCC 161.

⁴⁸ *Ibid.* at n.41.

⁴⁹ *Ibid.* at n.45.

Improved creditor protection seemed an attainable goal when Professor Prentice described section 214 of the Insolvency Act ('section 214') as 'one of the most important developments in company law this century.'⁵⁰ The profession and academics perceived wrongful trading, in its legislative form, had a bright future because it promised to provide much needed protection. 'Wrongful trading' attempts to minimise the abuse of limited liability by company officers. As we have seen, under fraudulent trading an honest director could not be liable for a company's debt despite reckless, unreasonable and cavalier business practices.⁵¹ Insolvency practitioners were increasingly having difficulty establishing dishonesty under the fraudulent trading provisions.⁵² The courts demanded a strict standard of proof for fraudulent trading. Despite a prospect of recovery against directors, many cases never made it to court.⁵³ Wrongful trading by comparison is a recent development⁵⁴ that, in theory, refines the standard of a director's duty and clarifies that conduct need not be fraudulent, illegal or unconscionable to attract legislative censure. Section 214 measures a director's conduct against a minimum standard of commercial morality and competence.

Wrongful trading is the minimum threshold standard of conduct demanded from corporate controllers. Wrongful trading occurs under section 214 when it appears in a winding up that directors permitted a company to continue trading in a manner that reduced a creditor's chance of full repayment.⁵⁵ In these circumstances, a liquidator can

⁵⁰ Dan D. Prentice, 'Creditor's Interests and Director's Duties' (1990) 10 *Oxford Journal of Legal Studies* 265 at 277.

⁵¹ Cork *op. cit.*, at 399 para. 1782.

⁵² Section 213. Formerly, section 332 Companies Act 1948.

⁵³ Cork, *op. cit.*, at 398 para. 1776.

⁵⁴ Fraudulent trading was introduced as section 275 Companies Act 1929.

⁵⁵ Department of Trade and Industry. 1984. *A Revised Framework for Insolvency Law*. Cmnd 9175. (herein after cited as 'The Revised Framework') at 28 para. 52.

apply to the court for a declaration that the director or shadow director⁵⁶ knew or ought to have concluded that the company had no reasonable prospect of avoiding insolvent liquidation. Moreover, if the director did not take every reasonable step necessary to minimise the loss to creditors,⁵⁷ the court can declare the director personally liable to contribute to the assets of the company. The section 214 declaration then empowers the court to make an order disqualifying the offending director. The disqualification can prohibit that person from acting as a director or in the management of a company for a minimum of two years and a maximum of fifteen years.⁵⁸

In the next section we will examine the scope of the term ‘shadow director’ to identify conduct that predisposes a parent to such a conclusion. We will see that the courts must grapple with a number of complex substantive law problems that focus around determining what level of legitimate control can be attributed to a particular role. Even if the shadow directorship issue is resolved in favour of including parent companies the legislative context of wrongful trading, and the judicial response have fundamental flaws that negate its effective use as a remedy.⁵⁹

⁵⁶ Section 214(7).

⁵⁷ *Re Produce Marketing Consortium Ltd (No 2)* [1989] BCLC 520.

⁵⁸ Section 10 of the Company Directors Disqualification Act 1986.

⁵⁹ R. C. Schulte, ‘Wrongful Trading: An Impotent Remedy?’ (1996) 4 *Journal of Financial Crime* 38.

A Parent as the Shadow Director of a Subsidiary

Section 251 of the Insolvency Act 1986 defines 'shadow director' in the following terms:

'shadow director', in relation to a company, means *a person in accordance with whose directions or instructions the directors of the company are accustomed to act* (but so that a person is not deemed a shadow director by reason only that the directors act on advice given by him in a professional capacity). (emphasis added)

Section 741 Companies Act 1985 offers a definition in the same terms, but sub-section (3) provides:

For the purposes of the following provisions of this Act, namely -

section 309 (directors' duty to have regard to interests of employees),
section 319 (directors' long-term contracts of employment),
sections 320 to 322 (substantial property transactions involving directors),
section 322B (contracts with sole members who are directors), and
sections 330 to 346 (general restrictions on power of companies to make loans, etc., to directors and others connected with them),

(being provisions under which shadow directors are treated as directors), a body corporate is not to be treated as a shadow director of any of its subsidiary companies by reason only that the directors of the subsidiary are accustomed to act in accordance with its directions or instructions.

This means that a parent is not a *shadow* for the purposes of the stated sections.

'Shadow director' consists of a number of inclusive threshold tests that require negotiation before a court can make a declaration. Broadly, the scope of the definition was first considered in *Re a Company (No 005009 of 1987), ex parte Copp*.⁶⁰ A company had traded profitably for a number of years until it had lost its major customer. The bank overdraft then reached its acceptable limit. The company's bank subsequently commissioned a report into the company's affairs and at the same time

⁶⁰ [1989] BCLC 13.

began to exert pressure for security to cover the overdraft. The court correctly inferred that the company was in 'low financial water'.⁶¹ The directors took various steps to implement the several recommendations contained in the report. The liquidator alleged that in so doing, the company acted according to the bank's directions and instructions and the actual directors did not exercise any free will in the direction of the company's affairs.⁶² Furthermore, compliance by the company and its directors with the report's recommendations made the bank a 'shadow director'. The reason for this being that the bank was aware at an early stage that the company was insolvent with no prospect of avoiding liquidation.⁶³ The bank applied to have the action struck out. Knox J. accepted that a bank could be a shadow director under section 214 because such a proposition was not 'obviously unsustainable'.⁶⁴

Whilst Knox J. gave little elucidation of how the definition would apply to a bank, the case sparked concern and demonstrated that the scope of section 214's operation remained uncharted territory. Our concern is how and when the definition of a shadow director will extend to a parent and related entities, such as directors of other subsidiaries. Primarily, the issue is, what conduct above and beyond the exercise of a parent's legitimate extra-legal control justifies a determination of shadow directorship.

In *Re Unisoft Group (No 3)*,⁶⁵ Harman J. in considering the propriety of an allegation that a certain person was a 'shadow director' under section 741(2) Companies Act 1985 stated:

⁶¹ *Ibid.*, at 18 d.

⁶² *Ibid.*, at 15 e f.

⁶³ *Ibid.*, at 18 e f.

⁶⁴ *Ibid.*, at 21 a b.

⁶⁵ [1994] 1 BCLC 609.

In my view, ... the shadow director must be, in effect, the puppet master controlling the actions of the board. The directors must be (to use a different phrase) the 'cat's paw' of the shadow director. They must be people who act on the directions or instructions of the shadow director as a matter of regular practice. That last requirement follows from the reference in the subsection to the directors being 'accustomed to act'. That must refer to acts not on one individual occasion but over a period of time and as a regular course of conduct.

In my view, there can be no way in which the acts of any one of several directors of a company in complying with the directions of an outsider could constitute that outsider a shadow director of that company. Of course, if the board of the company be one person only and that person is a 'cat's paw' for an outsider, the outsider may be the shadow director of that company. But ... with a multi-member board, unless the whole of the board, or at the very least a governing majority of it - in my belief the whole, but I need not exclude a governing majority - are accustomed to act on the directions of an outsider, such an outsider cannot be a shadow director. Further, there must be, as I say, more than one act and a course of conduct.⁶⁶

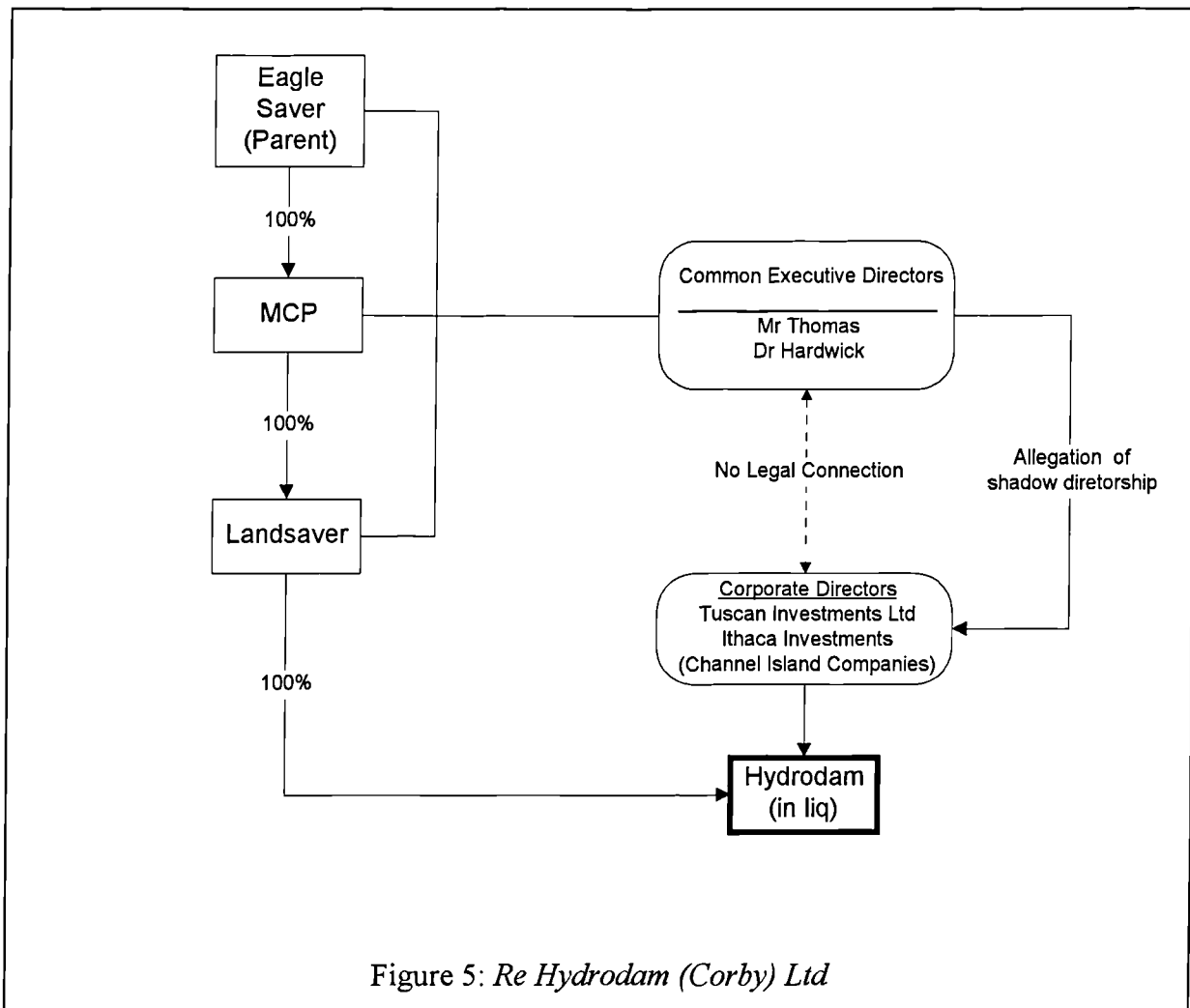
According to Harman J. the shadow director must be a controller of the board. To establish this first, the actual directors must as a matter of practice follow the shadow director's direction. Second, the directors must do so on more than one occasion as a course of regular conduct. Recent authority confirms that a parent falls within the ambit of the term 'shadow director'.

In *Re Hydrodam (Corby) Ltd*,⁶⁷ a parent ('Eagle Trust') wholly owned a subsidiary ('MCP'), which in turn wholly owned a subsidiary ('Landsaver'). Landsaver, in turn, wholly owned a subsidiary called Hydrodam (Corby) Ltd ('Hydrodam'). Hydrodam had two Channel Island corporate directors. The parent had approximately nine directors divided into executive and non-executive directors. The executive directors were directors of MCP and Landsaver but not Hydrodam. Hydrodam went into liquidation. The liquidator brought proceedings against two of the parent's directors

⁶⁶ *Ibid.*, at 620 e i.

⁶⁷ [1994] 2 BCLC 180.

(Thomas and Dr Hardwick) alleging they were de facto or shadow directors in connection with the affairs of Hydrodam.



For Millett J., ‘shadow director’ extends responsibility for wrongful trading to those who were able to prevent damage being done to creditors by taking proper steps to protect their interests. Accordingly, the imposition of liability cannot depend upon the validity of a person's appointment. Rather, the court must visit persons who assume to act as directors, exercising the powers and functions incumbent with the responsibilities of the office.⁶⁸ Notably, the terms de facto and shadow director are not

⁶⁸ *Ibid.*, at 182 d e.

interchangeable.⁶⁹ The distinction is an important one as a parent may fall into either category. Conduct which qualifies a person as a de facto director is overt.

A de facto director is a person who assumes to act as a director. He is held out as a director by the company, and claims and purports to be a director, although never actually or validly appointed as such. To establish that a person was a de facto director of a company it is necessary to plead and prove that he undertook functions in relation to the company which could properly be discharged only by a director. It is not sufficient to show that he was concerned in the management of the company's affairs or undertook tasks in relation to its business which can properly be performed by a manager below board level.⁷⁰

Admittedly, a parent would only be a de facto director in limited circumstances. It is more probable that a parent be categorised as a shadow director.

A shadow director, by contrast, does not claim or purport to act as a director. On the contrary, he claims not to be a director. He lurks in the shadows, sheltering behind others who, he claims, are the only directors of the company to the exclusion of himself. He is not held out as a director by the company. To establish that a defendant is a shadow director of a company it is necessary to allege and prove: (1) who are the directors of the company, whether de facto or de jure (2), that the defendant directed those directors how to act in relation to the company or that he was one of the persons who did so; (3) that those directors acted in accordance with such directions; and (4) that they were accustomed so to act. What is needed is first, a board of directors claiming and purporting to act as such; and secondly, a pattern of behaviour in which the board did not exercise any discretion or judgement of its own, but acted in accordance with the directions of others.⁷¹

In *Hydrodam*, the liquidator alleged that a director of the parent was a shadow director of a fourth tier subsidiary. For Millet J., such a connection alone was distantly insufficient because the director owed fiduciary and other duties to the parent. It did not follow that he ever gave instructions to the directors of the subsidiary or that the

⁶⁹ Followed in *Secretary of State for Trade and Industry v. Laing* [1996] 2 BCLC 324, (ChD) at 338 j *per* Evans Lombe J. In *Re Tasbian Ltd (No 3) Ltd* [1991] BCLC 792, (ChD) at 802 *de per* Vinelott J., the terms were thought to be interchangeable.

⁷⁰ *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180 at 183 a c.

⁷¹ *Ibid.*, at 183 c e.

subsidiary's directors customarily acted on his instructions.⁷² Millett J., *obiter*, considered if the directors of a parent gave directions to the directors of a subsidiary and they customarily acted in compliance then the result constituted the parent, but not the parent's directors, a shadow director of the company.⁷³ The directors would simply be acting as agents for or as an organ of the parent. Millett J. contends that parental directors are not *ipso facto* shadow directors of a subsidiary except where the subsidiary's board devolves its discretion regularly by acting according to directions emanating from the parent. This is difficult to reconcile with the proposition that a parent can legitimately, and often does, exercise complete dominion over a subsidiary. Yet, such a degree of control which is in line with normal business practice arguably should not implicate the parent as shadow director of a subsidiary. Arguably, the court is only concerned with the finding that a parent is a shadow director where there has been an abuse of extra-legal control to the detriment of third parties who have entered into legal relations with the subsidiary. There are very few cases from which we can derive the response of the courts. Recent Australian and New Zealand cases provide guidance. Amongst a number of complex issues dealt with by Finn J. in the Australian Federal Court decision of *Australian Securities Commission v. AS Nominees Ltd.*⁷⁴ included the scope of the term 'director'.⁷⁵ Just as Millett J. in *Hydrodam*, Finn J. sought to identify the locus of the board's decision making. Finn J. has added a dimension to the analysis by looking for criteria that might vitiate the legitimacy of the decision making process through external influences.

⁷² *Ibid.*, at 184 c d.

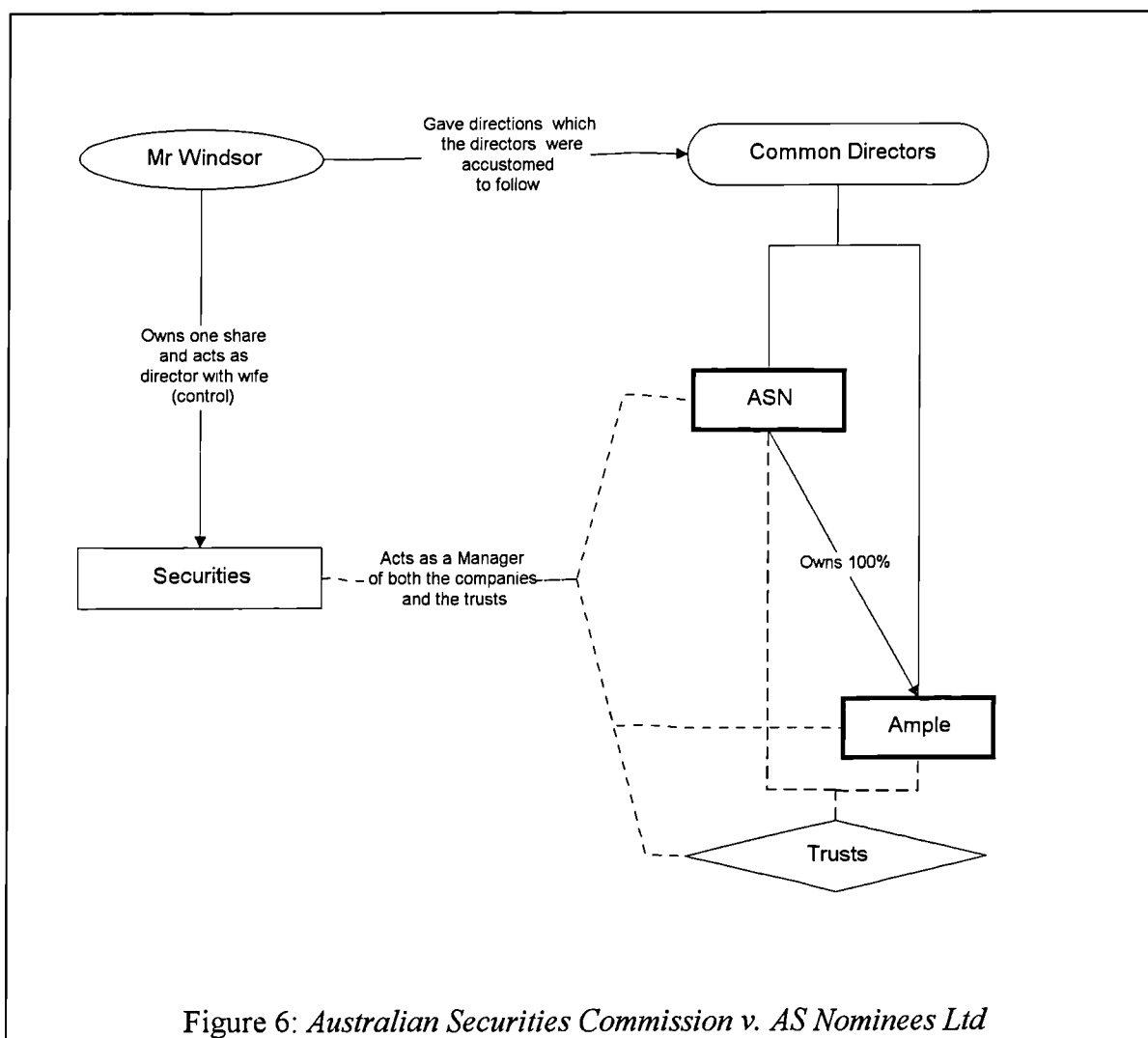
⁷³ *Ibid.*, at 184 c g.

⁷⁴ (1995) 18 ACSR 459.

⁷⁵ Section 60(1)(b) Australian Corporations Law provides that the term 'director' includes, 'a person in accordance with whose directions or instructions the directors of the [company] are accustomed to act'.

In *AS Nominees*, the Australian Securities Commission ('ASC') sought to wind up three related group companies. Without delving into the facts of the entire case, the group was founded by Windsor. Two of the companies, AS Nominees Ltd ('ASN') and Ample Funds Ltd ('Ample'), were trustees of various superannuation and unit trusts with a common board of directors. Importantly, Windsor was not a director of either of these companies. Finn J. described his relationship with the group as a 'strategic presence'.⁷⁶ Windsor and another group company each held one share in a third company, AS Securities Pty Ltd ('Securities'). Securities, was directly controlled by Windsor, and acted as manager of ASN and Ample as well as the trusts under their control. Diagrammatically:

⁷⁶ (1995) 18 ACSR 459 at 462.



The allegations included, that: (i) ASN and Ample were run at the direction of, and in some circumstances for the benefit of, Windsor and his interests; (ii) the common directors demonstrated little appreciation both of their own responsibilities as directors and of the trusteeship obligations of their companies, with the consequence that repeated breaches of the Corporations Law section 232⁷⁷ and regular breaches of trust

⁷⁷ Section 232 Corporations Law is in the following material terms:

232(2) [Officer to act honestly] An officer of a corporation shall at all times act honestly in the exercise of his or her powers and the discharge of the duties of his or her office.

232(4) [Care and diligence] In the exercise of his or her powers and the discharge of his or her duties, an officer of a corporation must exercise the degree of care and diligence that a reasonable person in a like position in a corporation would exercise in the corporation's circumstances.

232(5) [No improper use of inside information] An officer or employee of a corporation, or a former officer or employee of a corporation, must not, in relevant circumstances,

had occurred; and (iii) trust funds had been invested recklessly and improvidently often in circumstances of blatant conflict of interest or of partiality.⁷⁸

As Windsor was not a director of either ASN or Ample, the issue was whether his actions as the director of the management company went beyond the acceptable legitimate limits. Was Windsor a shadow director in relation to both companies? The consequences of such a determination were drastic. The imposition of all the incumbent obligations of directors found in the Corporations Law.⁷⁹ Windsor derived legitimacy for much of his conduct through his position as a director of the management company. With Windsor's position came a degree of justifiable influence. The ASC alleged that he was the moving force behind the boards, indeed that the boards of each company were mere accessories in the pursuit of his ends.⁸⁰ Of course, it was admitted that Windsor had influence upon the boards actions; but this was no more than the manifestation of his role as a director of the management company. Accordingly, Windsor defended his conduct as 'advice given by (him) in the proper performance of the functions attaching to ... (his) business relationship with the directors'⁸¹ This is the

make improper use of information acquired by virtue of his or her position as such an officer or employee to gain, directly or indirectly, an advantage for himself or herself or for any other person or to cause detriment to the corporation.

232(6) [No gain by improper use of position] An officer or employee of a corporation must not, in relevant circumstances, make improper use of his or her position as such an officer or employee, to gain, directly or indirectly, an advantage for himself or herself or for any other person or to cause detriment to the corporation.

⁷⁸ *Australian Securities Commission v. AS Nominees Ltd* (1995) 18 ACSR 459 at 463.

⁷⁹ *Supra*, n 77.

⁸⁰ *Australian Securities Commission v. AS Nominees Ltd supra*, at 508.

⁸¹ *Ibid.*, at 508. Section 60(2) Corporations Law provides:

A person shall not be regarded as a person in accordance with whose directions or instructions:

(a) a body's directors; or

(b) the members of the board of a body incorporated or formed outside Australia;

are accustomed to act merely because the directors or members act on advice given by the person in the proper performance of the functions attaching to the person's professional capacity or to the person's business relationship with the directors or the members of the

Australian version of the proviso 'that a person is not deemed a shadow director by reason only that the directors act on advice given by him in a professional capacity'.

Windsor's position in relation to ASN and Ample required Finn J. to determine the extent of his legitimate legal control and legitimate extra-legal control. Rather than a detailed analysis of each element in the definition of shadow director, Finn J. globally interpreted the terms as asking, 'Where is the locus of control?' Windsor had a degree of legitimate control or influence over the board via the management agreement. What qualities gave Windsor's purported legitimate managerial conduct the character of illegitimacy? We can conveniently deal with this under the ambit of 'accustomed to act' and 'directions or instructions'.

Sufficient evidence existed of the director's willing compliance, being 'accustomed to act' with Windsor's instructions. Earlier in his judgement, Finn J. found that Windsor induced or procured a range of transactions that constituted or resulted in breaches of trust, bringing Ample to the verge of financial disaster. In addition, the directors of ASN and Ample acted without due deliberation (and in some cases recklessly so) by entering transactions introduced by Windsor. Further, the directors acted in transactions involving Windsor's interests in ways calculated to protect or advance his interests. There were also examples of Windsor's abnormal degree of control over the boards of directors. On one occasion Windsor sacked the entire board of Ample after a disagreement with them. Obviously, no formal authority rested with Windsor in the

management agreement between the companies to do so, but the dismissed directors did not question his power to remove them.⁸²

Finn J. made a number of basic points about 'directions and instructions'. First, the directors did not always and for all purposes act entirely as Windsor's puppets; without exercising any discretion at all in company matters.⁸³ Second, the case was not one where the board acted in the manner of nominee directors who unduly favour the interests they represent.⁸⁴ Third, the 'directions and instructions' did not encompass all board decisions.⁸⁵ In summary, Finn J. described Windsor's relationship with the boards of ASN and Ample as 'primarily of a strategic character'. His control was such that it 'defined the context in which the companies ... operated' and 'it ... contrived the transactions of significance in which they were to be involved.' In those instances where Windsor played a role, the boards of either company devolved all their independence.⁸⁶

AS Nominees is a particularly important case concerning the exercise of a parent's extra-legal control over a subsidiary. The facts demonstrate a corporate and transactional structure designed to give Windsor control of assets and trusts of companies through the formal or 'professional' role as a manager. Practically this, no doubt, dispensed with the need of Windsor to refer all managerial matters to the board of each company. The rationale being that any advice given in this capacity gained the benefit of the words 'advice given by the person in the proper performance of the

⁸² *Ibid.*, at 508.

⁸³ *Ibid.*, at 509. Cf *Selangor United Rubber Estates v. Cradock* (1968) 1 WLR 1555 at 1577-1578.

⁸⁴ *Ibid.*, at 509. See *Scottish Co-operative Wholesale Society Ltd v. Meyer* (1959) AC 324 and also *Berlei Hestia (NZ) Ltd v. Fernyhough* (1980) 2 NZLR 150.

⁸⁵ *Ibid.*, at 509.

functions attaching to the person's professional capacity or to the person's business relationship' in section 60 *Corporations Law* – or the 'professional advisor' defence. However, Windsor made too much of this, as a formal management relationship usually defines the extent of control.

When compared, Windsor's legal relationship with Ample and ASN was much more remote than the ordinary parent and subsidiary. Windsor held no shares in either Ample or ASN. A parent's shareholding - the notion of ownership - is pivotal to the proposition that a parent can exercise complete dominion and control over a subsidiary. The courts extend with legal ownership of shares a component of legitimate extra-legal control. Consequently, without the legal relationship, justification for extra-legal control is flawed. It is fair to say that the role of director of a management company carries with it no legitimate component of extra-legal control; all power to control must be directly referable to the management agreement. Whilst the management agreement defined the degree of legitimate management control extended to Windsor and Securities; clearly, Windsor's conduct demonstrated an overbearing power to influence the directors of ASN and Ample. The problem was that the level of control went not only beyond control that would be legitimately referable to a management agreement but, potentially, also beyond legitimate extra-legal control referable to the prerogatives of share ownership.

This raises the interesting question of whether a parent exercising Windsor's degree of 'strategic intervention' over a subsidiary would be a 'shadow director'. In the alternative, what difference would it have made to the case if Windsor had been beneficially entitled to all the shares in ASN and Ample? 'Absolute control' of a

⁸⁶ *Ibid.*

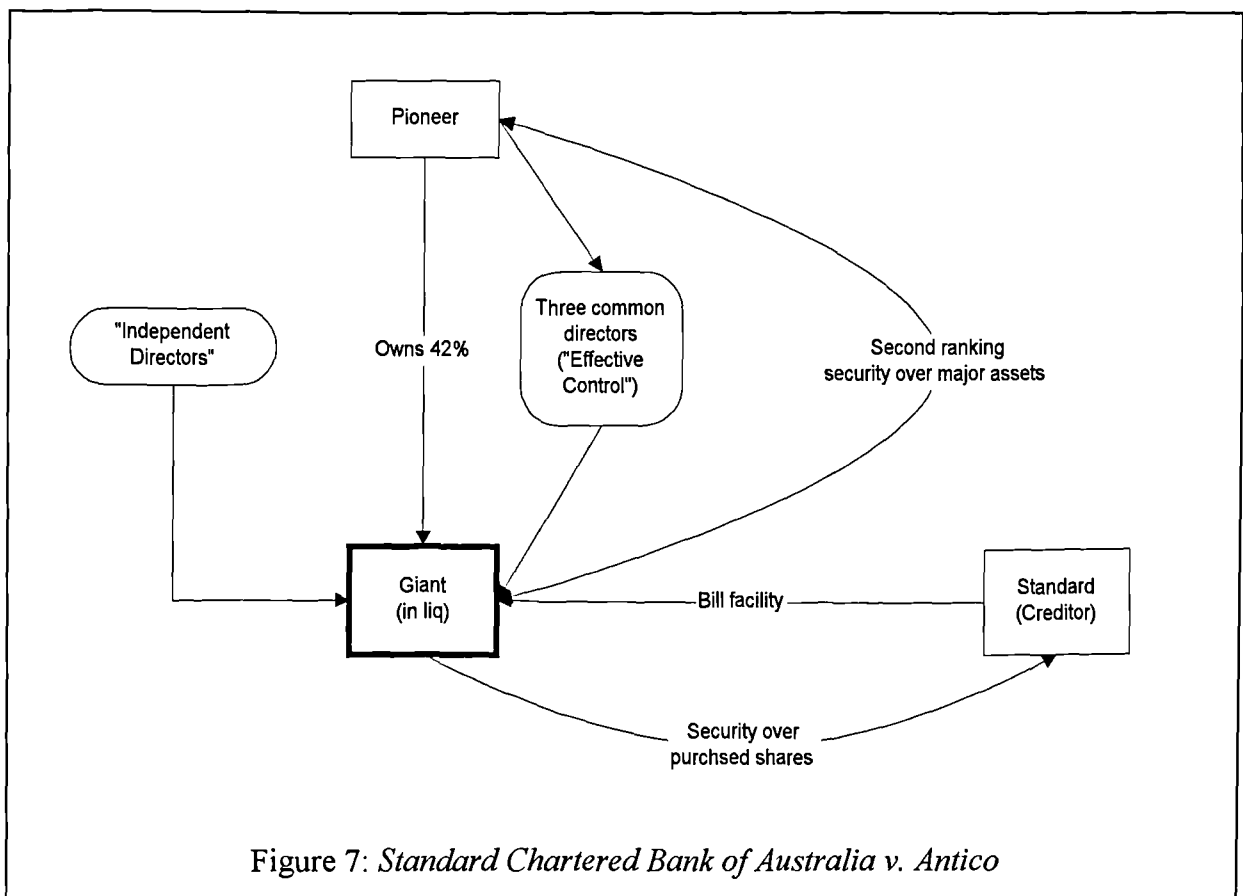
subsidiary provides a parent with a vast array of permissible conduct such that illegitimate conduct has a very high threshold. It may well be that the notion of 'strategic intervention' proposed by Finn J. is a lesser standard than 'absolute control'. Presently, a parent via the prerogatives of share ownership and the notion of extra-legal control is permitted a wide range of conduct that has a strategic character. It is submitted that exercise of control 'with a strategic character' alone – without some evidence of malafides is insufficient to amount to an abuse of a parent's legitimate extra-legal control.

In *AS Nominees*, there was no evidence of independent directors on the boards of either company. The question the case leaves unanswered is, how Windsor's position or a parent's position would have varied had there been independent directors?⁸⁷ Here we will direct our attention to the meaning of words 'directors of the company'. In particular, do the directions or instructions given by the shadow director to members of the board have to command the entire board? Further, does the existence of an independent director remove the risk of finding a shadow director?

In *Standard Chartered Bank of Australia v. Antico*,⁸⁸ the relevant facts included, Pioneer International Ltd ('Pioneer') held 42% of Giant Resources Ltd ('Giant'). Giant entered into a bill discount and acceptance facility with Standard Chartered Bank Australia Ltd ('Standard') to finance the purchase of shares in another company. Standard held the shares Giant purchased as the only security. Two other banks held security over the majority of Giant's assets. The bill facility was rolled over and re-negotiated on a number of occasions during 1989 and 1990. Giant's financial position

⁸⁷ We will recall Harman J's comments in *Re Unisoft Group (No 3)* discussing the difficulty of a shadow director existing on a multimember board. *Supra*, on page 202.

began to deteriorate. Pioneer through three representative directors on Giant's board provided funding on an increasing basis. Pioneer concerned about its increasing exposure sought and obtained a second ranking security over the majority of Giant's assets. Giant's board had an obligation to convey this information to Standard. Standard alleged that Pioneer's involvement caused Giant to make a number of breaches of the security. In particular, that Pioneer was a shadow director of Giant for the purpose of imposing liability for insolvent trading under section 556 of the Companies (Qld) Code.⁸⁹



⁸⁸ (1995) 18 ACSR 1.

⁸⁹ Predecessor of sections 592 and 588G Corporations Law.

Hodgson J. made a number of findings concerning the relationship between Pioneer and Giant. First, Pioneer had ‘effective legal control’ of Giant because of its shareholding. Moreover, Giant’s annual report admitted Pioneer’s control.⁹⁰ Second, Pioneer imposed financial reporting requirements on Giant such that it was to report monthly to and provide free access to all financial records.⁹¹ Third, there was evidence that Pioneer’s views delayed the acquisition of certain property and influenced the Giant board concerning finance arrangements.⁹² Fourth, Pioneer exercised management and financial control. Pioneer made the provision of finance conditional upon a number of changes in management. This included: the instruction of particular outside consultants, and the restructure of Giant’s board to give Pioneer three directorships, one being the chair.

Hodgson J. reviewed the decision in *Kuwait Asia Bank E.C. v. National Mutual Life Nominees Ltd*,⁹³ following the view that ‘interference’ enabled the imposition of liability on a parent for the actions of a director. The extended definition of director (that is, the notion of a shadow director) does not apply where only two out of five directors are alleged to be accustomed to act on the instruction of the parent. There were however a number of features that made this case different.

I accept that a holding company is not a director of its subsidiaries, merely because it has control of how the boards of its subsidiaries are constituted; that, it is not uncommon for lenders to impose conditions on loans, including conditions as to the application of funds and disclosure of the borrower’s affairs; and that it is even less uncommon for lenders to require security for a loan, and then to require the sale of property over which the security is given. Certainly, these factors on their own would not amount to assuming the position of a director, or taking part in the management of a borrower company.

⁹⁰ (1995) 18 ACSR 1 at 67.

⁹¹ *Ibid.*

⁹² *Ibid.*, at 67-68.

⁹³ [1991] 1 AC 187.

However, the circumstances in this case go far beyond these matters. In my view, the conditions imposed following the decision to fund Giant in March 1989 show a willingness and ability to exercise control, and an actuality of control, over the management and financial affairs of Giant. In my view also, the decision as to how Giant was to be funded by Pioneer, and as to the taking of security was never the subject of careful consideration by the Giant board, but was accepted by the Giant board as something necessary or as a *fait accompli*.
...

These matters were given careful consideration by [the three directors], *but the consideration which they gave was in the context of reports to and decisions by the Pioneer board, and so, in my view, was given by them as directors of Pioneer.*⁹⁴

Hodgson J. also saw that the directors were not accustomed to act in every instance but rather they did not carefully consider the interests of Giant on 'strategic' matters. Consequently, the use of the terminology is not absolute. The words 'directors of the company' does not imply all the directors of the company as was suggested in *Kuwait*. Rather, as Harman J. suggested in *Re Unisoft Group (No 3)*,⁹⁵ it can be either the whole of a multi-member board or the governing majority of it. Indeed, it is counter-intuitive to suggest that a person could manipulate a majority of a board of directors despite the presence of independent directors and is at odds with the rationale of the shadow director definition as suggested by Millett J. in *Re Hydrodam (Corby) Ltd*⁹⁶ and Finn J. in *Australian Securities Commission v. AS Nominees Ltd*.⁹⁷

In *Re Hydrodam (Corby) Ltd*,⁹⁸ the court did not perceive the nature of 'directions or instructions' as contentious, except if it was necessary to identify the correct party giving the orders. The same attitude prevailed in *Re PFTZM Ltd (in liquidation)*.⁹⁹ The

⁹⁴ *Standard Chartered Bank of Australia v. Antico* (1995) 18 ACSR 1 at 70.

⁹⁵ [1994] 1 BCLC 609.

⁹⁶ [1994] 2 BCLC 180 at 182 d.

⁹⁷ (1995) 18 ACSR 459.

⁹⁸ [1994] 2 BCLC 180.

⁹⁹ [1995] 2 BCLC 354.

Court demonstrated that there must be a causal connection between the direction and the regular practice of compliance to bring the direction into the scope of the definition. In *Re PFTZM Ltd (in liquidation)*, a company had obtained finance from Humberclyde Finance Group Ltd ('Humberclyde'). In January 1991, the directors informed Humberclyde that the profits of the company were not sufficient to cover the finance repayments. Following this event, the managing director of the company and officers of Humberclyde held weekly management meetings. The combined meetings arranged that all receipts of the company be paid into an account in the name of Humberclyde. The company's financial position deteriorated and it went into liquidation in March 1993. One issue concerned whether the Humberclyde officers were shadow directors. Judge Paul Baker QC drew a distinction between the directions proffered by a shadow director and the Humberclyde officers.

This definition [of 'shadow director' in section 251 Insolvency Act 1986] is directed to the case where the nominees are put up but in fact behind them strings are being pulled by some other persons who do not put themselves forward as appointed directors. In this case the involvement of the applicants here was thrust upon them by the insolvency of the company. They were not accustomed to give directions. The actions they took, as I see it, were simply directed to trying to rescue what they could out of the company using their undoubted rights as secured creditors.¹⁰⁰

That Humberclyde were acting in defence of their interests did not mean that the directors were accustomed to act according to the directions of the Humberclyde officers. Rather, faced with a threatened default of a debtor, Humberclyde's role as a creditor permitted it to make terms for the extension of credit with PZFTM. It was a matter for the company's directors to take the offer or leave it.¹⁰¹

¹⁰⁰ *Ibid.*, at 367 c d.

¹⁰¹ *Ibid.*, at 368 g h

Thus, it is possible for a bank to be a 'shadow director' in line with the views expressed in *Re a Company (No 005009 of 1987), ex parte Copp*.¹⁰² However, the threshold of issuing 'directions or instructions' to a compliant board must also be overcome. The definition seems to cope adequately with the situation where the potential shadow director acts in a single capacity toward the board. For instance, we can differentiate between *Australian Securities Commission v. AS Nominees Ltd*¹⁰³ and *Re PFTZM Ltd (in liquidation)*¹⁰⁴ as in the latter it was clear that whilst formal directions were given by the financier, it was very much a 'one off'. The directors demonstrated independence and were not accustomed to act in accordance with the financier's directions. Whereas, in the former, Windsor's involvement in giving directions and instructions was pervasive and strategic. In both cases a defined role is fulfilled; Humberclyde a financier and Windsor, the director of a management company.

The comparison of these two cases also permits differentiation between the legitimate exercise of prerogatives inherent in the *provision of* a resource, such as, finance and prerogatives attaching to the *use of* a resource, such as, a particular asset. As previously submitted in the context of *AS Nominees*, the prerogatives of ownership attaching to shares include a component of legitimate extra-legal control. Humberclyde's intervention to protect its security was the legitimate exercise of a prerogative inherent in the *provision of* a resource (finance) to PZFTM. In *AS Nominees*, Windsor sought to exercise prerogatives beyond those legitimate in the *use of* a resource (shares). Windsor was only equipped with the authority of a management agreement that gave a number

¹⁰² [1989] BCLC 13.

¹⁰³ (1995) 18 ACSR 459.

¹⁰⁴ [1995] 2 BCLC 354.

of legitimate prerogatives in the *provision of* a resource (management services) to each of the companies.

Such an analysis is convenient where we consider only one role and relationship as the basis for the legitimacy of the prerogatives exercised. The court's difficulty will occur in differentiating between directions and instructions a parent issues while occupying a multiplicity of roles. Further, in a corporate group, directions and instructions from a parent to a subsidiary may not have the formality of a parent resolving to have one of its directors give instructions to a subsidiary as was suggested by Millet J. in *Re Hydrodam (Corby) Ltd.*¹⁰⁵

A parent may with extra-legal control (not unlike that used by Windsor in *AS Nominees*) exercise power over the board of a subsidiary. If a parent occupies a number of positions such as shareholder, financier and perhaps even as a manager we can see a blurring of the directions given in discrete roles over a multiplicity of situations. Clearly, when looked at as a whole, the collection of directions evidence a strategic role for the parent with the subsidiary. Separately though, the directions given by the parent, in a particular capacity may be only a 'one off'. For example, the board of a subsidiary is not accustomed to act in accordance with a parent's directions as a financier, but the subsidiary does so as a requirement of the security documentation. Finn J. in *Australian Securities Commission v. AS Nominees Ltd.*¹⁰⁶ demonstrated a willingness to recognise a multiplicity of influences when he said:

This finding [that Windsor was a director of both ASN and Ample within the terms of section 60(1)(b) of the Corporations Law] does not, in my opinion, require it to be shown that formal directions or instructions were given in those

¹⁰⁵ [1994] 2 BCLC 180.

¹⁰⁶ (1995) 18 ACSR 459.

matters in which [Windsor] involved himself. The formal command is by no means always necessary to secure, as of course, compliance with what is sought.¹⁰⁷

*Dairy Containers Ltd v. N.Z.I. Bank Ltd*¹⁰⁸ linked the issue of directions and instructions to the capacity a person is exercising at the time. The liquidator alleged that the parent NZDB fell within the extended definition of director because it had control over two employee directors of its subsidiary, DCL. Thomas J. drew a distinction between the capacity of the two directors of DCL *qua* directors and their capacity as employees of NZDB. Upon this basis the employees fell outside the 'shadow director' definition.

As employees of NZDB I do not doubt that they were accustomed to act in accordance with their employer's directions or instructions, but as directors of DCL they did not as a matter of fact receive directions or instructions from the parent company. They were, as directors of DCL, standing (or sitting) in the shoes of NZDB at the board table, but they had not and did not receive directions or instructions from their employer. Even when a firm instruction from NZDB was made, it was directed at the company and not at the directors. As I pointed out to [counsel], his argument would mean that [each of the individuals] would, in their capacity as employees of NZDB, need to give themselves directions or instructions in their capacity as directors of DCL and, then, still in that capacity, be accustomed to carry them out. The artificiality of such an argument is plain to see. It would necessitate accepting a fiction which the law would do well to avoid.

No fiction or artificiality is involved, however, in regarding the directors of DCL as employees of NZDB acting in the course of their employment, for that is precisely what they were doing. But that does not mean that in carrying out their duties as directors of DCL they were acting on the directions or instructions of NZDB as contemplated in the statutory definition. As its employees, NZDB delegated the responsibility of running the company in its interests to them. But it did not give them identifiable directions or instructions as such.¹⁰⁹

¹⁰⁷ *Ibid.*, at 509.

¹⁰⁸ [1995] 2 NZLR 30. Section 2 of the New Zealand Companies Act 1955 (as amended) provides that the term 'director' includes 'a person in accordance with whose directions or instructions the persons occupying the position of directors of a company are accustomed to act' Section 126 Companies Act 1993 (NZ) contains the same provision.

¹⁰⁹ *Ibid.*, at 91 (lines 5-25)

To make any allegation of wrongdoing good it must be shown that separately the person's actions constituted themselves as shadow directors.¹¹⁰ The procedure of extending the definition of a shadow director to the parent will strike difficulties. This has already been demonstrated in the use of the term de facto director. In *Re Richborough Furniture Ltd*¹¹¹ Timothy Lloyd QC sitting as a deputy judge of the Chancery Division stated,

It seems to me that for someone to be made ... a de facto director, the court would have to have clear evidence that he had been either the sole person directing the affairs of the company (or acting with others all equally lacking in a valid appointment ...) or, if there were others who, were true directors, that he was acting on an equal footing with the others in directing the affairs of the company. *It also seems to me that, if it is unclear whether the acts of the person in question are referable to an assumed directorship, or to some other capacity such as a shareholder or, as here, consultant, the person in question must be entitled to the benefit of the doubt.*¹¹² (emphasis added)

Given the courts strict adherence to the duties and obligations attached to a particular role, it may prove difficult to show that a parent is acting as a shadow director. The parent's conduct may be characterised as the legitimate exercise of a shareholder's rights or action taken to protect its investment in the subsidiary – the prerogatives of ownership. A decisive feature would appear to be the presence of independent directors and whether they have any influence over the board's decisions. There was no evidence of independent directors in *AS Nominees* whereas in cases like *Dairy Containers* and *Kuwait* it was crucial. The 'irregular' case on this basis is *Antico*. The conclusion that Pioneer was a shadow director is distinguishable. Pioneer went beyond the role of either a shareholder or a financier. It took steps to avail itself of information concerning the accounts and imposed its management team on Giant. However, given the

¹¹⁰ *Secretary of State for Trade and Industry v. Laing* [1996] 2 BCLC 324 at 339 a per Evans-Lombe J.

dogmatism of the courts to adhere to the roles of companies acting in a number of capacities it seems unlikely a 'cross pollination' of roles will occur to provide the necessary strategic element. Finn J. in *AS Nominees* correctly sought to widen the scope of 'directions' to include extra legal control by a shareholder but the reasoning will need to overcome the sheer weight of company law authority before it is a view accepted in other courts.¹¹³

'Professional Capacity?'

The gloss placed on the notion of shadow director is that a person is not deemed a shadow director by reason only that the directors act on advice given by him in a professional capacity. Indeed, the dividing line between the position of a 'watch-dog' or advisor imposed by an outside investor and a shadow director is difficult to draw.¹¹⁴ Accordingly, just as an individual can occupy the role of shareholder and also perform a advisory role other than that of a director, a parent can do likewise. Parental conduct being characterised as either a financier, shareholder, or advisor. This raises the question of whether a parent could gain a blanket immunity from the imposition of a shadow directorship by entering into a formal consultancy agreement with a subsidiary. Such an agreement could 'soak up' the parent's conduct that falls outside its role as a shareholder or financier. Such a proposition would also erode the notion that the subsidiary's directors were 'accustomed to act' on the shadow's directions. The better

¹¹¹ [1996] 1 BCLC 507.

¹¹² *Ibid.*, at 524.

¹¹³ Finn J. makes the comment that his decision owes more to Equity than Company Law. *Australian Securities Commission v. AS Nominees Ltd* (1995) 18 ACSR 459 at 463.

¹¹⁴ *Re Tasbian Ltd (No 3), Official Receiver v. Nixon* [1993] BCLC 297, (CA), (CA) *per* Balcombe L.J. at 303 b.

view is that the role of a parent as a profit taker or owner of a subsidiary is at odds with the conception of the parent as an advisor.

There is a more plausible alternative available. If we recall that Millett J. in *Re Hydrodam (Corby) Ltd*¹¹⁵ placed the qualifier that a shadow directorship manifests only where there is 'a pattern of behaviour in which the board *did not exercise any discretion or judgement of its own*, but acted in accordance with the directions of others'.¹¹⁶

Academic's raise concern that the qualifier will defeat wide usage of the shadow directorship. All a subsidiary need do to extend protection to the alleged shadow, is recite that the board had considered the advice of the alleged shadow and decided to follow it.¹¹⁷ As each director has a duty to consider each resolution placed before a board meeting Millett J. merely states the obvious; as inherent in the action of blindly following a direction is the absence of discretion or judgement. It is also somewhat facile to suggest that a court in the face of inconsistencies and evidence of 'strategic external decision making' as suggested in *AS Nominees*, would not question the legitimacy of resolutions to follow 'advice'.

Bearing the above in mind, it would appear that there is some scope for wrongful trading to be an effective remedy in the context of the parent subsidiary relationship. Regrettably, the reality is more problematic. Despite being the primary avenue of recourse available to the creditor of a subsidiary against a parent for the debts of its

¹¹⁵ [1994] 2 BCLC 180.

¹¹⁶ *Ibid.*, at 183 e.

¹¹⁷ See Perlie M. C. Koh, 'Shadow Director, Shadow Director, Who Art Thou?' (1996) 14 *Companies and Securities Law Journal* 340 at 344 and N. R. Campbell, 'Liability as a Shadow Director' (1994) *Journal of Business Law* 609 at 613.

subsidiary wrongful trading is a sterile remedy because of substantive and procedural barriers.¹¹⁸

The Private Law Function and the Public Law Function

Section 214 Insolvency Act 1986 and section 10 Company Directors Disqualification Act 1985 (collectively called “the wrongful trading provisions”) attempt to serve a number of purposes which we may term *private law functions* and *public law functions*. First, there is the *private law function*, for the benefit of creditors, of personal liability on the part of those responsible for wrongful trading. The ability of a corporation to continue trading by obtaining further credit when it is unable to repay its debts is an impropriety that justifies such a measure.¹¹⁹ Section 214’s intention is to deter irresponsible conduct that abuses the privilege of limited liability by threatening to impose personal liability on the controllers of a company if they fail to comply with the minimum standard of conduct.¹²⁰ As such, section 214 is a statutory exception to the doctrine of separate corporate personality.

Second, the wrongful trading provisions, in particular the section 10 CDDA,¹²¹ have the *public law function* of providing a minimum standard of conduct for the company’s

¹¹⁸ Schulte, *op.cit.* n 59.

¹¹⁹ Cork Committee, *Insolvency Law and Practice - Report of the Review Committee* Cmnd 8558 (London: HMSO, 1982) at p 394 par. 1757.

¹²⁰ Cork, *op.cit.*, at p 404 par. 1805, *Re Produce Marketing Consortium Ltd* (No 2) [1989] BCLC 520 *per* Knox J. at p 549 ff.

¹²¹ Section 10 Company Directors Disqualification Act 1986 (herein after cited as “CDDA”) provides:

10(1) [Court’s power] Where the court makes a declaration under section 213 or 214 of the Insolvency Act that a person is liable to make a contribution to a company’s assets, then, whether or not an application for such an order is made by any person, the court may, if it thinks fit, also make a disqualification order against the person to whom the declaration relates.

10(2) [Maximum period] The maximum period of disqualification under this section is 15 years.

officers. Failure to meet the minimum standard allows the court to take away the privilege of limited liability by disqualifying the offender from acting as a company director or in the management of a company.¹²² The word “person” in section 10 includes a parent. Thus the implications of disqualification for a parent company upon a finding of wrongful trading are potentially catastrophic. It remains to be seen whether the creditor can gain recourse for their losses and the community can gain benefit by having the parent prohibited from being involved in the management of a subsidiary.

The *private law function* of personal liability is being stymied by the reluctance of liquidators to pursue claims under section 214 because of judicial barriers. These are barriers besides the normal difficulties a liquidator meets such as the expense and difficulty of gathering evidence, enforcement of the order, a director’s insolvency and the real risk of costs.¹²³ All this will weigh heavy on the liquidator’s mind. *Re M C Bacon Ltd (No 2)*¹²⁴ provides a recent example of the additional judicial barriers liquidators face. At first instance, the liquidator pursued a speculative action under section 214.¹²⁵ The action was unsuccessful and the liquidator ordered to pay costs. When the liquidator sought to recover these costs from the company’s assets the court held that costs were not “expenses properly incurred in the winding up” because an action under section 214 was not an “asset of the company”. Consequently, any claim the liquidator had for costs ranked with unsecured creditors.

On this point it should be recalled that a liquidator’s function is to “secure that the assets of the company are got in, realised and distributed to the company’s creditors

¹²² *Re Pamstock Ltd* [1994] 1 BCLC 716 per Vinelott J at p 737 e-f.

¹²³ A. Hicks, ‘Advising on Wrongful Trading’ (1993) 14 *Company Lawyer* 16.

¹²⁴ [1991] Ch 127, [1990] BCLC 607.

¹²⁵ The proceedings also included actions under sections 238 and 239.

and, if there is a surplus, to the persons entitled to it”¹²⁶ and to “take control of the company’s assets and papers.”¹²⁷ If a section 214 action is not an “asset of the company” there is no obligation placed on a liquidator to consider an action in the interests of creditors. Further, if the costs of an unsuccessful action rank with unsecured creditors and are not “expenses properly incurred in the winding up” then it is unlikely that a liquidator will risk personal liability if an indemnity from creditors and security is not forthcoming. The practical consequence is that liquidators, by their very nature risk averse beings, will not pursue a section 214 action because technically there is no obligation to do so and the risk of having to pay costs is too great.

The *public law functions* of sanction and deterrence are unfulfilled because the court’s power to disqualify a director is premised on a liquidator successfully obtaining a declaration of wrongful trading. The mechanism used to trigger a disqualification for wrongful trading is dependent on the actions of a liquidator who is essentially a private citizen. If a liquidator decides not to initiate proceedings then there is no chance of a director being disqualified for wrongful trading. Consequently, he is expected to pursue an action that serves a public law function with no assistance or incentive to do so from the State. *Re Oasis Merchandising Services Ltd; Ward v. Aitken*¹²⁸ (“*Oasis Merchandising*”) recently highlighted the procedural limitations that are brought to bear by the courts when a speculative yet meritorious case under section 214 is presented. In *Oasis Merchandising* the liquidator sought to get around the impasse presented in *Re M*

¹²⁶ Section 144(1).

¹²⁷ This includes “things in action” under Section 144(1), see also sections 160, 234; Rule. 4.172. Insolvency Rules 1986.

¹²⁸ [1995] 2 BCLC 493, (HC); [1997] 1 BCLC 689 (CA). The Court of Appeal comprised: Peter Gibson, Otton and Hutchinson L.J.J., the decision being delivered by Peter Gibson L.J.

*C Bacon Ltd (No 2)*¹²⁹ by “selling” the section 214 action and in so doing transfer any associated risk of costs. The creditors were to benefit if the action was successful depending on the amount actually recovered from the directors. The decision relies heavily on the reasoning in *M.C. Bacon* and dispatches the private law function by affirming that a section 214 action is not an “asset of the company”. Then, that trusty old steed, maintenance and champerty rears up and kicks out as unacceptable an arrangement that might benefit creditors and which would enable the court to perform the public law function, if necessary, of disqualifying directors.

The law and policy surrounding the imposition of personal liability on and the disqualification of directors in circumstances that amount to wrongful trading is clearly perverse. The perversity is evidenced by first, the reluctance of the court to assist a liquidator go after the people who have left the insolvent company as no more than a repository of rights and competing creditor claims. A company in liquidation is in a transitional phase. During a company’s life rights accrue, some are extinguished, some continue to exist and a liquidation is a way of finally vindicating those remaining rights. If all claims are satisfied on a winding up, a company is not insolvent and all existing rights have been exhausted. Where there is a deficit and there are competing claims, rights still exist and a few mechanisms such as wrongful trading are intended to create rights against people who are culpable in respect of the imbalance. The process of correcting the imbalance in a liquidation by using these few mechanisms is frustrated if the courts do not intervene effectively to enforce the private law dimension of section 214.

¹²⁹ [1991] Ch 127, [1990] BCLC 607.

Second, the judicial response to date also undermines the essentially *public law function* of policing wrongful trading conduct. Parliament has provided that a liquidator should pursue the disqualification of directors for wrongful trading without financial assistance. Pursuing directors for “unfit” conduct warrants the resources of the State, but legislative policy is otherwise.

STATUTORY REMEDIES CONSIDERED AS A WHOLE

The current statutory regime fails to deal adequately with situations where a parent abuses its extra-legal control. In the UK, there are no statutory remedies available to creditors prior to liquidation. This means a parent can abuse its power to control a subsidiary, in particular, where the subsidiary is on the verge of insolvency or where a transfer of property will result in insolvency. Recently, in *Yukong Lines Ltd v. Rendsberg Investments Corporation*,¹³⁰ the court acknowledged that a controller could move assets from one related company to another to put them out of the reach of a creditor’s reach. Such conduct being described by the court as ‘disreputable, but is unhappily not uncommon’.¹³¹ The removal of funds by a director from a company when its liabilities far exceed its assets to a related company is a breach of a director’s duty to the company, but breach of such a duty is not actionable by a creditor prior to liquidation.¹³²

When we consider the remedies available on liquidation it is clear that legislative policy did not have the parent subsidiary relationship in mind, in particular abuse of a parent’s extra-legal control. A parent acts in two capacities toward a subsidiary. First, the

¹³⁰ [1998] 1 WLR 294, (QB).

¹³¹ *Ibid.*, at 302 F G *per* Toulson J.

¹³² Arguably, the Mareva jurisdiction would permit recovery from a director that has an

parent is a shareholder. The law construes a parent's actions in this limited dimension. Second, a parent is a controller. The law in England fails adequately to attribute any responsibility to a parent in this role. A parent can control completely a subsidiary yet there are no mechanisms specifically designed to enable recourse for abuse of this privilege. Presently, transactional remedies for the creditors of insolvent group members are constrained substantively by time frames that often fail to encompass the course of dealing between parent and subsidiary over a number of years. The area of most confusion is the scope of minimum standards of conduct between parent and subsidiary and the adequacy of mechanisms available to seek redress for breach of these standards.

Reform proposals to date have been conspicuously deficient. The Cork Committee thought that a law was defective if it permitted a parent to act in a variety of detrimental ways toward a subsidiary. Factors such as undercapitalisation; all finance via internal group debt; and management in the interest of the parent do not form the basis for an action at law but cause a tangible advantage to the parent and disadvantage to the subsidiary.¹³³ The notions of wrongful trading¹³⁴ and the 'shadow director'¹³⁵ were a useful yet minimalist reform that was never intended to alter radically the parent - subsidiary relationship.¹³⁶ For more than sixteen years the recommendations of the

interest in the related company. *Ibid.*, at 314 H.

¹³³ *Ibid.*, at 435-436 paras. 1930-1934. One of the reform proposals we will consider further was 'an imposition of liability on a member of a group by a decision of a court in the course of the insolvency of another member of the group, the court having the widest discretion, but required to have regard to certain guidelines.' *Ibid.*, at 436 para. 1935(e).

¹³⁴ See section 214 Insolvency Act 1986. All further references are to the Insolvency Act 1986 unless otherwise stated.

¹³⁵ See sections 214(7) and 251.

¹³⁶ Cork, *op. cit.*, at 437, para. 1939. The Committee stated '[E]ven with the changes consequent upon the implementation of our wrongful trading proposal, the law will remain in an unsatisfactory state.'

Cork Committee¹³⁷ concerning the potential for abuse of the parent - subsidiary relationship and intercompany indebtedness have fallen on deaf legislative ears. Even so the redeeming feature of English law is the richness of the material from which meaningful reform could be generated.

¹³⁷ *Ibid.*, Chapter 51.

Part IV: The Direction for Reform of Creditors' Legislative Remedies

Chapter 5

Germany and The European Union

THE GERMAN *KONZERNRECHT*

Introduction

The German law of ‘combines’ or corporate groups (*Konzernrecht*) contained in the Stock Corporation Act of 1965¹ (*Aktiengesetz*), has been described by Blumberg as ‘the most advanced in the world’.² Antunes considers that in the global context, ‘Germany represents the most pioneering, elaborated and complex attempt so far developed at a general regulation of corporate groups.’³ Indeed, the innovation of the German legislation is beyond doubt, but as we shall see the legal and social context of its operation differs markedly from that found in the UK. The purpose of this Chapter is to demonstrate that whilst in theory the German legislation improves the position of ‘outsiders’ and creditors by seeking to balance power with accountability; in practice the law is rarely used.

¹ Law of September 6, 1965, [1965] 1 *Bundesgesetzblatt* 1089, effective as of 1 January 1966. Whenever one deals with legislation in another language there are the inherent risks that certain subtleties will be lost in the translation. In this instance a primary source translation has been used. See CCH, German Stock Corporation Act of 1965 Translated by Friedrich K Juenger and Lajos Schmidt (New York: CCH, 1967) (herein after cited as ‘Juenger’), Rudolf Mueller and Evan G. Galbraith, eds The German Stock Corporation Law 2nd ed Bilingual Edition with Introduction translated by Rudolf Mueller and Evan G Galbraith (Frankfurt: Fritz Knapp Verlag, 1976) (hereinafter cited as ‘Mueller’).

² Blumberg ’87, *op. cit.*, at 642-643.

³ Antunes, *op. cit.*, at 314.

Before delving into the legislation's features, we should briefly address the philosophical context of its operation. Importantly, the German Stock Corporation (*Aktiengesellschaft*) is merely one of the legal forms known to German Law.⁴ Each corporate form has a particular function in mind and their use is confined to these purposes. The *Aktiengesellschaft* (*AG*) is one of three legal forms used for business purposes, but only it and the partnership limited by shares (*Kommanditgesellschaften auf Aktien*) (*KGaA*) are incorporated under the *Aktiengesetz*.⁵ The internal structure of the *AG* is familiar and not unlike a registered public company limited by shares. It has articles of incorporation, a familiar capital structure, but two management boards placed in contraposition conducting the management of the company. First, the managing board (*Vorstand*) is the executive arm in charge of day to day operations. This includes the making of policy decisions similar to those made by a board of directors. Second, the supervisory board (*Aufsichtsrat*) elects each member of the management board and is charged with the duty of overseeing the management boards activities. To ensure independence, the members of the supervisory board are not permitted to be members of the management board. Shareholders and, through the co-determination principle, employees elect the membership of the supervisory board. Importantly, the supervisory board provides a level of internal management scrutiny with the inherent checks and balances that are unknown to UK company law.

⁴ For example, registered associations (*eingetragene Vereine*), co-operatives (*eingetragene Genossenschaften*), mutual insurance companies (*Versicherungsvereine auf Gegenseitigkeit*), and mining companies (*bergrechtliche Gewerkschaften*). See Juenger, *op. cit.* n 1 at 2.

⁵ The most widely used corporate form for business is the limited liability company (*Gesellschaft mit beschränkter Haftung*) and is governed by the *Gesetz betreffend die Gesellschaften mit beschränkter Haftung*, Law of April 20, 1892, [1892] *Reichsgesetzblatt* 447. See Juenger, *op. cit.* n 1 at 3.

With these brief structural and management points in mind, the *Aktiengesetz* proceeds on the foundation of a number of assumptions.⁶ First, it assumes that the non-existence of concentrations of voting control ensures there is a distribution of corporate power amongst shareholders. Management is dependent upon the common will of the beneficial owners of the enterprise (the shareholders) to determine the company's objectives. The rationale being, there is an internal equilibrium whereby shareholders are concerned with the welfare of the company because an improvement in the company's position is an improvement to their interests.⁷ Consequently, inherent in such *equilibrium* is the protection of both creditors and employees because if the company does well, then *outside* interest groups will have their claims satisfied as the company prospers.

Second, it is assumed, where a shareholder gains a controlling influence there is a risk of the relationship between the controlling shareholder and the company becoming one of subservience. If the controlling shareholder has interests in other enterprises then there is an increasing risk that the subservient company will suffer from the loss of independence because it becomes a part of the controlling shareholder's enterprise.⁸ Thus, there is a risk that the controlling shareholder will influence the dependent company's management. This upsets the *equilibrium* in place exposing minority shareholders, creditors, and employees to the danger of greater loss. The legislation

⁶ The principle of co-determination and the involvement of employees pervades German company law. This means that employees are 'insiders' and 'beneficial owners' of the company – though to a lesser degree than those words are understood in English company law. The assumptions of German company law discussed in this paragraph focus on the role of shareholders and will not dwell on the role of employees under the co-determination principle.

⁷ Herbert Wiedemann, 'The German Experience with the Law of Affiliated Enterprises' in K. Hopt ed, *Groups of Companies in European Laws* (Berlin / New York: Walter de Gruyter, 1982) 21-44 at 21.

attempts to deal with the dissonance between legality and commercial reality – the phenomenon of legal separateness but factual dependency.⁹

The *Konzernrecht* are specific rules setting standards for the conduct of a dominating enterprise that manages a controlled commercial company.¹⁰ Responsibility for the derivation of these rules lies in the economic and social history of Germany and the concerns raised by the long term trends towards the concentration of control in large corporate enterprises.¹¹ By virtue of the trend toward economic concentration, it was clear that the legal form of a stock corporation represented only a superficial description of the true organisational structure.¹² Consequently, there are two primary objectives to the provisions. Though not intended to be *anti-trust* in nature the first is to give greater protection to shareholders and creditors by curbing the concentration of control. The second is to demand greater disclosure of the interrelationships existing between companies.

The *Aktiengesetz* also views the relationship between controlling shareholder and company from a completely different perspective than that found in Commonwealth and Anglo-American legal systems. Weidemann suggests, in Germany the regulatory

⁸ *Ibid.*

⁹ Juenger, *op. cit.* n 1 at 13

¹⁰ Wiedemann, *op. cit.* n 7 at 21.

¹¹ At the time of the enactment of the *Aktiengesetz* in 1965 it was estimated that 70 percent of all German corporations and 20 percent of limited liability companies were no longer 'independent' enterprises. See Klaus J. Hopt, 'Legal Elements and Policy Decisions in Regulating Groups of Companies' in Clive M. Schmitthoff and Frank Wooldridge eds, Groups of Companies (London: Sweet & Maxwell, 1991). See also Enno W. Ercklentz, Modern German Corporation Law Vol 2 2 vols (New York: Oceania Publications Inc, 1979)

¹² K. Böhlhoff and J. Budde, 'Company Groups - The EEC Proposal for a Ninth Directive in the Light of the Legal Situation in the Federal Republic of Germany' (1984) 6 *Journal of Comparative Business & Capital Market Law* 163 at 165.

perspective starts with the welfare of the dependent enterprise.¹³ In essence, if it is established that there is a relationship of dependence then the interests of those ‘unconnected’ parties such as creditors need to be legislatively elevated to deal with the controlling shareholder’s influence over the enterprise. Whereas in many Commonwealth and Anglo-American legal systems the position of the ‘dependent enterprise’ is not altered, but rather the legislative philosophy tends to consider issues concerning the controlling shareholder’s responsibilities, organisation and tax advantages.¹⁴ Consequently, the regulatory rationale seeks to balance two of the perceived difficulties in corporate groups. First, the need to legitimise and legalise the power of control and direction exercised by parent companies,¹⁵ but in the same instance provide protective mechanisms for the related corporations, minority shareholders, and creditors.¹⁶

The *Konzernrecht*

The provisions comprising the *Konzernrecht* concern articles 15 – 19 and 291 – 337 of the *Aktiengesetz*. Articles 15 – 19 can relate to any German corporate form and define the nature of the enterprise relationships possible. Articles 291 – 337 are the substantive provisions for describing and regulating relations specifically between enterprises and limited in operation to the *KGaA* and the *AG*. However, where either a *KGaA* or an *AG* has a relationship with another legal form, they too may fall within the ambit of the legislation. We will focus on two broad types of enterprise affiliation; first those hinging on the notion of *dependency* and second those focussing on the *group*

¹³ Wiedemann, *op. cit.* n 7 at 22.

¹⁴ *Ibid.*

¹⁵ Antunes, *op. cit.*, at 319.

¹⁶ *Ibid.*

relationship. Then we will discuss the relevant substantive provisions concerning *contractual*, *defacto* and *integrated* groups.

One enterprise is *dependent* on another if the *dependent enterprise* is legally separate, yet another *dominant enterprise* can exercise a *dominating influence* over it either directly or indirectly.¹⁷ There is a presumption of dependence of one enterprise on another, where the first enterprise owns a majority of shares in the second enterprise.¹⁸

A *combine* or group of companies (*konzern*) forms, in general, when 'a *dominating* and one or more *dependent enterprises* are joined by the *uniform direction* of the dominating enterprise'.¹⁹ More specifically, *uniform direction* occurs where the enterprises have entered a *contract of domination* under Article 291 or the enterprises have undergone the process of *integration* under Article 319. As we shall also see, the *Aktiengesetz* also provides for relationships of dependency where there are no formal arrangements. The legislation also deems a group to exist where there are independent legal entities with *uniform direction* but neither entity is dependent on the other.²⁰

The *Aktiengesetz* provides no definition of either *uniform direction* or *dominating influence* and these matters are left to the courts. Uniform direction is established where the dominant enterprise gives the dependent enterprise guidelines as to day to day function and makes policy decisions.²¹ Interestingly, a bank exercises a different type of control through a security document than that exercised by a majority

¹⁷ *Aktg*, Article 17(1).

¹⁸ *Aktg*, Article 17(2).

¹⁹ *Aktg*, Article 18(1), See Mueller, *op. cit.* n 1 at 45.

²⁰ *Aktg*, Article 18(2).

²¹ Frank Wooldridge, Groups of Companies - The Law and Practice in Britain, France and Germany (London: Institute of Advanced Legal Studies, 1981) at 52

shareholder.²² However, where the bank's economic control is combined with the position of majority shareholder or where it is permitted to appoint managers then there is sufficient connection through the exercise of dominating influence.²³ Let us first consider those formal group relationships that require the consensual participation of both the intended dominant and controlled companies.

Contractual Groups

A contractual group forms when each company decides to enter a voluntary *domination contract*.²⁴ The existence of the domination contract is evidence of uniform control and exposes the group to a specific regulatory regime. The dominant company need not own any particular proportion of shares in the controlled company. However, primarily companies use domination contracts where there is some relationship of dependence.²⁵ The shareholders of the controlled company must approve of the domination contract by a majority of 75 percent of all share capital.²⁶ The document and its subsequent alteration or termination must comply with certain guidelines.²⁷ The consequences of forming a contractual group are *significant and exceptional yet seek to balance the increased power of the dominant company with accountability to minority shareholders and creditors*.

The dominant company is entitled to give directives to the board of management of the controlled company as concerns its management and day to day running.²⁸ The

²² Hopt, *op. cit.* n 11, at 93.

²³ Avgitidis, *op. cit.*, at 216.

²⁴ *Aktg*, Article 291.

²⁵ Wooldridge, *op. cit.* n 21 at 35.

²⁶ *Aktg*, Article 293(1).

²⁷ *Aktg*, Articles 293–299.

²⁸ *Aktg*, Article 308(1).

controlled company's board of management is obliged to comply with these directives²⁹ even if detrimental to the controlled company and serve only the interests of the dominant company alone.³⁰ Importantly, the dominant company and its officers must satisfy a minimum statutory standard of conduct when exercising the power to give directives to the controlled company. 'The diligence of an orderly and conscientious manager towards the association,'³¹ must be employed in giving directives. Breach of the duty imposes joint and several liability on the officers and the controlled company for any damage that accrues.³² The controlled company can only waive or ratify the breach on special resolution of the *outside shareholders*.³³

Outside shareholders of the controlled company receive protection from the consequences of a domination contract by gaining the right to 'adequate compensation'.³⁴ This may take the form of an exchange of the outside shareholders shares for either stock in the dominant company or a cash payment.³⁵ Alternatively, an outside shareholder may agree to accept a guaranteed dividend.³⁶ Further, the dominant company may use the controlled company's assets, sell its goods at under value, and essentially have all the resources of the subordinate placed at its disposal.³⁷ However,

²⁹ *Aktg*, Article 308(2).

³⁰ *Aktg*, Article 308(1).

³¹ *Aktg*, Article 309(1).

³² *Aktg*, Article 309(2).

³³ *Aktg*, Article 309(3).

³⁴ *Aktg*, Article 304.

³⁵ See generally *Aktg*, Articles 304–307.

³⁶ *Aktg*, Article 304.

³⁷ Frank Wooldridge, 'Aspects of the Regulation of Groups of Companies in European Laws' in Robert R. Drury and Peter G. Xuereb eds, European Company Laws A Comparative Approach (Aldershot: Dartmouth, 1991) at 109

the dominant company must maintain sufficient assets and capital to meet any annual losses the controlled company may incur.³⁸

Despite some 70 percent of stock corporations being part of a group, Weidemann suggested in a personal study during the period from 1970 – 1979 that interested parties concluded no more than 130 domination contracts or combined domination and profit transfer contracts.³⁹ We can explain this simply. The objective of company controllers is tax driven and not motivated by a desire to be subject to the legislation's myriad of rights and obligations. The tax benefits can be obtained by establishing a relationship through a 'transfer of profits' contract without the onerous consequences of entering a domination contract.⁴⁰ While it remains more economical, the tendency toward control without a domination contract will remain.⁴¹ We shall also see that the informal measure of *de facto* groups is favoured because enforcement is difficult.⁴² Thus, domination contracts are rarely used.

Integrated Groups

An integrated association between two or more stock corporations occurs where the parent enterprise owns 95–100 percent of the shares in a subsidiary and the procedures adopted in Articles 319–327 *Aktg* followed.⁴³ Integration *merges* the parent and subsidiary enterprises giving concessions to both the parent and the *outside* creditors

³⁸ *Aktg*, Article 302.

³⁹ Weidemann, *op. cit.* n 7 at 28-29.

⁴⁰ *Ibid.*, at 30. The discussion of the tax effects is highly complicated and beyond the scope of this work.

⁴¹ Thomas W. Wälde, 'Parent-Subsidiary Relations in the Integrated Corporate System: A Comparison of American and German Law' (1974) 9 *Journal of International Law and Economics* 455

⁴² Karl Hofstetter, 'Parent Responsibility for Subsidiary Corporations Evaluating European Trends' (1990) 39 *International and Comparative Law Quarterly* 576 at 581.

⁴³ Compare this with sections 428-430F Companies Act 1985 Compulsory Acquisition after a

and minority shareholders of the subsidiary. The primary consequence of integration deems the parent and subsidiary enterprises to be under 'uniform management'.⁴⁴ Initially, integration requires both the parent and subsidiary to pass resolutions agreeing to the procedure.⁴⁵ When the acknowledgement of integration is noted on the trade register, the parent and subsidiary are deemed 'integrated'⁴⁶ for the purposes of the *Aktg*. Minority shareholders and creditors are given a number of protections against abuse by the parent in this instance as a trade-off for the rights given to the parent. Any shares not held by the parent (those held by a minority shareholder for instance) pass by operation of law to the parent.⁴⁷ The minority shareholder is entitled to claim 'adequate indemnity' as compensation for the compulsorily acquired shares. This may be either shares in the parent enterprise or cash, determined according to a statutory pricing mechanism.⁴⁸

Unsecured creditors who exist before the integration of a subsidiary enterprise and remain after gain substantial protection. To the extent that there is a shortfall of the subsidiary's assets to meet creditor's demands each is granted security provided it is claimed within six months of the integration being entered on the trade register.⁴⁹ From the time of formal integration, the parent enterprise is accountable, jointly and severally, for the debts of the integrated subsidiary enterprise.⁵⁰ However, if the integrated enterprise disputes the debt in anyway then the parent gains the right to

take-over.

⁴⁴ *Aktg*, Article 18(1).

⁴⁵ *Aktg*, Articles 319, 320.

⁴⁶ *Aktg*, Article 319(4).

⁴⁷ *Aktg*, Article 320(4).

⁴⁸ *Aktg*, Article 320(5).

⁴⁹ *Aktg*, Article 321.

⁵⁰ *Aktg*, Article 322(1).

contest the creditor's claim as if it were the subsidiary.⁵¹ The parent, however, cannot raise objections based on its own position or independent claims it may have against the subsidiary's creditors.⁵²

The statutory imposition of unlimited parental liability for the debts of the integrated subsidiary does have some concessions. First, the parent as dominating enterprise gains unrestricted and legitimate power to control the subsidiary even if such control is detrimental to the enterprise.⁵³ Second, contrary to the general provisions of the legislation⁵⁴ an integrated parent may also use the property of the integrated subsidiary as if it were its own.⁵⁵ Finally, the integration of parent and subsidiary enterprise permits the group preferential tax treatment and improves the strength of its goodwill.⁵⁶

The liability consequences of integration are drastic for a parent. Whilst the organisational structure and separate personality of the subsidiary are retained the corporate veil between parent and subsidiary is pierced. As integration is an 'elective' process initiated by the parent, the rationale for adopting the procedure would focus on whether its adoption was economically viable. The minimisation of agency costs between parent and subsidiary together with the tax advantages would need to outweigh the inherited liability and costs of removing minority shareholders and accepting unlimited liability for the subsidiary's debts. Thus, it comes as no surprise that the

⁵¹ *Aktg*, Article 322(3).

⁵² *Aktg*, Article 322(3).

⁵³ *Aktg*, Article 323(1). For example if the Board of Management is directed to enter a transaction but the Supervisory Board of the subsidiary refuse, the direction can be given by the parent to the Board of Management and carried out directly, bypassing the Supervisory Board. See Article 308(3).

⁵⁴ *Aktg*, Articles 57, 58, and 60.

⁵⁵ *Aktg*, Article 323(2).

⁵⁶ Avgitidis, *op. cit.*, at 218.

provisions concerning integration are of no practical importance and rarely used.⁵⁷ Let us now consider the provisions governing the situation where no formal or consensual act on the part of companies is necessary to form a group.

De facto Groups

A *de facto* group forms in the absence of formality and occurs where the uniform management of a controlling enterprise joins dependent enterprises.⁵⁸ Strict and comprehensive provisions guard against the potential for abuse in this circumstance. The general principle is, if a contract of domination does not exist, then a dominating enterprise may not use its influence to cause a dependent company to enter transactions or take measures that may be disadvantageous *except* when the dependent company receives compensation.⁵⁹ Such compensation, to be paid either at the time or at the end of the fiscal year and constitutes a legal claim against the dominating enterprise.⁶⁰

A number of measures are in place to ensure compliance with this obligation. First, the board of management must prepare a report on relations with dependent companies detailing the nature of the transactions and dealings. Each matter in the report must detail the advantages and disadvantages that were encountered by the dependent company and detail whether adequate compensation was paid.⁶¹ As a further requirement, the report is available to the supervisory board and auditors of the dependent company who are obliged to consider its content.⁶² Independent auditors

⁵⁷ Hoffstetter, *op. cit.* n 42 at 580.

⁵⁸ *Aktg*, Article 18(1).

⁵⁹ *Aktg*, Article 311(1).

⁶⁰ *Aktg*, Article 311(2).

⁶¹ *Aktg*, Article 312.

⁶² *Aktg*, Article 313.

may be appointed to examine the report.⁶³ If there is no compliance with the obligation to compensate, then the dependent company is entitled to claim the accrued damages from the dominating enterprise.⁶⁴ Further, the officers of the dominant enterprise are also jointly and severally liable for having caused the offending disadvantageous transaction with the dependent company.⁶⁵

The efficacy of the *de facto* group provisions is doubtful, as their use has remained very limited with a successful damages action unknown.⁶⁶ The barriers are the high cost of such actions and the difficulty of proof of detrimental interference on a transaction by transaction basis.⁶⁷

Comments

The provisions mentioned, in theory, have merit. They are innovative and seek to balance the relationship between power and accountability. The foundational presumptions are easily understood and seem rational provided there are economic justifications for the dissolution of limited liability between parent and subsidiary. Some commentators say that the legislation still fails to go far enough. The concentration of the legislation on the dependent company, its creditors and shareholders still neglects the problems posed by multinational enterprise and their regulation.⁶⁸

Regrettably, the provisions have made little impact because they are rarely used to achieve these ends because the benefits of a group structure can be obtained by using

⁶³ *Aktg*, Article 315.

⁶⁴ *Aktg*, Article 317(1).

⁶⁵ *Aktg*, Article 317(3).

⁶⁶ Hoffstetter, *op. cit.* n 42 at 582.

⁶⁷ *Ibid.*

entities other than stock corporations. Limited liability in Germany, like other countries, is a desirable facet of enterprise. The impotency of the provisions is further emphasised by a number of points. First, when we consider that the majority of corporations participating in groups in Germany are *GmbH*, and as such, fall outside the scope of the *Aktiengesetz*. According to Professor Hopt, by the end of 1988, there were only 2,373 stock corporations, 400,000 *GmbH* and an estimated 60,000 *GmbH & Co.*⁶⁹ As the legal form of the parent has little effect on the function of a group⁷⁰ this is not surprising. The development of a *law of qualified groups* by German courts that seeks to extend the ideas espoused in the *Aktg* to other entities has countered this emergence.⁷¹ If one regulatory lesson is to be gained from the German experience, it is that the regulation of the group must cover the field of corporate entities. This also demonstrates that free enterprise using corporations has a natural tendency toward limited liability and minimal regulation. This inadequacy of the German law has ensured it is not a regulatory burden.⁷² Second, the broad undefined nature of the decisive terms opens the way for a parent to use a vast array of control mechanisms and yet not fall within the terms of the legislation.⁷³ Third, the negotiation of agreements between parent and subsidiary for the purposes of integration or domination contracts presumes independence of the subordinate. Clearly, the dominant company will have already exercised influence, making difficult arms-length negotiation.⁷⁴

⁶⁸ Böhlhoff and Budde, *op. cit.* n 12, at 168.

⁶⁹ Hopt, *op. cit.* n 11, at 82.

⁷⁰ *Ibid.*, at 83.

⁷¹ *Ibid.*, at 84 and the cases cited at footnote 15.

⁷² Böhlhoff and Budde, *op. cit.* n 12, at 169.

⁷³ *Ibid.*

⁷⁴ *Ibid.*

Despite these detractors, shareholders and creditors of subsidiaries gain better protection because the legislation and its guiding principles seek to make public the relationships between related companies. In addition, creditors and minority shareholders are protected by the requirements of parent companies to maintain capital and to compensate against any disadvantage respectively.

THE EUROPEAN COMMUNITY

Introduction

Many of the substantive provisions attempting to reform the law relating to corporate groups in the context of the European Community have been rejected. The attempted influences of the EC in this area were radical and the fact of their rejection demonstrates that such measures were unacceptable. Their consideration is, however, necessary as they illustrate that whilst the purposes of shareholder and creditor protection are worthy causes the mechanisms employed to achieve these ends are crucial to their appeal. Whilst recognising the credence the UK must accord to future EC draft company law directives, there may well still be merit in a consideration of relevant law and law reforms in the more familiar common law jurisdictions of Australia, New Zealand, and the US. The boldest EC reform attempt was the ill-fated Proposed Ninth Company Law Directive, now scrapped from the EC's Company Law reform programme.⁷⁵ Heavily based on the German *Konzernrecht* provisions of the *Aktg*, it is the closest the UK has come to introducing enterprise principles to govern the parent

⁷⁵ Department of Trade and Industry, The Single Market, Company Law Harmonisation (London: August 1992) at 15. Discussions with the Company Law Division of the Department of Trade and Industry in June 1997 confirmed that there seemed very little likelihood of the Ninth Directive being resurrected.

subsidiary relationship. Let us now consider EC reforms directed at reforming the parent subsidiary relationship.

The European Company Statute

The former draft of the European Company Statute of 1970/1975⁷⁶ contained significant provisions intended to create parental liability for a subsidiary's debts.⁷⁷ The provisions were to apply to the group if either the parent or a subsidiary had been incorporated under the Statute.⁷⁸ A group was constituted where a *controlling company* and one or more of the companies *dependent* upon it came under the *unified management* of the controlling company.⁷⁹ *Dependency* of one company on another was established if the latter could directly or indirectly exercise a controlling influence.⁸⁰ A *controlling influence* was presumed where the parent owned a majority of shares in the subsidiary. Where the parent proved that it occupied merely a passive role the presumption could be rebutted.⁸¹

The notion of *unified management* does not receive definition in the former draft statute. This for Antunes is a source of 'unbearable legal uncertainty' because the attribution of liability to a group is entirely dependent on the meaning of this term.⁸² If unified management is established then the controlling company of the group shall be

⁷⁶ *Societas Europea* Statute. For a detailed discussion of the statutes history see Karl Gleichmann, 'The Law of Corporate Groups in the European Community' in D. Sugarman and G. Teubner eds, *Regulating Corporate Groups in Europe* (Baden-Baden: Nomos, 1990) 435-56; Antunes, *op. cit.*, at 277-285 and L. C. B. Gower, *Gower's Principles of Modern Company Law* 5th ed (London: Sweet & Maxwell, 1992) at 67.

⁷⁷ See generally Avgitidis, *op. cit.*, Hoffstetter, *op. cit.* n 42.

⁷⁸ Article 224.

⁷⁹ Article 223.

⁸⁰ Article 6(1).

⁸¹ Articles 6(3), 223(2). See also Hoffstetter, *op. cit.* n 42, at 588.

⁸² Antunes, *op. cit.*, at 295-6.

liable for the debts and liabilities of its dependent subsidiaries.⁸³ Even authors sympathetic to enterprise principles recognise that the seriousness of these provisions could not be underestimated. Parent companies would be permanently exposed to the possibility of liability causing financial and economic instability through out the group of companies.⁸⁴ Consequently, it is not surprising that the group aspects of the draft statute were abandoned.⁸⁵ This, of course, had not been the first experience of EC reforms being rejected. The member states reluctance to proceed with EC reforms had earlier been demonstrated by the rejection of certain aspects of the proposed Draft Convention on Bankruptcy, Winding Up, Arrangements, Compositions and Similar Proceedings (1970).⁸⁶ The problem for the UK was the sheer vagueness of terms; their lack of definition and perception that the provision was ill suited to the regime existing in the UK at the time.⁸⁷ This, together with the parent's automatic liability for the debts of a subsidiary through the mere fact of control, no doubt contributed to the provision being abandoned.⁸⁸

⁸³ Article 239. Avgitidis, *op. cit.*, at 245; Antunes, *op. cit.*, at 282.

⁸⁴ Antunes, *op. cit.*, at 297.

⁸⁵ A Council Regulation on the Statute for a European Company COM (89) 268 OJ C263 16.10.89 at 41.

⁸⁶ 143. C.E.E. Doc. 3.327/I/XIV/70-E, English Dept. of Trade, Draft Bankruptcy Convention of the European Economic Communities (HMSO, 1974) . See also Avgitidis *op. cit.*, at 243. Article One provided:

Any person who has de jure or de facto, and whether openly or secretly, been directing or managing a company or firm which has been declared bankrupt, and who has:

- (a) Carried on a personal activity, while using that company or firm as a cloak for misdeal ings, or
- (b) Wrongfully dealt with the property of that company or firm as if it were his own,or
- (c) Wrongfully carried on an insolvent business in his own personal interest, may be declared bankrupt, if the dealings referred to at (a), (b) and (c) above led to or contributed to the suspension of payments of the company or firm.

⁸⁷ Clare Connerton, 'Directors' Liability and the EEC Draft Convention on Bankruptcy' (1977) *Journal of Business Law* 8 at 12-14.

⁸⁸ Avgitidis, *op. cit.*, at 273. See also Blumberg '85, *op. cit.*, at 655-656; Muir Hunter, 'The

The Proposed Draft Ninth Company Law Directive

The Draft Proposal for a Ninth Company Law Directive⁸⁹ pursuant to Article 54(3)(g) of the EEC Treaty⁹⁰ relating to links between undertakings and in particular groups represent the high point of all previous attempts at reform of the parent subsidiary relationship.⁹¹ The objective was to regulate the interests associated with public companies and linked to other business undertaking, as well as the grouping of legally independent companies under a common management.⁹² In doing so, the Draft Proposal closely adheres to the German model and differentiates between four different types of groups: *de facto* groups,⁹³ a control contract group,⁹⁴ a unilateral declaration group,⁹⁵ and national law groups.⁹⁶ The conceptual focus of the Proposed Directive was the subordination of a company's management to the decision-making influences of another business undertaking.⁹⁷

Draft EEC Bankruptcy Convention A Further Examination' (1976) 25 *International and Comparative Law Quarterly* 310 at 319.

⁸⁹ The European Commission never officially released the Draft Ninth Directive and attempts to gain copies from EC Archives proved fruitless. However, a late version of the directive was published as an appendix to Böhlhoff and Budde, *op. cit.* n 11, and I am grateful to the Company Law Division of the Department of Trade and Industry for providing me with a copy of Department of Trade and Industry, European Communities Draft Ninth Company Law Directive on the Conduct of Groups Containing a Public Limited Company as a Subsidiary - A Consultative Document (London: 1985). (Hereinafter cited as 'Consultative Document'). See also Gleichmann, *op. cit.* n 76.

⁹⁰ *Supra*, on page 41 n 41.

⁹¹ For detailed discussions of the Proposed Draft Ninth Directive, see Antunes, *op. cit.*, at 285-289; Gleichmann, *op. cit.* n 76, Avigidis, *op. cit.*, at 246-252

⁹² Consultative Document, *op. cit.* n 89, Explanatory Notes at 6.

⁹³ *Ibid.*, Explanatory Notes at 24, See Article 9.

⁹⁴ Articles 13 – 32.

⁹⁵ Articles 33 – 37a.

⁹⁶ Article 38. These groups are those established under the national laws of member states and are not considered further here.

⁹⁷ Consultative Document, *op. cit.* n 89, Explanatory Notes at 7.

The Proposed EC *De facto* Group

In the terms of the Draft Proposal, for the purposes of a *de facto* group, a *subsidiary undertaking* occurs where another undertaking – the parent:

- (a) has a majority of the voting rights;
- (b) has the right to remove a majority of the members of the administrative, management or supervisory body and at the same time is a member;
- (c) is a shareholder or member and a majority of the members of the administrative, management or supervisory body who have held office during the last financial year have been appointed solely as a result of the exercise of its rights; or
- (d) is a shareholder or member and alone via an agreement with other members of the subsidiary undertaking controls the voting rights in that undertaking.⁹⁸

The primary objective being, to increase the transparency of the relationship between parent and subsidiary. With this in mind, the draftsmen of the Proposed Directive adhere closely to the German model obliging the management body to prepare a special report similar to the dependency report of the *Aktg*. The report was to take into account a number of matters. Including, details of any agreements entered into with the parent or matters instigated by the parent, and whether such agreements or measures are detrimental, involve particular risk or differ substantially from the nature of the subsidiary's usual business.⁹⁹ Like the German dependency report, the special report could on the application of a shareholder or creditor form the basis of an action to recover damages suffered due to the parent undertakings detrimental conduct toward the subsidiary.¹⁰⁰

⁹⁸ Article 2, para. 1.

⁹⁹ Article 7.

¹⁰⁰ Articles 8 and 9.

The Proposed Directive utilised the fundamental principle that ‘the parent corporation shall be liable for all the unpaid debts and acts of its subsidiaries for the reason that the former controls the latter forming thereby a unitary economic enterprise’.¹⁰¹ This principle is borne out of Article 9, which provides:

1. Any undertaking which conducts itself toward a company as a de facto member of the management body shall be liable to the company for any damage resulting from such interference and attributable to mismanagement, under the same conditions as if the undertaking were a member of the management body of the company and consequently obliged to ensure that the interests of the company are safeguarded.
2. For the purposes of paragraph 1, any undertaking which directly or indirectly exercises a decisive influence over the decision-making by the management body of a company shall be regarded as a de facto member of the management body of that company.
3. Any person who, under the law governing the undertaking, is responsible for its management shall, together with it, bear joint and several unlimited liability. He may, however, be relieved of liability if he proves that the act giving rise to the damage is not attributable to him.
4. Where members of the management body of the company are also liable they shall bear joint and several liability with the undertaking and the person liable pursuant to subparagraph (a).

The idea of a *de facto* member of management is not new and since the development of the ‘shadow director’ poses little conceptual difficulty to English or Commonwealth lawyers. Significantly, though the cause of action provided under Article 9 gave several interested parties’ locus standi. Article 10 permitted proceedings to be taken by the company, any shareholder acting on its behalf, or any competent employees’ representatives.¹⁰² In addition to damages, a number of orders could be made by the court, including:

¹⁰¹ Antunes, *op. cit.*, at 277.

¹⁰² Interestingly, giving locus standi to employees in this instance goes further than the

- a) suspension from office of one or more members of the management or supervisory board;
- b) prohibition of the performance of contracts that are damaging to the subsidiary and the revocation of measures that are damaging without prejudice to the rights of third parties acquired in good faith; or
- c) imposition of the requirement that the parent shall offer to purchase the shares of shareholders in the subsidiary.¹⁰³

The difficulty here is the automatic imposition of liability and the rigidity of the system. There is no place for flexibility or any accommodation of the organisational and governance structures in place.¹⁰⁴

The Proposed EC Control Contract Group

On a more formal level, a 'control contract' detailing the grouping of companies would grant the parent the express right to exert influence over subsidiaries¹⁰⁵ in the interests of the group as a whole. We are given no guidance as to the nature of the controlling influence, but it can be assumed that it means *complete control*, fettered only by the requirement to maintain capital and grant certain concessions to creditors and outside shareholders. As the use of complete control by the parent is legitimated, there is no need to draw the difference between legal and extra-legal control. For the legitimate use of complete control by the parent, creditors and minority shareholders are given a number of rights against the parent company. As we shall see, these rights are inconsistent with the traditional canons of corporate law. First, the control contract was to offer every outside shareholder of the subsidiary a choice between the acquisition of

provisions of the German law.

¹⁰³ Article 11.

¹⁰⁴ Antunes *op. cit.*, at 300-301.

¹⁰⁵ Article 13.

their shares for cash.¹⁰⁶ Alternatively, the control contract had to offer outside shareholders an 'annual equalisation payment'. This payment is designed to compensate the outside creditor for any disadvantage suffered as a consequence of the parent's control of the subsidiary. It took the form of an estimate of the dividend that would have been received had the parent not interfered.¹⁰⁷

The Proposed EC Unilateral Declaration Group

Once again drawing heavily on the German model, a unilateral declaration group was established where the parent held directly or indirectly 90% or more of the capital of the subsidiary. This permitted the parent, unilaterally and compulsorily, to acquire the shares of any outside shareholders on the same terms as mentioned above.¹⁰⁸

Comments

Not surprisingly, the Proposed Draft received a hostile reception in the UK. Let us consider some of the reasons why the draft directive is objectionable to the legal regime in the UK. Whilst we can only speculate, the consequences for the UK had the measures been introduced, would have been to cause a fundamental change to the legal nature of corporate groups with unknown effects on business. Then again, the provisions may have had little efficacy and been a 'toothless tiger' like its German forebear.

¹⁰⁶ Articles 14(1) and 15.

¹⁰⁷ Articles 14(1) and 16(1). A number of checks and balances were to be placed on this process including the appointment of an independent expert to report on the appropriateness of the offers made under either the cash offer or the annual equalisation payment. See Article 17.

¹⁰⁸ Article 33, *supra*, n 106.

The European Community reform proposal for ‘harmonisation’ of the law relating to groups of companies underestimated the complexity of issues needed to be addressed. The process of harmonisation in this instance has proceeded on the assumption that to achieve the goal set out in Article 54(3)(g) of the EEC Treaty¹⁰⁹ a new liability regime needed to be introduced in respect of groups of companies. Harmonisation in this instance is fraught with difficulty. The consequence being that, if adopted, the Draft Directive would result in a paradigm shift undermining limited liability and separate personality on which corporate groupings are based. This is difficult to justify if limited liability remains economically efficient.¹¹⁰ The process of harmonisation also proceeds on the basis that there must be a commonality across the European Community of the corporate form and protections available to creditors if business is to become ‘seamless’. We have this commonality in that the notions of limited liability and separate personality are common features in the law of the European Community. The concern should not be to undermine well established internal liability and personality rules, but with the mechanisms that ensure certainty in commerce such as expeditious and effective enforcement procedures, stable currencies and free entry with the right of establishment in all national economies of the European Union. Discussion of these matters is beyond the scope of this work.

Not surprisingly, the Law Society’s Standing Committee on Company Law viewed the possible effects of the draft directive as ‘unpredictable’.¹¹¹ Indeed, business representatives from all Member States except Germany disputed the need for

¹⁰⁹ *Supra*, on page 41 n 41.

¹¹⁰ For example, Frank H. Easterbrook and Daniel R. Fischel, ‘Limited Liability and the Corporation’ (1985) 52 *University of Chicago Law Review* 89.

¹¹¹ The Law Society, ‘European Communities Draft Ninth Company Law Directive on the Conduct of Groups containing a Public Limited Company as a Subsidiary’ Law Society’s

harmonisation of the law in this area.¹¹² The German position was predictable because the Draft Ninth Directive draws heavily on the German legislation concerning groups of companies.¹¹³ It is uncertain whether the adoption or more correctly, the ‘transplantation’ of law based heavily on the *Konzernrecht* would improve the position of creditors because the German law is also considered unsatisfactory.¹¹⁴ Further, the British Confederation of Industry strongly objected to the use of a legal regime familiar to only one of the member states.¹¹⁵ It is ironic that the ideal of harmonisation in this area is driven by a format originating from a member state, ill-adapted to the variety of different regimes prevailing in the member states of the Union. This demonstrates the ‘myth of harmonisation’¹¹⁶ that has in turn encouraged ‘adaptation’ of principles to the particular national law.¹¹⁷ For this reason, it is not surprising that the UK position stresses the need for reform but that it should not be done at a community level.¹¹⁸ In view of these difficulties, the proposed draft directive has been withdrawn from the programme.¹¹⁹ Professor Hopt considers that the future of EC group law harmonisation

Standing Committee on Company Law Memorandum, October 1985. Part I para. 1.3

¹¹² Böhlhoff and Budde, *op. cit.* n 12, at 173

¹¹³ *Supra*, The *Konzernrecht*, at 237.

¹¹⁴ Wooldridge, *op. cit.* n 37, at 127.

¹¹⁵ The EC Committee of the American Chamber of Commerce in Belgium, ‘The Draft Proposal For a Ninth Directive pursuant to Article 54(3)(g) of the EEC Treaty relating to links between undertakings and in particular groups’ *Business Guide to EC Initiatives* 1991 Spring.

¹¹⁶ Martin Boodman, ‘The Myth of Harmonization of Laws’ (1991) 39 *American Journal of Comparative Law* 699.

¹¹⁷ Gleichmann, *op. cit.* n 76 at 444.

¹¹⁸ The EC Committee of the American Chamber of Commerce in Belgium, ‘The Draft Proposal For a Ninth Directive pursuant to Article 54(3)(g) of the EEC Treaty relating to links between undertakings and in particular groups’ *Business Guide to EC Initiatives* 1991 Spring.

¹¹⁹ *Supra*, n 75. See also 1990 *European Report* January 13, 1990., Eddy Wymeersch (ed.), Groups of Companies in the EEC: A Survey Report for the European Commission on the Law relating to Corporate Groups in various Member States, 1993, foreword at vi.; Avidgidis, *op. cit.*, at 246; Antunes, *op. cit.*, at 292; Janet Dine and Paul Hughes, EC Company Law loose leaf service (London: Jordans, 1996-) para. 9.4; Hopt, *op. cit.* n 11, at 86.

is doubtful but hopes that both national and European courts will seek to obtain more uniform solutions. His reasons are to achieve greater unity and overall simplicity because the law in each member state is conceptually difficult to handle and equally as diverse in practice.¹²⁰ With this in mind, it is logical to consider alternative reform measures that are more amenable to the UK position yet seek to achieve the objectives in Article 54(3)(g) of the Treaty of Rome.¹²¹ Several lessons can be drawn from the above. First, the German dual management and supervisory board provides a number on internal checks and balances not found in UK law. Second, any reform measure must apply to the whole range of corporate entities if any reform is to be effective and not undermine by avoidance strategies based on alternative corporate forms. Third, reform proposals should go with the grain of the different laws and traditions to be found in the respective member states. Harmonisation must be perceived in terms of shared objectives and should not be too prescriptive as to how the objective is to be achieved. There is very little point in a formal elaborate scheme for groups of companies if it causes undue transaction costs and uncertainties and, as appears to be the case in Germany, does little in practical terms to further the interests of creditors.

¹²⁰ Hopt, *op. cit.* n 11, at 86.

¹²¹ *Supra*, on page 41 n 41.

Chapter 6

Australia: Specific Insolvent Trading Provisions, Injunctions, and Orders

The Australian Corporations Law is a formidable piece of legislation¹ and contains a number of safeguards against the problems posed by corporate groups. Despite this, the term 'group of companies' is not defined and the legislation's focus, in terms of liability, is the atomistic view of the company. Australian courts, like their UK counterparts are unwilling to impose the notion of 'enterprise entity' on the group for the debts of insolvent subsidiaries.² Even so, the courts have been vocal in their call for change. Recent judicial comments have a familiar ring recognising that groups present a conflict between 'the realities of commercial life and the applicable law' but any changes to the law would require legislative sanction.³ Like the UK Companies Act 1985, separate provision is made to recognise a group as an economic enterprise for the

¹ CCH editors, *Australian Corporations & Securities Legislation* 7th ed (North Ryde: CCH Australia Ltd, 1996) at 1 interestingly states 'Few statutes in Australia come close to the Corporations Law for complexity, disorganisation and sheer weight'.

² *Industrial Equity Ltd v. Blackburn* (1977) 137 CLR 576, *Pioneer Concrete Services Ltd v. Yelnah Pty Ltd* (1986) 5 NSWLR 254, *Briggs v. James Hardie & Co Ltd* (1989) 16 NSWLR 549, *Sharrment Pty Ltd v. The Official Trustee in Bankruptcy* (1988) 82 ALR 530. See more recently *Wimborne v. Brien* (1997) 23 ACSR 576 where the New South Wales Court of Appeal rejects the notion of the group as a separate entity stating: '... to treat the companies as a single group without regard to their separate assets and liabilities would have breached a fundamental concept of company law – namely that except in respect of limited statutory exceptions ... there is no such thing as a 'group' and each company must be treated as a separate entity', at 581 *per* Dunford AJA.

³ *Qintex Australia Finance Ltd v. Schroders Australia Ltd* (1990) 3 ACSR 267 at 268-269 *per* Rogers C.J. of the Supreme Court of New South Wales. See also Bob Baxt, 'Is corporate law reform needed? - The Courts do not recognise commercial reality in assessing corporate groups' (1997) 71 *Australian Law Journal* 830.

purposes of accounting and the preparation of consolidated group accounts establishing a distinct dichotomy between accounting and legal issues. Similarly in the 1980's, Australia also undertook a major inquiry into insolvency problems. Like the Cork Committee, the Australian Law Reform Commission identified that the group presented particular problems to the creditor on the liquidation of a group member.⁴ As we shall see the call for reform in Australia achieved greater legislative focus than the reforms recommended in the Cork Report.

Despite the historical legal affinity, the complexity of the Australian Corporations Law is somewhat disconcerting. This is evident from the rather embarrassing process of 'corporate law simplification' being undertaken so soon after the Corporations Law's introduction in the early 1990's. Had the legislative draftsman prepared a simple and coherent document such a process would have been unnecessary. This however is a familiar experience and the UK has had its own problems with the shortcomings of the reform and legislative process surrounding the Companies Act 1989.⁵ Even so, the highly detailed legislation and the complimentary jurisprudence in Australia provide a fertile source of possible reform measures for the UK. To this end, it is necessary to delve into the functioning of the relevant Australian provisions in some depth. The major attraction of the Australian legislation is that it uses mechanisms that protect creditors and operate, arguably, both before and on liquidation. Pivotal to operation of the Corporations Law is the regulatory or 'watch dog' role given to the Australian

⁴ Currently, the Australian Liberal (Conservative aligned) Government is undertaking the Corporate Law Economic Reform Program ('CLERP'). This is a broad-based package that has little bearing on groups of companies except the introduction of a statutory derivative action and business judgement rule. See <http://www.treasury.gov.au> for full copies of the reports.

⁵ Brian R. Cheffins, Company Law: Theory, Structure, and Operation (Oxford: Clarendon Press, 1997) at 186.

Securities and Investments Commission ('ASIC') and the underlying philosophy derived primarily from the harm caused by the corporate collapses of the late 1980's. Essentially, the philosophy is that ASIC must have powers to investigate and intervene before too much damage is done to investors and creditors. Consequently, the Corporations Law facilitates the use of mechanisms that operate before winding up, such as the use of orders to prohibit the transfer of assets from a traumatised subsidiary. Such an order can also involve the appointment of 'provisional' receivers and managers to protect the assets of failing companies. ASIC also has an investigative role complementing these powers. Such investigations are done at the State's expense, subject to any favourable costs orders, for the benefit of investors and creditors. As we shall see, the Australian Courts also play a role in creditor protection. Recent decisions demonstrate such a willingness by allowing liquidators to pursue meritorious insolvent trading claims using 'litigation sponsors' without being overly concerned about champerty and maintenance issues.⁶ This position highlights the stark deficiencies of the UK's wrongful trading provisions and decisions such as *Re MC Bacon Ltd (No 2)*⁷ and *Re Oasis Merchandising Services Ltd; Ward v. Aitken*.⁸ Let us first briefly address the role of the Australian Securities and Investments Commission.

THE AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION

The role ASIC plays in the scheme of the Australian Corporations Law is of primary importance. Whilst the Secretary of State through the Department of Trade and

⁶ Cf the position in the UK. See R. C. Schulte, 'Wrongful Trading: An Impotent Remedy?' (1996) 4 *Journal of Financial Crime* 38.

⁷ [1991] Ch 127, [1990] BCLC 607.

⁸ [1995] 2 BCLC 493, (HC); [1997] 1 BCLC 689 (CA). The Court of Appeal comprised: Peter Gibson, Otton and Hutchinson L.J.J., the decision being delivered by Peter Gibson

Industry has certain responsibilities regarding the administration of the Companies Act 1985 and the Insolvency Act 1986; the powers of ASIC are, by comparison, more pervasive and stronger.⁹ In performing its functions, ASIC must: *first*, strive to maintain certainty by facilitating and improving the performance of companies and securities markets with a view to reducing business costs and improving the efficiency and development of the economy.¹⁰ *Second*, maintain the confidence of investors in the securities markets and futures markets by ensuring adequate protection for such investors.¹¹ *Third*, to take whatever action it can take, and is necessary, in order to enforce and give effect to national scheme laws¹². To achieve these ends, ASIC possesses a number of powers that include a general power to investigate,¹³ to examine persons,¹⁴ and to inspect books.¹⁵ Perhaps the most significant of these is the general power to investigate suspected contraventions of the Corporations Law especially where the contravention concerns the management or affairs of a body corporate¹⁶ or involves fraud or dishonesty relating to a body corporate, securities or futures contract.¹⁷ Consequently, the role of ASIC is crucial and a necessary government 'watch dog' in the Australian scheme.

L.J.

⁹ The British Labour Government is reportedly taking steps to end the largely failed self regulation of the 1980's with the introduction of a 'Super Securities Investment Board' see Financial Times, 6th August 1997 at <http://www.info.ft.com/about/brc/archive/06081997.htm>.

¹⁰ Section 1(2)(a) Australian Securities and Investments Commission Act 1989 (hereinafter 'ASIC Act').

¹¹ *Ibid.*, section 1(2)(b).

¹² *Ibid.*, section 1(2)(g). The definition of 'national scheme law' includes the Corporations Law. See section 5(1) ASIC Act.

¹³ *Ibid.*, section 13.

¹⁴ *Ibid.*, Part 3 Division 2 (ss 19-27).

¹⁵ *Ibid.*, Part 3 Division 3 (ss 28-39A).

¹⁶ *Ibid.*, section 13(1)(b)(i).

¹⁷ *Ibid.*, section 13(1)(b)(ii).

REMEDIES AVAILABLE ON INSOLVENCY

In 1988, the Australian Law Reform Commission published a report entitled 'General Insolvency Inquiry' otherwise known as the *Harmer Report*.¹⁸ A small section of the chapter dealing with 'Director Liability and Director Disqualification' is devoted to the liability for debts or liabilities of related corporations.¹⁹ *Harmer* correctly viewed the issue of related corporation liability for the debts of a subsidiary as doctrinally connected the notion of director liability and disqualification. The similarity being that liability should be imposed on persons who are closely linked with the management of a company, but who would ordinarily gain the protection of *Salomon*.²⁰ *Harmer* called for a relaxation of *Salomon* pertinent to related companies, submitting that separate personality operated unfairly where the business activity of a company is directed or controlled by a related company. The analogy being that the related company is acting as a 'director' of the company causing it to incur debts and liabilities.²¹ The legislative provision recommended by *Harmer* proposed an 'open textured' remedy that gave the court a wide discretion in the terms: 'if [the court] is satisfied that it is just' to order that the related company be liable for the debts of another company. *Harmer* specified three important criteria to which the court may have regard. First, the extent to which the related company took part in the management of the company. Second the conduct of the related company towards the creditors of the company. Third, the extent to which the related company is responsible for the company's failure.²² In response to strong criticism of the proposals, *Harmer* acknowledged that the parent's use of a corporation

¹⁸ The Law Reform Commission (Australia), General Insolvency Inquiry Vol 1 ('The Harmer Report') Report No 45 (Canberra: Australian Government Publishing Service, 1988).

¹⁹ *Ibid.*, paras. 334-336.

²⁰ *Ibid.*, para. 334.

²¹ *Ibid.*, para. 334.

was illegitimate if it permitted a subsidiary to incur debts when insolvent.²³ The proposals sought to rely primarily on the wide discretion of the courts and the relevant criteria to impose liability. If this were to be successful, the criteria would need greater attention to detail because the terms used were capable of wide definition. Importantly, there needs to be a differentiation between the offending behaviour and legitimate control derived from contractual sources and the provision of resources such as finance or advisory services.

Liability of a Holding Company for the Debts of its Subsidiaries

Part 5.7B Division 5 of the Corporations Law, though considerably watered down, derives directly from *Harmer*. Whereas *Harmer* recommended an ‘open textured’ criteria based equitable jurisdiction for the court; the explanatory memorandum accompanying the introduction of the new part provided that the guiding principle was ‘as far as practicable [the part’s operation] mirrors the operation of proposed s 588G [director’s duty to prevent insolvent trading], as though the holding company were a director of the subsidiary’.²⁴ Most importantly, the scope of the operation for the new part was confined to a ‘holding company’ and does not extend to other related companies. As we shall see, the term ‘holding company’ is virtually the same as that used in the UK and has a wide operation. The primary effect of Part 5.7B Division 5 is to allow an action for compensation against a holding company where the subsidiary is permitted to trade while insolvent.

²² *Ibid.*, para. 335.

²³ This brings to mind the statement of Lord Templeman in *Re Southard & Co Ltd* [1979] 1 WLR 1198 at 1208. *Supra*, Introduction, on page 24.

²⁴ Corporate Law Reform Bill 1992, Explanatory Memorandum (1992), para. 1122.

A corporation contravenes Section 588V if a number of criteria are satisfied.²⁵ *First*, the corporation must be the *holding company*²⁶ of a subsidiary at the time when the subsidiary *incurs a debt*.²⁷ A company is a subsidiary of a holding company if any of the following criteria are satisfied if the holding company:²⁸

²⁵ Except where the contrary is shown, all statutory references in this chapter are to the Australian Corporations Law.

Section 588V When Holding Company Liable.

(1) [Holding company of company incurring debt] A corporation contravenes this section if:

- (a) the corporation is the holding company of a company at the time when the company incurs a debt; and
- (b) the company is insolvent at that time, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt; and
- (c) at that time, there are reasonable grounds for suspecting that the company is insolvent, or would so become insolvent, as the case may be; and
- (d) one or both of the following subparagraphs applies:
 - (i) the corporation, or one or more of its directors, is or are aware at that time that there are such grounds for so suspecting;
 - (ii) having regard to the nature and extent of the corporation's control over the company's affairs and to any other relevant circumstances, it is reasonable to expect that:
 - (A) a holding company in the corporation's circumstances would be so aware; or
 - (B) one or more of such a holding company's directors would be so aware; and
- (e) that time is at or after the commencement of this Part.

(2)[No offence] A corporation that contravenes this section is not guilty of an offence.

²⁶ Section 9 provides: 'holding company' means:

- (a) in relation to a *body corporate* - a body corporate of which the first-mentioned *body* is a *subsidiary* by virtue of Division 6; or
- (b) in Part 3.6 or 3.7 - a company of which some body corporate is a subsidiary by virtue of Division 6 of this Part;

The highlighted terms are defined as follows:

'body' means a body corporate or an unincorporated body and includes, for example, a society or association;

'body corporate' includes a body corporate that is being wound up or has been dissolved and:

- (a) in this Chapter (except subsection 66A (3)) and section 230, includes an unincorporated registrable body; and
- (b) in Chapter 6, includes a Chapter 6 body;

'subsidiary', in relation to a body corporate, means a body corporate that is a subsidiary of the first-mentioned body by virtue of Division 6;

²⁷ Section 588V(1)(a).

²⁸ Sections 46(a) and (b).

1. controls the composition of the company's board;²⁹
2. is in a position to control more than one half of the votes able to be cast at a general meeting of the company;
3. holds more than half the issued share capital of the company; or
4. has a subsidiary that falls into any of the above categories in relation to the company.

The Courts have had little opportunity to consider Part 5.7B Division 5. Despite this, the part in particular section 588V borrows heavily from section 588G – ‘director’s duty not to trade while insolvent’ – and many of these terms have previously received judicial consideration. The term ‘incurs a debt’ concerns the incurring of an obligation that sounds in the payment of a sum of money or money’s worth. It must also be ascertainable, concerning an obligation to pay a liquidated sum. Consequently, equitable damages for breach of fiduciary or any other like duty owed by a parent or its director’s would represent an obligation to pay unliquidated damages.³⁰ However, a contingent liability such as a subsidiary’s assumption of the liability under a guarantee has been held to fall within the definition of ‘incurs a debt’ and may expose the holding company to liability,³¹ even if the guarantee is unlikely to be called on. The guarantee need only impose an obligation that is definite and ascertainable.³²

Therefore, the scope of the section covers most commercial transactions that concern

²⁹ Section 47 for the definition of ‘control’ in this context.

³⁰ *3M Australia Pty Ltd v. Watt* (1984) 9 ACLR 203 at 206-207; affirmed at [1984] 2 NSWLR 671 and see also *Hawkins v. Bank of China* (1992) 7 ACSR 349 at 356-7.

³¹ *Hawkins v. Bank of China* (1992) 7 ACSR 349 and *Dunn v. Shapowloff* [1978] 2 NSWLR 235 at 243 *per* Mahoney JA. Affirmed by the High Court of Australia in *Shapowloff v. Dunn* (1981) 148 CLR 72. Cf *Hussein v. Good* (1990) 1 ACSR 710 at 717-19, (CA)(NSW).

unsecured and secured creditors. Clearly, the unliquidated debts of ‘involuntary’ creditors or the incurring of liability for damages are not included.³³

Second, the subsidiary must be insolvent at that time, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt.³⁴ Being able to identify precisely the time when the debt is incurred relative to the company’s solvency is crucial to the operation of the section.³⁵ Importantly, the holding company’s obligation under section 588V only arises if the debt is incurred when the company is insolvent. No duty arises when the subsidiary is ‘approaching insolvency’ or ‘imminently insolvent’ unless a debt is incurred causing the subsidiary to become insolvent.³⁶

Third, at the time of incurring the debt, there are *reasonable grounds for suspecting* that the subsidiary is *insolvent*, or would become insolvent.³⁷ The notion of *reasonable grounds for suspecting insolvency* introduces an element of objective analysis that obliges the holding company to predict from prevailing circumstances the anticipated financial position of the subsidiary. This imposes a very high duty upon the holding company to monitor the subsidiary’s financial position in the same manner as it had previously increased the director’s duty to monitor a company’s finances.³⁸ *Suspicion* has been described, in a similar context, as ‘more than a mere idle wondering whether or not [something] exists; it is a positive feeling of actual apprehension without

³² *Hawkins v. Bank of China* (1992) 7 ACSR 349 at 356-7.

³³ For example in *Hamilton v. Abbott* (1980) 5 ACLR 391 at 394 a refusal to accept goods under a contract gave rise to a claim in contractual damages yet did not constitute the ‘incurring of a debt’.

³⁴ Section 588V(1)(b).

³⁵ *Re Newark Pty Ltd (in liq); Taylor v Carroll* (1991) 6 ACSR 255, SC(QLD).

³⁶ C.f the common law position for the duties of directors toward creditors under *Kinsela v. Russell Kinsela Pty Limited* (1986) 4 NSWLR 711.

³⁷ Section 588V(1)(c).

³⁸ *3M Australia Pty Ltd v. Kemish* (1986) 10 ACLR 371 at 378; *Dunn v Shapowloff* [1978] 2 NSWLR 235 at 249.

sufficient evidence.³⁹ *Reasonable grounds* places an objective gloss on the notion of suspicion that requires reference to a holding company of ordinary competence or reasonable ability.⁴⁰ The intention is to remove any aspects of subjective appreciation from the analysis.⁴¹ The 'reasonable' component provides an objective standard referring to the holding company of ordinary competence in relation to its subsidiary. In relation to a director, the standard of foresight is described as falling between that expected of an office boy and the standard expected of an auditor.⁴² What objective standard for suspicion is imposed on a holding company? Do the same standards apply to a holding company with a mere majority of shares to that of entire ownership of the subsidiary? Is a holding company at greater risk if all or most of the subsidiary's directors are in common with its own board? As we shall see, Section 588V(d) provides some guidance concerning these issues. *Insolvency* is defined in Section 95A. Simply, a company that is not solvent is insolvent. A company is solvent if, and only if, the company is able to pay all its debts, as and when they become due and payable.⁴³ In the absence of evidence to the contrary,⁴⁴ there are two presumptions of insolvency⁴⁵ that operate in a civil recovery proceeding for compensation for loss resulting from a subsidiary's insolvent trading.⁴⁶ Presumption one permits the court to assume that the

³⁹ Butterworths, eds *Halsbury's Laws of Australia* Vol 7 Title 120 Corporations (Sydney: Butterworths, 1996) para. [120-15580]. *Queensland Bacon Pty Ltd v Rees* (1966) 115 CLR 266 at 303 *per* Kitto J.

⁴⁰ There are no decisions dealing with the issue as it relates to parent companies but there is clear authority in relation to directors. See *3M Australia Pty Ltd v Kemish* (1986) 10 ACLR 371 at 382-3, *Rema Industries and Services Pty Ltd v Coad* (1992) 7 ACSR 251 at 259 (Fed C of A).

⁴¹ *3M Australia Pty Ltd v Kemish* (1986) 10 ACLR 371 at 372-3, 376, 378; *Commonwealth Bank of Australia v Friedrich* (1991) 5 ACSR 115 at 123-4 SC(WA); *Rema Industries and Services Pty Ltd v Coad* (1992) 7 ACSR 251 at 259 (Fed C of A).

⁴² *3M Australia Pty Ltd v Kemish* (1986) 10 ACLR 371 at 373.

⁴³ Section 95A(1) Solvency and Insolvency.

⁴⁴ Section 588E(9).

⁴⁵ Section 588E Presumptions to be Made in Recovery Proceeding.

⁴⁶ Section 588W.

insolvent company was insolvent during the twelve months prior to the ‘relation-back day’⁴⁷ or, more simply, the date the successful winding up application was filed.⁴⁸ Presumption two permits the court to assume, if the company has failed to keep accounting records that correctly record and explain its transactions and financial position in accordance with the statutory standard⁴⁹ then the company was insolvent during that period.⁵⁰

Fourth, one or both of two alternatives is satisfied: One, the holding company, or one or more of its directors must have actual knowledge that the debt is incurred at a time of suspect insolvency.⁵¹ If a director is on the board of both the holding company and the insolvent subsidiary, then such knowledge is attributed to the holding company. Two, having regard to the nature and extent of the holding company’s control over the subsidiary’s affairs and to any other relevant circumstances,⁵² it is reasonable to expect that either a holding company in the corporation’s circumstances would be aware; or one or more of the holding company’s directors would be aware, of the subsidiary’s insolvency.⁵³

It is significant that the legislative draftsman saw fit to ensure that a subsidiary’s insolvent trading only had civil consequences.⁵⁴ The consequence is that a parent company found responsible under the section could not be ‘disqualified’ from acting in

⁴⁷ Section 9 defines ‘relation-back day’, in relation to a winding up of a company or Part 5.7 body, means: (a) if, because of Division 1 A of Part 5.6, the winding up is taken to have begun on the day when an order that the company or body be wound up was made — the day on which the application for the order was filed; or (b) otherwise — the day on which the winding up is taken because of Division 1 A of Part 5.6 to have begun.

⁴⁸ Section 588E(3).

⁴⁹ Section 286(1) details the duty of the company to keep accounting records.

⁵⁰ Section 588E(4).

⁵¹ Section 588V(1)(d)(i).

⁵² Section 588V(1)(d)(ii).

⁵³ Finally, the debt was incurred after the commencement of Part 5.7B - 23 June 1993.

the management of a company because of a subsidiary's insolvent trading.⁵⁵ As we shall see, there are other opportunities available to threaten the 'disqualification' of a parent from the management of other companies.

A Creditor's Recovery of Compensation for Loss Resulting from Insolvent Trading of a Subsidiary

Under section 588W, a subsidiary's liquidator may recover insolvent trading losses from the holding company if each of the following preconditions is satisfied.⁵⁶ First, the holding company has contravened section 588V in relation to the incurring of a debt by a subsidiary.⁵⁷ Second, the creditor has suffered loss or damage in relation to the debt because of the subsidiary's insolvency.⁵⁸ Third, the creditor's debt was wholly or partly unsecured when the loss or damage was suffered.⁵⁹ Fourth, the company is being wound up.⁶⁰ The section raises two issues. First, which creditors are entitled to distribution of the proceeds from an action and second, what is the measure of

⁵⁴ Section 588V(2) No Offence.

⁵⁵ Section 1317EA(3) [Order of Court] The Court may also make against the person either or both of the following orders in relation to the contravention:

- (a) an order prohibiting the person, for such period as is specified in the order, from managing a corporation;
- (b) an order that the person pay to the Commonwealth a pecuniary penalty of an amount so specified that does not exceed 2,000 penalty units.

Currently a penalty unit is equal to \$100.

⁵⁶ Section 588W(1) [Liquidator may recover from holding company] Where:

- (a) a corporation has contravened section 588V in relation to the incurring of a debt by a company; and
- (b) the person to whom the debt is owed has suffered loss or damage in relation to the debt because of the company's insolvency; and
- (c) the debt was wholly or partly unsecured when the loss or damage was suffered; and
- (d) the company is being wound up;

the company's liquidator may recover from the corporation, as a debt due to the company, an amount equal to the amount of the loss or damage.

588W(2) [Time limit] Proceedings under this section may only be begun within 6 years after the beginning of the winding up.

⁵⁷ Section 588W(1)(a).

⁵⁸ Section 588W(1)(b).

⁵⁹ Section 588W(1)(c).

⁶⁰ Section 588W(1)(d).

compensation? Clearly, the intention of the section is to protect unsecured creditors. This is confirmed when we consider section 588Y which provides that any money recovered is to be applied for the benefit of unsecured creditors in priority to secured creditors. The measure of compensation is the amount equal to the loss or damage suffered as a consequence of the subsidiary's insolvency. It is unclear whether loss or damage is the difference between the face value of the debt and the expected liquidation dividend or whether there is any component of consequential loss or interest included.⁶¹

A Holding Company's Defences to an Action for Compensation

Section 588X provides a holding company with four possible defences to an action under section 588W. First, where it can be shown that at the time the subsidiary incurred the debt the holding company had reasonable grounds to expect that the subsidiary was solvent.⁶² The use of the word 'expectation' imports greater certainty than the word 'suspicion'.⁶³ Accordingly, the defence requires a holding company to prove that it had complied with the duty imposed under section 588V.

The second possible defence⁶⁴ is established where reliance is placed on another person for information concerning the solvency of the subsidiary. It must be shown that both, the holding company and each relevant director⁶⁵ had reasonable grounds to believe that a competent and reliable person was responsible for providing adequate information to

⁶¹ Butterworths, eds *Halsbury's Laws of Australia* Vol 7 Title 120 Corporations (Sydney: Butterworths, 1996) para. [120-15665] and [120-15680].

⁶² Section 588X(2).

⁶³ *Dunn v. Shapowloff* [1978] 2 NSWLR 235 at 249; *3M Australia Pty Ltd v. Kemish* (1986) 10 ACLR 371 at 378 *per* Foster J. (adopting the Shorter Oxford English Dictionary definition of 'expect' as meaning, to regard as about to happen; to anticipate the occurrence or the coming of).

⁶⁴ Section 588X(3).

⁶⁵ A 'relevant director' is a director who was aware as mentioned in section 588V(1)(d)(i). See section 588X(6).

assess the solvency status of the subsidiary,⁶⁶ and that on the basis of that information the company was solvent at the time the subsidiary incurred the debt.⁶⁷

The third defence, permits a relevant director to plead non-participation in management due to illness or other good reason⁶⁸ at the time the subsidiary's debt was incurred. Fourth, the holding company took all reasonable steps to prevent the subsidiary from incurring the debt. In the equivalent provision providing a defence for directors,⁶⁹ factors such as the action taken to place the subsidiary in voluntary administration may be taken into account.⁷⁰

Comments

The provisions of Part 5.7B Division 5 clarify any confusion associated with the interpretative hurdle encountered in the UK of seeking to place the parent within the ambit of 'shadow directorship'. Further, any duty that may be imposed on a parent via the *Kuwait* type interference is replaced by a relatively clear duty to monitor a subsidiary's finances. This is potentially significant erosion of *Salomon*. Having gone as far as they have, given the layers of complexity, it does seem odd that greater attention was not paid to the actual delineation of the duty imposed on parent companies to the creditors of their subsidiaries. Given the threshold definition of 'holding company' and the need for the subsidiary to be in liquidation, the imposition of the obligation on the parent to virtually 'show cause' why it should not be held liable for the debts of a subsidiary is an advance on the English position. The Australian position recognises the principle of accountability for control.

⁶⁶ Section 588X(3)(a).

⁶⁷ Section 588X(3)(b).

⁶⁸ Section 588X(4).

The difficulty of the provisions lies in the uncertainty of the judicial response to the criteria used to determine the nature of the relationship between parent and subsidiary as the courts retain a significant degree of discretion. The judiciary must bear in mind the sanctity of *Salomon* and the need to recognise the boundaries of legitimate legal and extra-legal control of a subsidiary. The risk posed by a haphazard treatment of these issues will evoke enterprise entity notions and introduce a further level of unnecessary uncertainty.

Another significant feature is how an award of compensation may be awarded. Any amount that is subsequently paid to a company following section 588W is not available for the satisfaction of secured debts except where all unsecured debts have been paid in full.⁷¹ Thus, it is clear that the object of the Part is to allow an unsecured creditor the opportunity to gain compensation for an otherwise irrecoverable wrong. Interestingly, the court is also given a power to subordinate the payment of a creditor's debt where it can be shown that the creditor knew that the company was insolvent at the time the debt was incurred.⁷² This is not a novel idea as the same principle is also reflected in section 215(2)(a) Insolvency Act 1986.⁷³

⁶⁹ Section 588H(5).

⁷⁰ Section 588H(6).

⁷¹ Section 588Y Application of Amount Paid as Compensation subsidiary section (1).

⁷² Section 588Y(2) Injured party knew of insolvency.

⁷³ Section 588Y is in the following material terms:

588Y(2) [Injured party knew of insolvency] Where:

- (a) under section 588J or 588K, or in proceedings under section 588M or 588W, a court orders a person to pay to the company compensation, or an amount, equal to the amount of loss or damage suffered by a person in relation to a debt because of the company's insolvency; and
 - (b) the court is satisfied that, at the time when the company incurred the debt, the person who suffered the loss or damage knew that the company was insolvent at that time or would become insolvent by incurring the debt, or by incurring at that time debts including the debt, as the case requires;
- the court may order that the compensation or amount paid to the company is not

The positive aspect has been the willingness of the courts to support liquidators go after those responsible for corporate collapses for the benefit of creditors where a liquidator's aversion to the risk of a costs order would otherwise see a meritorious action founder.⁷⁴ Whilst the language of the UK's wrongful trading provisions are different to the Australian insolvent trading provisions, the philosophy of accountability for trading whilst a corporation is at risk or insolvent is the same. Australia, like the UK relies on private individuals - liquidators - to pursue the *private law function* of recovering losses suffered because of insolvent trading of subsidiaries.⁷⁵ The difference is that the Australian Courts have not hindered the operation of the insolvent trading provisions by treating the cause of action as an asset of the company - as opposed to characterising the wrongful trading action as an asset that springs from the office of liquidator through the operation of legislation.⁷⁶ The *public law function*⁷⁷ of director disqualification because of insolvent trading is not entirely dependent on a liquidator's actions. Indeed, locus standi is given to ASIC, members and creditors of the company to apply to the court to

available to pay that debt unless all the company's unsecured debts (other than debts to which orders under this subsection relate) have been paid in full.

Whereas section 215 Insolvency Act 1986 provides:

215(2) [Further court directions] Where under either section [213 or 214] the court makes a declaration, it may give such further directions as it thinks proper for giving effect to the declaration; and in particular, the court may-

- (a) provide for the liability of any person under the declaration to be a charge on any debt or obligation due from the company to him, or on any mortgage or charge or any interest in a mortgage or charge on assets of the company held by or vested in him, or any person on his behalf, or any person claiming as assignee from or through the person liable or any person acting on his behalf, and
- (b) from time to time make such further order as may be necessary for enforcing any charge imposed under this subsection.

⁷⁴ R. C. Schulte, 'Wrongful Trading: An Impotent Remedy?' (1996) 4 *Journal of Financial Crime* 38.

⁷⁵ Section 588W Recovery of Compensation for Loss Resulting from Insolvent Trading.

⁷⁶ See *Movitor Pty Ltd (Receiver and Manager appointed) (In Liquidation) v. Sims* (1996) 14 ACLC 587.

⁷⁷ *Supra*, discussion on page 225 concerning The Private Law Function and the Public Law Function of wrongful trading.

have a person debarred from acting in the management of a corporation where there have been repeated breaches of the legislation.⁷⁸ Whilst these provisions apply to a parent that is characterised as a ‘director’, holding companies do not commit an offence under the Corporations Law when a subsidiary is permitted to trade whilst insolvent.⁷⁹ This means a holding company cannot be ‘disqualified’ from the management of a company by the use of the ‘civil penalty provisions’.⁸⁰

REMEDIES AVAILABLE PRIOR TO INSOLVENCY

One novel feature of the Australian Corporations Law is the potential capacity for creditors to bring actions against directors, and in turn, actions against parent companies before a subsidiary’s insolvency. Although we await the emergence of an authoritative judicial response in the area, a recent decision demonstrates the use of these remedies to prevent the dissipation of assets before liquidation proceedings. This mechanism gives creditors standing to sue for a remedy akin to a Mareva injunction⁸¹ in that its purpose is to protect assets that are at risk of ‘dissipation’ from the subsidiary. The Corporations Law provides a mechanism that permits either a creditor or ASIC to take action prior to a liquidation where a parent’s conduct implicates it, as a ‘shadow director’ in breaches of a director’s statutory duties.

⁷⁸ Section 230(1) and subsection (6) for the definition of those ‘prescribed persons’ entitled to apply. Cf the power of the Secretary of State under Section 10 Company Directors Disqualification Act 1986.

⁷⁹ Section 588V(2).

⁸⁰ Part 9.4B Civil and Criminal Consequences of Contravening Civil Penalty Provisions.

⁸¹ *Supra*, Chapter 4, Introduction, on page 184 at n 1 and n 2 and accompanying text.

The Imposition of Duties upon the Parent in its Capacity as a ‘Shadow Director’

The Corporations Law has specific provisions that set out the statutory basis of director’s duties. For a director, that is a natural person, these are legislative recognition of the director’s ordinary fiduciary duties to the company. Their inclusion in the Corporations Law serves a number of purposes. First, the standard of corporate conduct expected by the legislature is clear. Second, the duties form the cornerstone of a number of legislative causes of action that are not available under the common law. Third, a breach of the duties gives ASIC jurisdiction to obtain both civil and criminal sanctions and also provides creditors with grounds to intervene in the management of a company.

The duty and liability of an officer of a corporation is dealt with in section 232. The provision applies to ‘officers’. This term encompasses ‘directors’⁸² and as such includes the extended definition incorporating the notion of ‘shadow director’.⁸³ We should recall that the cases of *Standard Chartered Bank of Australia v. Antico* and *Australian Securities Commission v. AS Nominees Ltd* were concerned with the imposition of duties upon shadow directors. Consequently, a finding of *shadow directorship* can impose duties upon a parent as follows:

1. to act honestly;⁸⁴
2. to exercise the degree of care and diligence that a reasonable person in a like position in a corporation would exercise in the corporation’s circumstances;⁸⁵

⁸² Section 232(1) Provides: In this section: ‘officer’, in relation to a corporation, means: (a) a *director*, secretary or executive officer of the corporation; ...

⁸³ Section 60(1)(b).

⁸⁴ Section 232(2).

3. to not make improper use of information acquired by virtue of their position to gain, directly or indirectly, an advantage for themselves or for any other person or to cause detriment to the corporation,⁸⁶ and
4. to not make improper use of their position to gain, directly or indirectly, an advantage for themselves or for any other person or to cause detriment to the corporation.⁸⁷

If it can be shown that a parent had engaged in a breach of these sections then Chapter 9 Part 9.4B Civil and Criminal Consequences of Contravening Civil Penalty Provisions operates. These provisions permit ASIC - not creditors⁸⁸ to obtain orders prohibiting the parent 'shadow director' from managing a company and also permitting ASIC to obtain a pecuniary penalty.⁸⁹ As we shall see, creditors are permitted to rely on breaches of the statutory duties under the miscellaneous powers of the court to order injunctions.⁹⁰

The provisions are emancipatory in the sense that there is a clear attempt to place accountability at the hands of those in charge of a company. The provisions are clear and we do not need to grapple with the limitations of fiduciary duties nor the Rule in *Foss v. Harbottle*. Importantly, the provisions demonstrate a responsibility on the part of the Australian legislature to maintain and enforce standards of corporate conduct.

⁸⁵ Section 232(4).

⁸⁶ Section 232(5).

⁸⁷ Section 232(6).

⁸⁸ Section 1317EB Who may apply for a civil penalty order.

⁸⁹ Section 1317EA(3).

⁹⁰ Section 1324 Injunctions. *Infra*, Injunctions on page 283.

The Power of the Court to Prohibit Certain Payments or Transfers of Property

Under section 1323 an ‘aggrieved person’⁹¹ may apply to the court for an order prohibiting the payment or transfer of money, securities, futures contracts, or property.

An ‘aggrieved person’ is a person whom the court considers it is necessary or desirable to take action pursuant to the section, ‘for the purpose of protecting the interests of a person’. The court looks at the conduct of the offending person and determines if their has been a breach of the Corporations Law and then determines if the complainant falls within that class of persons needing protection.⁹² It is sufficient if the applicant demonstrates that in the absence of relief that there is a danger of assets being dealt with in a way that will prevent the aggrieved person recovering judgement. A recent case has considered that it is arguable that an investor is an ‘aggrieved person’.⁹³ Whilst there are no decisions directly on point it would seem likely, bearing the above in mind that an ordinary creditor would fall into this category where for example a parent company was moving assets out of a subsidiary at times of doubtful solvency.

Before an order being made a number of criteria must be fulfilled. First, it must be established that either ASIC is carrying out an investigation in relation to an act or omission by an ‘offending’ person,⁹⁴ being an act or omission that constitutes or may constitute a contravention of the Corporations Law;⁹⁵ or a prosecution has been begun

⁹¹ This term is not specifically defined in the Corporations Law.

⁹² The methodology of determining if a person is an ‘aggrieved person’ has recently been demonstrated by R D Nicholson J. in *Australian Securities Commission v Allan Cooke* [1996] ACSR 580 at 585.

⁹³ *Australian Securities Commission v. Macleod* (unreported) Fed Ct of Aust Gummow J. 3 August 1992 para. 16 see Australian Legal Information Institute <http://www.austlii.edu.au>.

⁹⁴ Section 1323(1) uses the term ‘relevant person’ to denote the party who has offended against the terms of the Corporations Law. For the purpose of clarity, the term ‘offending person’ is used.

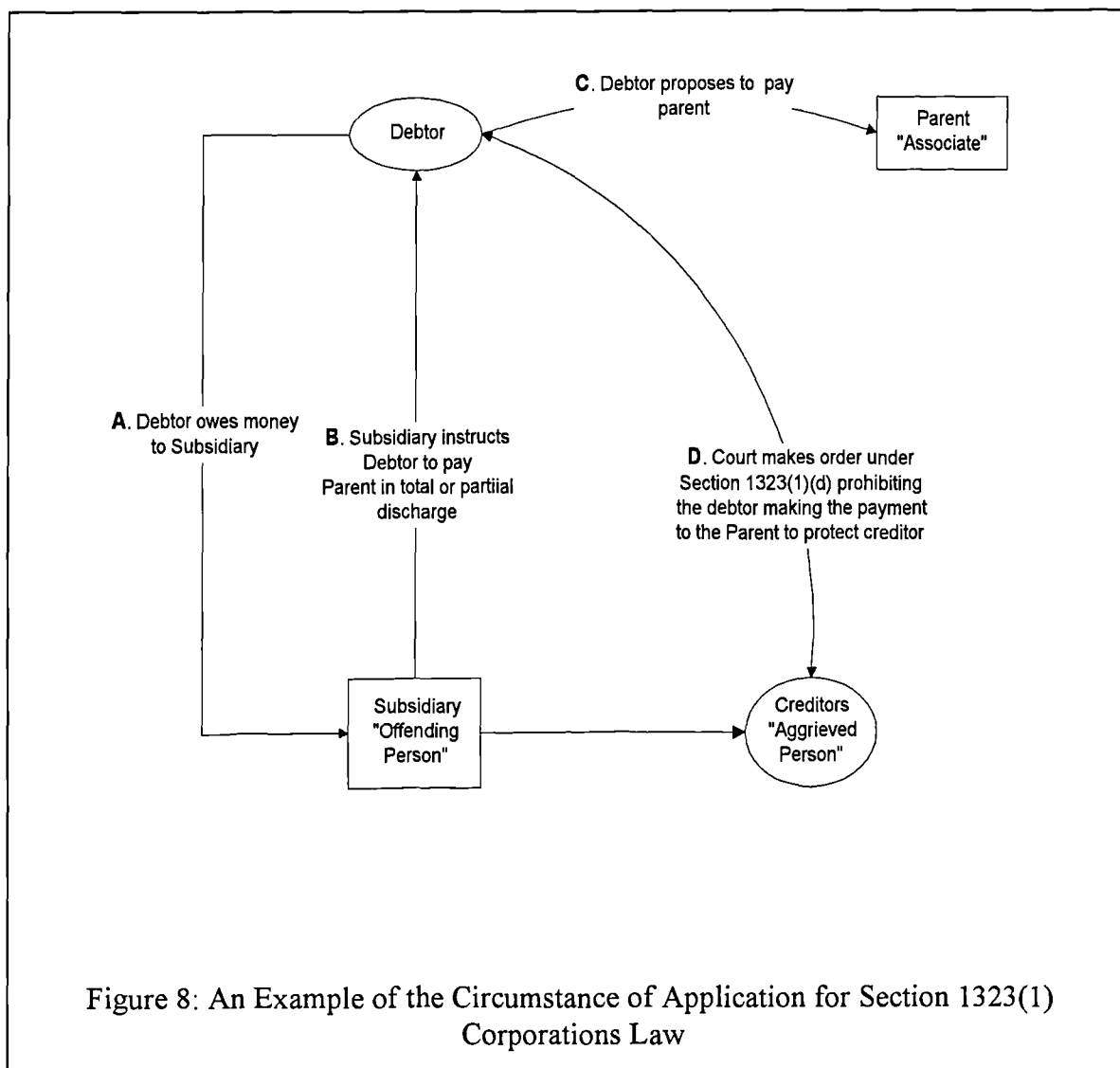
⁹⁵ Section 1323(1)(a).

against an ‘offending’ person for a contravention of the Corporations Law,⁹⁶ or a civil proceeding has been begun against an ‘offending’ person under the Corporations Law.⁹⁷

Second, the Court must consider it necessary or desirable to make an order for the purpose of protecting the interests of a person (called an ‘aggrieved person’) to whom the offending person is liable, or may be or become liable, to pay money, whether in respect of a debt, by way of damages or compensation or otherwise, or to account for securities, futures contracts or other property. As the terms of the section are rather convoluted, a diagrammatic representation of a situation in which the provision will operate is appropriate.

⁹⁶ Section 1323(1)(b).

⁹⁷ Section 1323(1)(c).



If this is established then the court may make an order prohibiting a debtor of the offending person or the debtor of an associate⁹⁸ from repaying the debt by directing the money to be paid to a third party (in the above situation, the parent).⁹⁹ Alternatively, the court can order the prohibition of a person holding property,¹⁰⁰ on behalf of the 'offending' person, or on behalf of an associate, from paying any money, or otherwise parting with possession of the property to another third party at the direction or request

⁹⁸ A detailed description of an 'associate' is provided in Chapter 1 Part 1.2 Division 2. Corporations Law.

⁹⁹ Section 1323(1)(d).

¹⁰⁰ Section 1323(1)(e) makes reference to 'money, securities, futures contracts or other

of the offending person or associate on whose behalf the property, is held.¹⁰¹ Insofar as the other provisions of section 1323 are concerned a court can also order the prohibition of money or property being transferred out of the jurisdiction¹⁰² or appoint a receiver and manager.¹⁰³

The nature of the order given under section 1323 is necessarily interlocutory¹⁰⁴ and often preliminary to the more severe measure of appointing a receiver and manager to protect the assets of the company. In essence, the intention of the section is to safeguard the assets of the company until the claims of creditors and potential creditors can be determined in other proceedings.¹⁰⁵ More generally the remedies available under section 1323 are intended to protect the interests of ‘aggrieved persons’ who might have claims against a corporation and also against those ‘related’ to the corporation who are subject to the provisions of the Corporations Law whether or not those claims flow from a breach of the Corporations Law.¹⁰⁶ The mechanism secures assets that may be used in the future to meet the ‘aggrieved person’s’ claims. As was pointed out by Finn J. in *Australian Securities Commission v. AS Nominees Ltd*,¹⁰⁷ the mechanism of the section achieves this end by protecting first, the assets of persons, against whom the

property’.

¹⁰¹ Section 1323(1)(e).

¹⁰² Sections 1323(1)(f)-(g).

¹⁰³ Section 1323(1)(h)(ii).

¹⁰⁴ Section 1323(5).

¹⁰⁵ *ASC v. MacLeod* (1994) 48 FCR 152 *per* Drummond J. at 160; *Corporate Affairs Commission (NSW) v. Walker* (1987) 5 ACLC 884 at 888 and *Corporate Affairs Commission v United International Technologies Pty Ltd* (1988) 6 ACLC 637 at 643 L and cases on the corresponding provision in the previous Companies Code.

¹⁰⁶ *Australian Securities Commission v. AS Nominees Ltd* [1995] 18 ACSR 459 at 511-512 *per* Finn J. See also *Corporate Affairs Commission (NSW) v. Walker* (1987) 11 ACLR 884; *Corporate Affairs Commission (SA) v Lone Star Exploration NL (No 2)* (1988) 14 ACLR 499.

¹⁰⁷ [1995] 18 ACSR 459 at 511-512 *per* Finn J.

relevant claims may lie to secure the claims of 'the aggrieved person',¹⁰⁸ or second, assets for which that person may be liable to account in such a claim.¹⁰⁹

The evidence relied upon to establish actual or potential liability in a respondent should be compelling.¹¹⁰ Indeed, the extreme nature of the appointment of a receiver and manager justifies that such an order only be made after 'great scrutiny and in extraordinary circumstances' and that lesser remedies should be considered.¹¹¹

Injunctions

Section 1324 is one example of the tendency in Australian law to provide a statutory remedy of an injunctive nature. The purpose is to clarify and empower use of the inherent or traditional jurisdiction of a court of equity.¹¹² Indeed, the statutory injunction is a familiar and long-standing technique use by regulators in both the United States and Canada to ensure compliance with commercial legislation.¹¹³ It must be noted that the section does not confer any right to apply to the court for relief where the allegation is a breach by the company of the general law, nor is there any such provision elsewhere to be found in the Corporations Law.¹¹⁴

¹⁰⁸ *Corporate Affairs Commission (NSW) v. Walker*, (1987) 11 ACLR 884 at 888; *Corporate Affairs Commission (NSW) v. Transphere Pty Ltd* (1988) 15 NSWLR 596 at 611

¹⁰⁹ *Australian Securities Commission v. Corplan Nominees Pty Ltd*, 29 April 1994 (unreported) Drummond J. Federal Court of Australia. See Australian Legal Information Institute <http://www.austlii.edu.au>

¹¹⁰ *Australian Securities Commission v. AS Nominees Ltd* [1995] 18 ACSR 459 at 511 per Finn J.

¹¹¹ *Bond Brewing Holdings Ltd v National Australia Bank* (1990) 1 ASICR 445 at 458; *Beach Petroleum NL v. Johnson* (1992) 9 ACSR 404 at 406

¹¹² For example, section 80 Trade Practices Act 1974. See also *ICI Operations Ltd v. Trade Practices Commission* (1992) 38 FCR 248.

¹¹³ Abram Chayes, 'The Role of the Judge in Public Law Litigation' (1976) 89 *Harvard Law Review* 1281 at 1292 ff.

¹¹⁴ *Australian Agricultural Company v. Oatmont Pty Ltd* (1992) 106 FLR 314 per Mildren J. at 323 with whom Asche C.J. and Martin J. agreed. Northern Territory Court of Appeal.

Section 1324 gives locus standi to ‘a person whose *interests* have been, are, or would be affected’¹¹⁵ by ‘a person [who] has engaged, is engaging or is proposing to engage in conduct that may constitute:’

1. any contravention, attempted contravention, or aiding, abetting, counselling or procuring a person to contravene the Corporations Law;¹¹⁶
2. inducing or attempting to induce, whether by threats, promises or otherwise, a person to contravene the Corporations Law;¹¹⁷
3. being in any way, directly or indirectly, knowingly concerned in, or party to, the contravention by a person of the Corporations Law;¹¹⁸ or
4. conspiring with others to contravene the Corporations Law.¹¹⁹

If established, the court may grant an injunction either restraining or requiring the offending person to do any act or thing on such terms as the Court thinks appropriate.¹²⁰

¹¹⁵ Section 1324(2)(b). The word ‘interests’ was considered in *Broken Hill Proprietary Company Ltd v. Bell Resources Ltd* (1984) 8 ACLR 609 at 613-614 by Hampel J. in relation to the section 574(1)(b) of the Companies (Qld) Code 1981 which is replicated in section 1324(2) Corporations Law.

‘The Companies Code, in my view, is legislation which is clearly concerned in the broadest sense with the protection of the public in respect of commercial activities of corporations. The whole legislative scheme is designed to ensure that the greatest possible protection is afforded in many instances by the provision to the public of information relevant to those commercial activities. severe penalties are imposed by many sections of the Code for non-compliance with it and s.574, in my view, is intended to enable interested persons to obtain relief in the form of injunctive relief to prevent actual or proposed conduct in contravention of the Code. It follows that in interpreting s.574(1) (b) a broad interpretation consistent with the objectives of the [Code]...In my view the *interests* referred to in this section are interests of any person (which includes a corporation) which go beyond the mere interest of a member of the public. It is not necessary that personal rights of a proprietary nature or rights analogous thereto are or may be affected or need it be shown that any special injury arising from a breach of the Act ... has occurred.’

¹¹⁶ See sections 1324(1)(a),(b) and (c).

¹¹⁷ Section 1324(1)(d).

¹¹⁸ Section 1324(1)(e).

¹¹⁹ Section 1324(1)(f).

However, the issue of concern to creditors is whether they have locus standi to use the section. Recent authority has held that the test to be applied under section 1324(2)(b) is substantially the same as the test of locus standi under the general law.¹²¹ Under the general law a private citizen who has no *special interest* is incapable of bringing proceedings unless he is permitted by statute to do so.¹²² The *special interest* is not a mere intellectual or emotional concern. A person is specially interested where he is likely to gain some advantage, other than the satisfaction of righting a wrong, upholding a principle or winning a contest, if his action succeeds or to suffer some disadvantage, other than a sense of grievance or a debt for costs, if his action fails.¹²³

Consequently, the issue for a creditor of a subsidiary is whether there is a sufficient nexus between the creditor's interest and the parent's non-compliance with statutory duties. This is clearly an arguable point but would depend heavily on the period in which the creditor chose to assert his rights. The suggestion being that a creditor would have little chance of success unless there was a real risk of the parent's actions toward the subsidiary resulting in the likelihood of insolvency.

The recent case of *Airpeak Pty Ltd v. Jetstream Aircraft Ltd*,¹²⁴ demonstrates the potential of section 1324. The facts are complex and the relevant arrangements can be illustrated as follows:

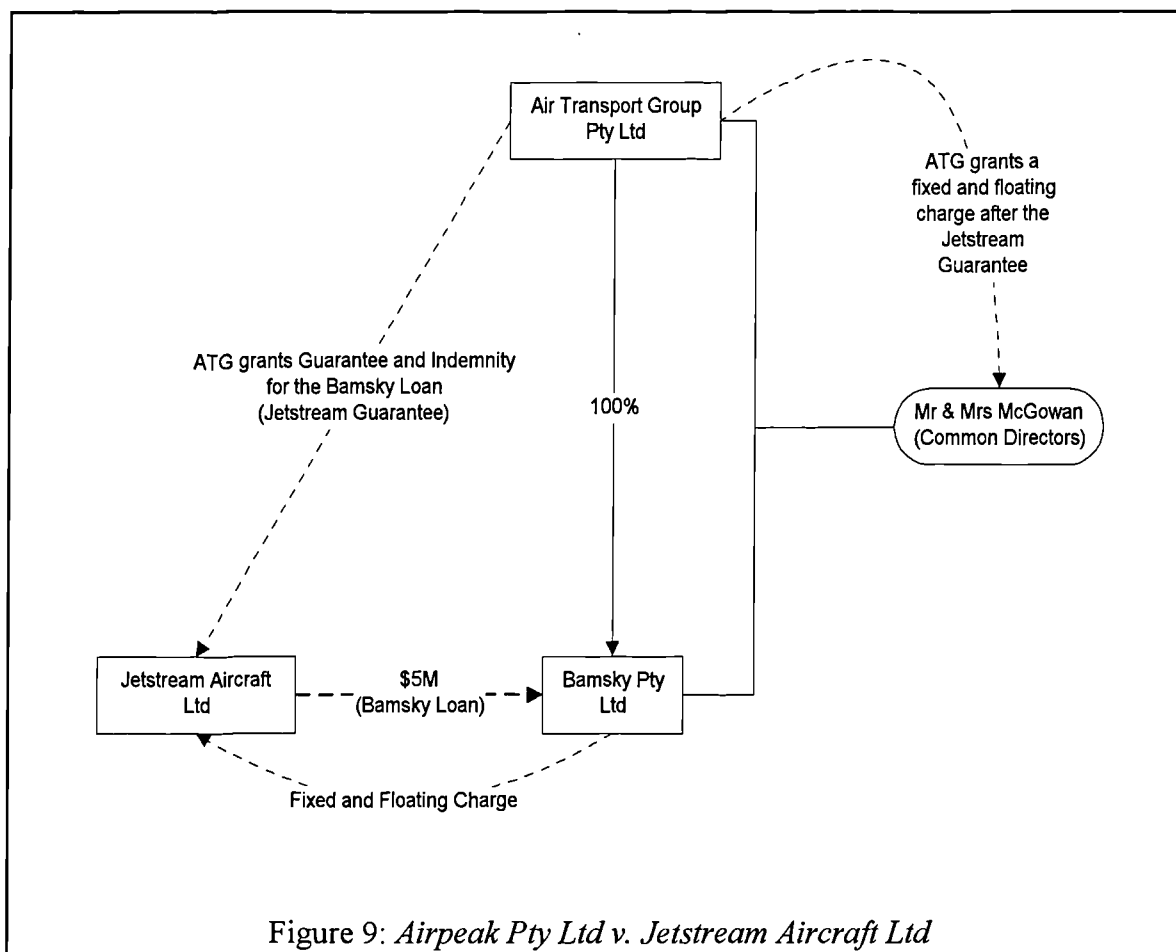
¹²⁰ Sections 1324(1) and (2).

¹²¹ *Re QIW Retailers Ltd* (1992) 8 ASICR 333 per Cooper J. at 336.

¹²² *Australian Conservation Foundation Incorporated v. The Commonwealth of Australia* (1980) 146 CLR 493 at 526 per Gibbs J.; See also *Onus v. Alcoa Australia Ltd* (1981) 149 CLR 27

¹²³ (1980) 146 CLR 493 at 530.

¹²⁴ (1997) 23 ACSR 715.



In essence, Jetstream Aircraft Ltd ('Jetstream') loaned five million dollars to Bamsky Pty Ltd (a wholly owned subsidiary of Air Transport Group Pty Ltd ('ATG')). Bamsky granted Jetstream a fixed and floating charge of all its assets. Jetstream also gained a guarantee and indemnity from ATG to secure the Bamsky loan ('the Jetstream guarantee'). Mr and Mrs McGowan ('the McGowans') were directors of both ATG and Bamsky. In breach of the Jetstream guarantee, ATG granted a fixed and floating charge over all assets to the McGowans in their capacity as individuals. Jetstream alleged first, that the McGowans improperly used their positions as directors of ATG¹²⁵ in securing the charge for their own benefit. Second, the McGowans failed to take due care as

¹²⁵ Section 232(6).

directors¹²⁶ by permitting the charge to be granted without making due enquiries. The consequence that flowed resulted in a reduction in the value of the Jetstream guarantee because the McGowans' charge, as a secured charge, would take priority. The value of the Jetstream guarantee being lessened to the extent of the McGowans' charge.¹²⁷

Jetstream argued that the McGowans' actions caused a detriment to ATG thus affecting Jetstream's ability as an unsecured creditor to recover against it.¹²⁸ Consequently, Jetstream was a person whose interests have been affected by a breach of the Corporations Law with in the terms of section 1324. Jetstream did not seek damages but rather the return of cash and property removed from ATG in breach of the Corporations Law. This case arose as a consequence of an application to strike out Jetstream's claim on the grounds that it did not have locus standi to make an application for an injunction under section 1324.

Einfeild J. held that Jetstream had standing to sue because 'interested persons' where those who had interests that go beyond the mere interest of a member of the public.¹²⁹

The court accepted that:

... it is ... arguable that a creditor having a right to prove in the liquidation of a company may be a person whose interests are affected by a contravention which is alleged to have led to the diminution in the value of his claim against the company¹³⁰

¹²⁶ Section 232(4).

¹²⁷ (1997) 23 ACSR 715 at 719.

¹²⁸ *Ibid.*, at 719-720.

¹²⁹ *Ibid.*, at 720 citing *Broken Hill Proprietary Co Ltd v. Bell Resources Ltd* (1984) 8 ACLR 609; ACLC 157 at 162 *per* Hampel J. and also *QIW Retailers Ltd v. David Holdings Pty Ltd (No 2)* (1992) 109 ALR 377.

¹³⁰ (1997) 23 ACSR 715 at 720 quoting *Allen v. Atalay* (1993) 11 ACSR 753 at 757 *per* Hayne J.

The court recognised the serious problem this posed and acknowledged that clearly the concern was that shareholders and creditors should not be allowed through litigation to interrupt the proper running of a company. However, in theory at least this would not occur because the court retained the discretion whether to make the order or not and refuse relief where the circumstances were unworthy of intervention.¹³¹ Clearly, a vexatious litigant would also run the risk of an unfavourable costs order.

Whilst the decision is emancipatory it is unlikely to extend to the unsecured trade creditor. Jetstream could easily show ATG's actions were in breach of the guarantee's positive obligation not to grant any security. Where no such contractual obligation arises – in the case of the unsecured trade creditor – it is difficult to see whether the court would be as forthcoming. Nevertheless the decision demonstrates the value of enabling an 'open textured' discretionary remedy before liquidation in response to blatant breaches of duty by a company's officers.

COMMENTS

The inherent intricacy of the above provisions is a characteristic of Australian Corporations Law.¹³² Professor Farrar has been particularly scathing of the 'gratuitous complication', employment of undefined concepts, regular arbitrary switching from the subjective to the objective standard and the 'constitutional incapacity on the part of the Australian authorities to legislate in a simple and coherent manner.'¹³³ Farrar cites the Australian tradition of very technical drafting, excessive use of criminal sanctions and

¹³¹ *Ibid.*, at 721.

¹³² John H. Farrar and Alistair B. Darroch, 'Insolvency And Corporate Groups - The Problem of Consolidation' in J. P. G. Lessing and J. F. Corkery eds, Corporate Insolvency Law (Gold Coast: The Taxation & Corporate Research Centre, Bond University, 1995) 231-62 at 238.

an inability to think clearly about policy issues as fundamental concerns.¹³⁴ This may be true of the overall structure of the Australian legislation and direct adoption of the Australian model is not recommended. The real reform lesson to be drawn from Australia is the willingness to codify and fortify common law themes in a legislative context. The legislative development of these common law principles is not uncongenial to UK law but a demonstration of the opportunity to clarify and extend the operation of existing remedies such as Mareva Injunctions and Receivership.

The potential for 'wrongful trading' by a parent is clarified in the Australian provisions and removes the problem faced in *Re Augustus Barnett & Son Ltd*. Under section 588X Corporations Law, the Spanish parent Rumasa would have had a duty to monitor the financial position of the subsidiary. Creditors would have then had recourse against the parent. The obligation to monitor the accounts of a subsidiary would also prevent some, though not all, of the difficulties found in *Multinational Gas Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd & Ors* from reoccurring. Under the provision making 'holding companies' liable for the debts of its subsidiaries, Multinational would have been liable for the debts of Services but the three joint venturing oil companies would have escaped liability because they would not fit into the definition of 'holding company'. As we shall see in Chapter 7, New Zealand has a provision that would overcome this problem by permitting the court to order related companies to make contributions to the liquidation assets where it is 'just and equitable' to do so.

¹³³ *Ibid.*, at 238.

¹³⁴ *Ibid.*, at 238. Professor Farrar's criticisms are not confined to Australia. See John H. Farrar, 'The United Kingdom Companies Act 1989' (1990) 17 *Canadian Business Law Journal* 150.

The real advance to be gained from the Australian Corporations Law is the use of remedies for creditors before insolvency. Ideally, the remedy found in section 1324 dovetails with a statutory derivative action.¹³⁵ The injunction provision permits creditors to sue for the wrongs done by management in wholly owned companies whereas such an action would logically have lesser priority to that of a statutory derivative action in a non wholly owned subsidiary. Even though their interests often differ, minority shareholders in subsidiaries perform a watch dog role for creditors because any properly non-ratifiable managerial misfeasance is actionable. Thus, minority shareholders have a proximity permitting intervention in the management of a company where wrongs are identified in precedence to and for the ultimate advantage of creditors. Clearly the Australian provisions show that where this check is not available – the wholly owned subsidiary – careful legislative drafting can permit a creditor to maintain the likelihood of full repayment of their debt where conduct of a parent or the officers blatantly breach their duties to the disadvantage of the company and in turn the creditors.

¹³⁵ CLERP Report 3 proposes the introduction of a statutory derivative action in Australia. See The Treasury, Director's Duties and Corporate Governance Corporate Law Economic Reform Program Proposals for Reform: Paper No. 3 (Canberra: Australian Government Publishing Service, 1997). See also The Treasury, Corporate Law Economic Reform Program Policy Reform (Canberra: Australian Government Publishing Service, 1998). <http://www.treasury.gov.au>

Chapter 7

New Zealand: Related Company Contributions and Pooling Orders

In June 1989, the New Zealand Law Commission delivered its report on company law.¹ The Commission was charged with the responsibility of considering the form and content of new Companies legislation to replace the existing Companies Act of 1955. New Zealand has retained closer links to UK companies law via its continued use of appeals to the Privy Council.² Because of this affinity, and their simplicity, the proposals made in the New Zealand Law Commission's Report and the provisions of the subsequent Companies Act 1993 offers significant prescriptive merit and guidance for the UK. In addition to considering the detail of the relevant legislative provisions, it will be shown that despite the measures adopted in Australia, the New Zealand Legislature refrained from adopting measures to protect creditors before insolvency. As we shall also see, another feature of the New Zealand legislation is its simplicity relative to the complexity of the Australian Corporations Law.

¹ See the initial report New Zealand Law Commission, Company Law Reform and Restatement Report No 9 (Wellington: NZ Government Printer, 1989) and the draft legislation suggested by the Law Commission in New Zealand Law Commission, Company Law Reform: Transition and Revision Report No 16 (Wellington: NZ Government Printer, 1989)

² *Meridian Global Funds Management Asia Ltd v. Securities Commission* [1995] 2 AC 500 and *Kuwait Asia Bank E.C. v. National Mutual Life Nominees Ltd*, [1991] 1 AC 187 are recent examples of the Privy Council making valuable contributions to common law company law via cases on appeal from New Zealand.

REMEDIES PRIOR TO INSOLVENCY

Unlike the Australian Corporations Law, the Companies Act 1993 (NZ) provides little assistance to creditors wishing to pursue asset protective measures prior to insolvency.

Under Section 126 of the Law Commission's draft Act³ creditors had standing to restrain any action that contravened the company's constitution by use of a statutory injunction. However, this was removed from the final legislation for unknown reasons.⁴ This may have been seen as an unnecessary concession by legislators as the Law Commission would not permit creditors to claim for breaches of the Act during a company's solvency⁵ and emphasised that it was always open to a creditor to negotiate a higher level of protection than that offered on insolvency.⁶ This position would seem consistent with the Law Commission's rejection of the suggestion in cases like *Nicholson v Permakraft (NZ) Limited*⁷ and *Kinsela v Russell Kinsela Pty Limited*⁸ that in cases of near insolvency a creditor is owed and can enforce duties against directors directly.⁹ Grantham has suggested that as the Companies Act 1993 in its final form was amended to omit operation of the common law, the final legislation may be interpreted as a code and operate to extinguish any duties a director may have for the benefit of

³ Part 8 Enforcement, section 126, Injunction to restrain action

(1) Where a company or the board proposes to engage in any conduct that contravenes the constitution of the company or the Act, the company or any director, shareholder or other entitled person, or any creditor of the company may apply to the Court for an order restraining the company or the director, as the case may be, from so acting.

(2) Where the Court grants an order under subsection (1), it may grant such consequential relief as it thinks proper.

(3) No order may be made under this section in respect of any conduct or course of conduct that has been completed at the time the order is to be made.

⁴ Ross Grantham, *Private Correspondence* 1 May 1997.

⁵ New Zealand Law Commission Report 9 *op. cit.*, n 1 para. 215.

⁶ *Ibid.*, para. 216.

⁷ [1985] 1 NZLR 242.

⁸ (1986) 4 NSWLR 711.

⁹ New Zealand Law Commission Report 9 *op. cit.*, n 1 para. 220.

creditors.¹⁰ Consequently, there is doubt as to whether the possibility of a director's duty to creditors subsists be they tortious or equitable in origin.

Rather than the imposition of duties for the benefit of creditors, the Law Commission opted for a much more conservative approach. A broad range of duties including the duty not to unreasonably risk the company breaching the solvency test (draft act section 105¹¹) were properly seen as duties owed to the company, in tune with *Foss v. Harbottle*. On breach of such statutory duties during solvency, it is a matter for the company or shareholders suing derivatively to enforce such duties. On insolvency, only liquidators are permitted standing to sue - any concession to creditors seen as undermining the statutory liquidation regime.¹² However, in the legislation's final form, on liquidation a creditor may bring proceedings against a director for misfeasance or breach of duty.¹³ This offers creditors the opportunity to pursue an action in circumstances where a liquidator may be reluctant to risk an unfavourable cost order.

¹⁰ Grantham, *op. cit.*, n 4.

¹¹ Draft Section 105 Solvency.

- (1) A director of a company must not agree to the company entering into a contract or arrangement or acting in any other manner unless he or she believes at that time on reasonable grounds that the act concerned does not involve an unreasonable risk of causing the company to fail to satisfy the solvency test.
- (2) A director of a company must not agree to the company incurring an obligation unless he or she believes at that time on reasonable grounds that the company will be able to perform the obligation when required to do so.

¹² New Zealand Law Commission Report 9 *op. cit.*, n 1 para. 219

¹³ Section 301 Companies Act 1993 (NZ). Power of Court to require persons to repay money or return property.

- (1) If, in the course of the liquidation of a company, it appears to the Court that a person who has taken part in the formation or promotion of the company, or a past or present director, manager, liquidator, or receiver of the company, has misapplied, or retained, or become liable or accountable for, money or property of the company, or been guilty of negligence, default, or breach of duty or trust in relation to the company, *the Court may, on the application of the liquidator or a creditor or shareholder---*
 - (a) Inquire into the conduct of the promoter, director, manager, liquidator, or receiver; and
 - (b) Order thaterson---

The difference in the approach of the Australian and New Zealand legislatures is a philosophical one. The New Zealand legislature is less willing to intervene in the process of management opting for a market driven, discrete entity, and contractarian line before liquidation. However, this position changes dramatically once the company is in liquidation. Whereas, the Australian Corporations Law permits limited incursions, pre-insolvency, to the management of a company in circumstances where a wrong has clearly caused damage to the continued financial viability of the company.

REMEDIES ON INSOLVENCY

On the liquidation of a company, the New Zealand Companies Act gives courts a discretionary power to deal with related corporations. Since 1980, the New Zealand Companies Act 1955 has permitted the court to make two innovative orders on the liquidation of a company.¹⁴ First, that a company related to a company in liquidation

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- (i) To repay or restore the money or property or any part of it with interest at a rate the Court thinks just; or
 - (ii) To contribute such sum to the assets of the company by way of compensation as the Court thinks just; or
 - (c) Where the application is made by a creditor, order that person to pay or transfer the money or property or any part of it with interest at a rate the Court thinks just to the creditor.
 - (2) This section has effect even though the conduct may constitute an offence.
 - (3) An order for payment of money under this section is deemed to be a final judgment within the meaning of section 19 (d) of the Insolvency Act 1967.
- ¹⁴ Section 271 Pooling of assets of related companies
- (1) On the application of the liquidator, or a creditor or shareholder, the Court, if satisfied that it is just and equitable to do so, may order that
 - (a) A company that is, or has been, related to the company in liquidation must pay to the liquidator the whole or part of any or all of the claims made in the liquidation:
 - (b) Where 2 or more related companies are in liquidation, the liquidations in respect of each company must proceed together as if they were one company to the extent that the Court so orders and subject to such terms and conditions as the Court may impose.
 - (2) The Court may make such other order or give such directions to facilitate giving effect to an order under subsection (1) of this section as it thinks fit.
- Section 272 Guidelines for orders
- (1) In deciding whether it is just and equitable to make an order under section 271 (1) (a)

contributes to the assets available for distribution on liquidation. Second, that the assets of related companies in liquidation are pooled and the liquidations be treated as one liquidation. The court must be satisfied that it is *just and equitable* to make the order according to certain criteria. Despite the existence of the remedy for some time, there have been only a few cases that provide insight concerning the operation of the provision. The Companies Act 1993 sets out two different sets of criteria for the different orders that are available. Even so, the legislation still recognises that it is legitimate for companies to be related. Notably, the mere relation of companies does not automatically hasten the operation of the section 271.

Criteria for an order that a related company contribute to the liquidation

In deciding whether it is *just and equitable* to make an order that a related company contribute to the liquidation the court must consider:

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- of this Act, the Court must have regard to the following matters:
- (a) The extent to which the related company took part in the management of the company in liquidation:
 - (b) The conduct of the related company towards the creditors of the company in liquidation:
 - (c) The extent to which the circumstances that gave rise to the liquidation of the company are attributable to the actions of the related company:
 - (d) Such other matters as the Court thinks fit.
- (2) In deciding whether it is just and equitable to make an order under section 271 (1) (b) of this Act, the Court must have regard to the following matters:
- (a) The extent to which any of the companies took part in the management of any of the other companies:
 - (b) The conduct of any of the companies towards the creditors of any of the other companies:
 - (c) The extent to which the circumstances that gave rise to the liquidation of any of the companies are attributable to the actions of any of the other companies:
 - (d) The extent to which the businesses of the companies have been combined:
 - (e) Such other matters as the Court thinks fit.
- (3) The fact that creditors of a company in liquidation relied on the fact that another company is, or was, related to it is not a ground for making an order under section 271 of this Act.

- a) The extent to which the related company took part in the management of the company in liquidation;
- b) The conduct of the related company toward the creditors of the company in liquidation;
- c) the extent to which the circumstances that give rise to the liquidation of the company are attributable to the actions of the related company; and
- d) such other matters as the court thinks fit.

In *Rea v Barker*¹⁵ the liquidator sought to gain a contribution from a related company toward the assets available for distribution. The court clarified that it was permissible, in considering whether it was *just and equitable* to seek such a contribution, to take into account conduct of the related company both before and after the liquidation. Importantly, the scope of the conduct considered could also have a direct or indirect affect on the likelihood of the creditors full recovery. As regards *such other matters as the court thinks fit* it is clear that the continued solvency of the contributing company is an issue. Where the contribution risks the continued solvency, then it is doubtful that the court will authorise the order.¹⁶

Criteria for an order that the companies in liquidation be treated as one

On this point, there is only marginally more authority. Under section 272(2) the court must consider:

¹⁵ (1988) 4 NZCLC 64,312.

¹⁶ See *Lewis v. Poultry Processors* (1988) 4 NZCLC 64,508 and *Re Liardet Holdings Ltd* (1983) BCR 604.

- a) the extent to which any of the companies took part in the management of any of the other companies;
- b) the conduct of any of the companies toward the creditors of any of the other companies;
- c) the extent to which the circumstances that give rise to the liquidation of any of the companies are attributable to the actions of any of the other companies;
- d) the extent to which the businesses of the other companies have been combined; and
- e) such other matters as the court thinks fit.

In *Re Pacific Syndicates (NZ) Ltd (in liq)*¹⁷ Hardie Boys J. considered a predecessor of section 271 and 272 in the context of the administration of two investment companies. Whilst the counsel for all parties consented to the pooling order being made Hardie Boys J. justified the making of the order in the following terms:

First, there is the pooling of investor's funds in the one account. Secondly, there is the complex and possibly arguable situation of inter-company debt. Thirdly, and related to it, is the intertwined liability of the companies to investors.... Fourthly, there is the [im]possibility of dividing the Cattle Syndicates fund between the two companies. Fifthly, there is yet another fund which has finally come into the hands of the liquidator, subject to the approval of a compromise.... Sixthly, the investigating accountant has expressed the view that it would be equitable to allocate any final dividend pro rata between all creditors of both companies. If the liquidator were permitted to do this, this protracted liquidation would be brought to a prompt conclusion without further expenditure on what are likely to be futile accounting and legal exercises...¹⁸

The case demonstrates that the primary function of the section is to facilitate the administration of a liquidation where the affairs of the related insolvent companies are

¹⁷ (1989) 4 NZCLC 64,757.

¹⁸ *Ibid.*, at 64,767 - 64,768.

commingled to such an extent that to untangle the affairs is virtually impossible and would place a significant strain on the funds available for creditors. This is a rationale familiar to the similar remedy of Substantive Consolidation found in the United States.¹⁹

In *Re Dalhoff and King Holdings Ltd*²⁰ liquidators of a parent and two subsidiaries sought an order under section 315B Companies Act 1955 (a predecessor of sections 271 and 272 Companies Act 1993) to have the three companies wound up together as if they were one company. In making the order the court took into account a number of factors. First that there were a number of interlocking directorships and directors were often confused as to which company they were dealing and with or whose management they were discussing.²¹ Most notably, the directors of one of the subsidiaries had admitted in a statement of affairs that all activities of each company were closely related. Gallen J. considered this admission significant in determining that the companies were operated as substantially one enterprise with management seeing no reason to differentiate.²² This was a significant yet not decisive factor. Second, in relation to the conduct of the companies toward the creditors of the other companies it was shown that creditors were confused with whom they had contracted because management did not make any differentiation between the companies.²³ Again, the image portrayed was of one enterprise. Third, all the companies operated one bank account and creditors of one company were indiscriminately treated as creditors of the another company. Fourth, employees were unsure which company employed them.

¹⁹ *Infra*, Chapter 8, Substantive Consolidation on page 340

²⁰ [1991] 2 NZLR 296.

²¹ *Ibid.*, at 302 (lines 20-25).

²² *Ibid.*, at 302 (lines 30-35).

²³ *Ibid.*, at 303 (lines 40-45).

Accordingly, that proofs of debt were lodged with the liquidator of the wrong company. Each of these factors alone was insufficient to warrant the intervention of the court, but together formed grounds for the pooling order. One of the primary considerations was the benefit for creditors should the order be made. Without the pooling order, the shareholders of the parent expected a dividend of 28 cents per share. Whereas the pooling order would ensure that all creditors of each company received 90.88 per cent of their debts with no shareholder dividend. In *Re Dalhoff and King Holdings Ltd*,²⁴ in the absence of the pooling remedy, it would be surprising given the level of disregard for entity by management, the level of commingling of funds, and confusion amongst creditors as to with whom they contracted that a court would not have lifted the veil of the other companies.

Comments

The UK has had limited experience with pooling assets of companies in liquidation. In *Taylor v. Morris*²⁵ the Scottish Inner House of the Court of Sessions was called on to authorise the joint winding up of two companies and the sequestration of one of the directors and controlling shareholders of the companies. The liquidator argued that he was unable to distinguish between (1) transactions entered by the companies from those entered by the director; (2) the respective assets and liabilities of each entity. The director opposed the application to consolidate the actions on the grounds that it would prejudice his personal estate and further that the court lacked jurisdiction to make such an order. The court balked at the opportunity to elucidate on whether the court had the

²⁴ *Ibid.*

²⁵ [1993] BCLC 1343.

power to consolidate the administration and assets of separate liquidations.²⁶ Rather, the court recognised that a liquidator, as an agent of the company, had authority to enter a compromise,²⁷ stating:

In our view, it is established that the assets of the companies and of the sequestration are so confused that it is impossible separately to identify the assets of each and if also it appears that it is practically impossible to determine who are the true debtors for those creditors who have claims arising out of the same business with the companies and/or the sequestrated estate then it would be open to the noter [the director] to enter into a compromise arrangement with [the liquidator] so as to enable an overall settlement to be reached with all the creditors.²⁸

The court recognised that this would minimise cost but the overall explanation of the court is far from satisfactory. There is no clear legal entitlement to consolidate and there is uncertainty as to the procedure necessary. The New Zealand provisions offer the feature of procedural certainty and access to the equitable jurisdiction of the court to obtain an assessment of the degree of commingling etc.

In terms of clarity, the apparent legislative rejection of common law director's duties to creditors removes a confusing area of the law. In doing so, the New Zealand legislature emphasises the contractual relationship between creditors and the company, leaving creditors to their own investigations. Before insolvency, separate personality remains firmly rooted in New Zealand Law but on liquidation creditors gain the concession of legislative erosion of *Salomon* for the purposes of the contribution and pooling provisions. We will recall the Cork Committee favoured a philosophy that held firm to *Salomon* during solvency but encouraged recourse against the parent or directors on

²⁶ *Ibid.*, at 1348 a.

²⁷ Section 245(1)(f) Companies Act 1948 (section 167, Schedule 4 para. 2 Insolvency Act 1986).

²⁸ [1993] BCLC 1343 at 1347 h i.

liquidation.²⁹ These provisions are a legislative recognition that enterprise principles assist in the facilitation of the liquidation process. The tendency of a group's business to be run under one management umbrella and the risk of uncommercial intercorporate transactions place an unbearable burden on maintaining the strict letter of *Salomon* on insolvency. Clearly, the challenge to separate personality is warranted, at a time when a company is approaching or in liquidation because the company at this time is comprised essentially of the creditors' interests.

In Australia, the mechanisms of the Corporations Law allow pre-insolvency remedies provided there is sufficient evidence of clear and immediate danger to creditors' interests. Whereas in New Zealand, the emphasis is after insolvency, the key to this process being the 'open textured' *just and equitable* threshold. Such a wide power is necessary if 'common notions of fairness in all the circumstances'³⁰ are to be achieved for the benefit of creditors. For this reason, it is submitted that the New Zealand provisions would provide avenues to creditors in both *Re Augustus Barnett & Son Ltd* and *Multinational Gas Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd & Ors.*

The Cork Committee was obviously attracted to the New Zealand provisions,³¹ but resiled from making any recommendations. Any reform similar to the New Zealand experience would have gone beyond group trading because it also calls for a serious relaxation of *Salomon* after insolvency. Even so, authoritative statements from the Cork Committee gives New Zealand based reform measures credibility:

²⁹ Cork, *op. cit.*, at 435, para. 1928.

³⁰ *Re Home Loans Funds (NZ) Ltd (in group liq)* (1983) 1 NZCLC 95,073 at 95,583 per Casey J.

³¹ Cork, *op. cit.*, at 439, para. 1950.

[G]iven the command which the parent company has in practice over the affairs of the subsidiary, it is absurd and unreal to allow the commercial realities to be disregarded and the technical legal separate status to predominate once a subsidiary has gone into insolvency.³²

Further, there is a strong doctrinal similarity between the New Zealand contribution and pooling provisions and the principle of substantive consolidation in the United States. Indeed, the New Zealand courts have been called on to utilise US law in the process of crafting a jurisprudential response to the application of the sections.³³

³² Cork, *op. cit.*, at 435, para. 1928.

³³ John H. Farrar and Alistair B. Darroch, 'Insolvency And Corporate Groups - The Problem of Consolidation' in J. P. G. Lessing and J. F. Corkery eds, Corporate Insolvency Law (Gold Coast: The Taxation & Corporate Research Centre, Bond University, 1995) 231-62.

Chapter 8

The United States: Veil Piercing, Fiduciary Duties, Equitable Subordination, and Substantive Consolidation

INTRODUCTION

Professor Gower earlier this century encouraged the ‘cross-fertilisation’ of US ‘corporations’ law and British company law¹ because ‘American corporation law is now incomparably richer and more highly developed than its English parent’.² However, European influences have played a major role in the past 25 years on British company law.³ Nevertheless, the continuing relevance of Professor Gower’s sentiments are underscored in the context of corporate groups by the demonstrated inadequacy and unsuitability of European reforms.⁴ Further, the Cork Committee was attracted to US principles in relation to the problems posed by groups and considered that the US had a lot to offer.⁵ As previously mentioned,⁶ more than is the case with Australia or New Zealand, the use of US material as a source of reform poses greater difficulties of

¹ L. C. B. Gower, ‘Some contrasts between British and American Corporation Law’ (1956) 69 *Harvard Law Review* 1369.

² *Ibid.*, at 1400.

³ Davies, *op. cit.*, at 54.

⁴ *Supra*, Chapter 5, The European Community on page 247.

⁵ Cork, *op. cit.*, Chapter 51.

⁶ *Supra*, Introduction, A Cautionary Note on page 42.

transplantation. With this in mind, we should dwell briefly on some of the essential similarities and differences between the US corporation and the British company.⁷

The US company is familiar in structure and liability rules to the British company. In the US, 'A corporation and its stockholders are generally to be treated as separate entities. Only under exceptional circumstances... can the difference be disregarded.'⁸ Equally, 'Limited liability is the rule, not the exception; and on that assumption large undertakings are rested, vast enterprises are launched, and huge sums of capital attracted.'⁹ Despite, the initial similarity with principles such as limited liability and separate personality, there are fundamental legal differences in the nature of the relationship between directors, parents, subsidiaries, creditors and the US approach to regulation. The reason for this is historical.

The English company evolved primarily from the unincorporated partnership with an emphasis on agreement between the parties and as such owes a significant debt to partnership principles. Whereas, the US corporation is a creature of statute and is derived from both Federal and State sources.¹⁰ What a corporation can and cannot do is defined usually by statute. The consequence of these two different approaches has left a significant residue. As previously mentioned,¹¹ in the UK companies were exploited early on because there was no perceived impediment to a company owning shares in

⁷ The US differences apply equally to Australia and New Zealand.

⁸ *Burnet v. Clark* 287 US 410, 415 (1932). See also *New Colonial Ice Co. v. Helvering*, 292 US 435, 442 (1934).

⁹ *Anderson v. Abbott*, 321 US 349, 362 (1944).

¹⁰ There has been a continual debate concerning the issue of whether there should be a Federal corporate law covering all jurisdictions in the US. See William L. Cary, 'Federalism and Corporate Law: Reflections upon Delaware' (1974) 83 *Yale Law Review* 663; Ralph K. Winter, 'State Law, Shareholder Protection, and the Theory of the Corporation' (1977) 6 *Journal of Legal Studies* 251; Roberta Romano, *The Genius of American Corporation Law* (AEI Press, 1993).

¹¹ *Supra*, Chapter 1, Parent as a Shareholder on page 96.

another company because this was a private contractual question. Whereas, corporate ownership caused concern in the US because the statutory power to sanction such ownership did not initially exist. However, where the UK law may have appeared less formal, *Salomon* sets out a strict regime of separate personality that remains as solid and unyielding as ever. Whereas, the US approach to separate personality is treated more as a presumption that may be rebutted¹² rather than a strict rule with few exceptions. Admittedly a subtle difference, it becomes more obvious when we consider that, in general, US courts seem more concerned with reaching an equitable result rather than complying with the strictness of the entity principle. Further, the US courts have developed a range of remedies that complement strict veil piercing jurisprudence based largely on the equitable jurisdiction of the court. Blumberg's works demonstrate that veil piercing is not the sole domain of corporate law. For instance, tort law utilises the doctrine of *assumption of duty* and *successor liability*; contract law uses *estoppel* and *misrepresentation*; and bankruptcy law uses principles such as *fraudulent conveyances*, *equitable subordination*, and *substantive consolidation*.¹³

Importantly, these remedies are comprehensible to UK Lawyers but in many instances unknown to UK law and consequently provide a source of possible reform measures. One reason for the richness of US remedies derives from the competition for incorporation waged by many of the US States. EC reforms imposed on the Companies Act have caused it to balloon in detail and complexity with a tendency toward regulation rather than market forces. The US Federal Government has left the states to

¹² Robert B. Thompson, 'Piercing the Corporate Veil: An Empirical Study' (1991) 76 *Cornell Law Review* 1036.

¹³ Blumberg '85, *op. cit.* at 285ff. (fraudulent conveyances), 41ff. (equitable subordination), 385ff. (substantive consolidation). Blumberg '87, *op. cit.* at 316ff. (assumption of duty) and 277ff. (Successor liability), 295ff. (misrepresentation). See also Antunes, *op. cit.* at 249.

formulate corporations legislation, notably in Delaware, aims to facilitate the inception and continuance of viable commercial enterprises, freeing business from undue regulation and complexity.¹⁴ Thus, the presence of a competitive pressure makes the legislation leaner and less restrictive. Whereas, in the UK there is no emphasis placed on making the State's desire for revenue an impetus for the regular updating and pruning of companies legislation.¹⁵ In the US legislative environment, it is fair to say that, the courts have a greater onus to be flexible and innovative in the absence of clear statutory intention. Some account must also be made of the influences of the law and economics debate. Coasian analysis¹⁶ infiltrates US corporations' jurisprudence via the appointment of a number of law and economics scholars to the bench.¹⁷ This by contrast to the UK is unprecedented where economic analysis has received a frosty reception.¹⁸

A survey of the US law provides a contrast to the legislative reform measures found in Australia and New Zealand because many of the US remedies are not legislative but court based. With the similarity of the principles of separate personality and limited liability in mind we can concern ourselves with the question of how the US has framed its rules to deal with the problem posed by the parent subsidiary relationship. What can we learn from the US experience? What are the features that will contribute to the improvement of English Law?

¹⁴ Brian R. Cheffins, Company Law: Theory, Structure, and Operation (Oxford: Clarendon Press, 1997) at 424-425.

¹⁵ *Ibid.*, at 425.

¹⁶ A convenient collection of Coase's work is, Ronald Coase, The Firm, The Market and The Law (Chicago: Chicago University Press, 1988)

¹⁷ For example, Frank H. Easterbrook (7th Circuit Court of Appeals), Richard A. Posner (7th Circuit Court of Appeals), Ralph K. Winter (2nd Circuit Court of Appeals).

¹⁸ '[The courts] are concerned not with economics but with law. The distinction between the

Because of the diversity of jurisdictions, we will focus on the decisions of the US Supreme Court, but where necessary the decisions of the various divisional Courts of Appeal will be considered. Accordingly, treatment of the material can only provide a broad-brush approach to give a flavour for the state of the US law.

For the purposes of what may be plausible reforms in the UK, we will be concerned with three areas. First, the nature of veil piercing jurisprudence in the US. Here we are concerned with identifying those qualities in US corporations law that make it less rigid. This will lead to the second matter: the difference in the nature of the fiduciary relationship and its incursion into the US parent subsidiary relationship. Finally, the US bankruptcy principles of equitable subordination and substantive consolidation will be discussed. It will be demonstrated that the US has a scheme of remedies that apply to cover a variety of conduct and enable redress at different times during the life and dissolution of a company. For example, veil piercing and the enforcement of fiduciary duties are remedies available during the entire life and death of a company. By contrast, equitable subordination and substantive consolidation are confined to liquidation. In its scope, the US scheme covers a range of conduct. Simply, the first tier has remedies for serious abuses of entity theory that justify veil piercing. The second tier concerns less serious abuses that justify the court using its equitable jurisdiction to right wrongs though the level of culpability does not justify piercing the veil. Finally, the third tier is a layer of law that seeks to combat fraudulent conveyances such as voidable dispositions etc. and takes the familiar form of legislative measures such as those in the UK. If we recall the UK position in this context, it soon becomes clear that the UK has no second tier where the court is willing to use a greater degree of

two is, in law, fundamental and cannot here be bridged.’ See *Bank of Tokyo Ltd v Karoon*

intervention using its equitable jurisdiction. The problem in the US is that there is no clear delineation of principle between the first and second tier and this contributes to a general confusion as to when veil piercing principles should be applied.

US VEIL PIERCING

If any general rule can be laid down, in the present state of authority, it is that a corporation will be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears; but, when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime; the law will regard the corporation as an association of persons...¹⁹

The complexity, equity, fluidity, inconsistency, and doctrinal variations that are found in US veil piercing jurisprudence offers diversity second to none.²⁰ Adopting all of these qualities in the UK, of course, would be fruitless – certain only to send pandemonium pumping through the veins of commerce and give English Lawyers a nervous rash. Professor Thompson in a recent study has indicated that although US veil piercing is the most litigated corporate law issue, it remains an enigma.²¹ Professor Blumberg has demonstrated in his extensive work on the US law relating to corporate groups that there is an immense complexity of influences shaping the law. He describes the law concerning veil piercing in the US as ‘hundreds of decisions that are irreconcilable and not entirely comprehensible.’²² We are lead into a vast wilderness of jurisdisdictional variations and idiosyncrasies.²³ Let us focus on veil piercing between parent and subsidiary.²⁴

[1986] 3 All ER 468, (CA) *per* Robert Goff L.J. at 486 d e

¹⁹ *United States v. Milwaukee Refrigerator Transit Co* 142 F 2d 247, 255 (1905) *per* Sanborn J.

²⁰ For a comprehensive discusson see 18 *Amercian Jurisprudence* 2d, Corporations § 42 ff.

²¹ Thompson, *op. cit.* n 12.

²² Blumberg '83, *op. cit.*, at 8.

²³ Because of this, it is admitted that there is a grave risk of treating the material superficially,

In the US, the courts recognise as a basic proposition that absent circumstances justifying disregard of corporate form, a parent is treated as a legal entity separate from its subsidiary.²⁵ Equally, subsidiaries are treated as independent of each other.²⁶ Almost without exception, veil piercing is confined to close corporations and corporate groups and rarely occurs in public companies.²⁷ Separate corporate status of the parent will be upheld where the subsidiary is wholly owned and each enterprise shares common directors and officers.²⁸ In circumstances akin to *Salomon*, where an individual owns all the shares and is the sole controller and director in a parent, the finding that the individual is the alter ego of a subsidiary is not an automatic assumption.²⁹ Further, the fact that a parent has loaned money to subsidiaries with few formalities and both parent and subsidiaries shared employees, offices, stationary is not sufficient to justify removal of separate entity.³⁰ There is no justification for piercing corporate veil where a parent and subsidiary keep corporate officers and finances separate, balanced profits and losses separately, have not commingled funds and there is no indication that the parent had fraudulent intent in purchasing or maintaining

but the constraints of length justify this compromise.

²⁴ Familiar to the decisions of Lord Denning in *Littlewoods Mail Order Stores Ltd v. Mc Gregor (Inspector of Taxes)* [1969] 3 All ER 855 at 860 F H and *DHN Food Distributors Ltd v. London Borough of Tower Hamlets* [1976] 3 All ER 462 at 467 b e. and Professor Gower's early views, L. C. B. Gower, The Principles of Modern Company Law 3rd ed (London: Stevens & Sons, 1969) at 216 the relationship between parent, subsidiary, and other affiliated corporations is perceived as susceptible to veil piercing in the US. See Harry G. Henn and John R. Alexander, Laws of Corporations and Other Business Enterprises 3rd ed (St Paul: Minnesota: West Publishing Co., 1983) at 347.

²⁵ *Skidmore, Owings & Merrill v. Canada Life Assur. Co* 907 F 2d 1026 (10th Cir, 1990). *Milgo Electronics Corp v. United Business Communications Inc* 523 F 2d 645 (10th Cir, 1980), cert denied 449 US 1066.

²⁶ *Miller v. Robertson* 266 US 243 (1924).

²⁷ Thompson, *op. cit.*, n 12 at 1039.

²⁸ *McKinney v. Gannett Co, Inc* 817 F 2d 659. (10th Cir, 1987)

²⁹ *US. v. Fidelity Capital* 920 F 2d 827, rehearing denied 933 F 2d 949 (11th Cir, 1991).

³⁰ *Ibid.*

subsidiary.³¹ Whereas, where corporate formalities are not respected, such as, where assets of two entities are commingled and their operations intertwined, subsidiaries may be deemed the alter ego of its parent.³² Variations occur; for example under Californian law, inadequate capitalisation of a subsidiary may alone be a basis for holding parent corporation liable for acts of subsidiary.³³ On the other hand, a parent will be held liable under Delaware law for activities of subsidiary ‘only if [the] parent dominates those activities.’³⁴ Under New York law, shareholder liability may be predicated either upon showing of fraud or upon complete control by a dominating corporation that leads to wrongs against third parties.³⁵

Ultimately, the true test of US veil piercing jurisprudence is the whether it achieves equitable results balancing the interests of all concerned. In the US, there has been a real attempt to develop a comprehensible prognostic tool but the difficulty continues to be the addiction of the US judiciary to the use of metaphors to describe the relationship between parent and subsidiary. Here we encounter the world of alias, coat, mere instrumentality, alter ego, adjunct, puppet, and snare to name only a few. Though, in *Berkley v. Third Avenue Railway Co.*,³⁶ Judge Cardozo (as he then was) warned against the substitution of epithets for rigorous analysis.

The whole problem of the relation between parent and subsidiary corporations is one that is still enveloped in the mists of metaphor. Metaphors in law are to be

³¹ *Ministry of Defense of the Islamic Republic of Iran v. Gould, Inc.* 969 F 2d 764 (9th Cir, 1992).

³² *Mobil Oil Corp v. Linear Films Inc* 718 F Supp 260 (1989)

³³ *Slottow v. American Gas. Company. of Reading, Pennsylvania* 1 F 3d 912 (9th Cir, 1993).

³⁴ *Phoenix Canada Oil Company. Ltd. v. Texaco, Inc.* 658 F Supp 1061, affirmed 842 F 2d 1466, (1987) certiorari denied 488 US 908 (1988), certiorari denied *Texaco Petroleum Ca v. Phoenix Canada Oil Company Ltd* 488 US 916 (1988).

³⁵ *Passalacqua Builders. Inc. v. Resnick Developers South. Inc.* 933 F 2d 131 (1991).

³⁶ 244 NY 84, 155 NE 58 (1926).

narrowly watched, for starting as devices to liberate thought, they end often by enslaving it.³⁷

Indeed the primary critique of the law focuses on the form and language of the decisions rather than substantive question of whether the results are correct.³⁸ It seems that contrary to the litany of academic descent, a number of notable voices acknowledge that ‘in spite of conflicting and misleading dicta the judicial hunch usually carries through to a correct decision.’³⁹ Let us now consider the methods used by the courts to reach these decisions.

There are two tests generally used in the US concerning veil piercing. First, the *instrumentality test* and second, the *alter-ego test*.⁴⁰ As we shall see, the basic theory is the same and the difference is essentially one of form. Primarily, the court must be satisfied that the subsidiary lacks a real separate legal existence because of the nature of the parent’s involvement. However, parental involvement alone is insufficient to permit veil piercing. There must also be some degree of ‘fundamental unfairness’, ‘inequity’, or ‘injustice’ akin to fraud present in the relationship.⁴¹ We must note that ‘fraud’ in this context is not the comparatively strict formulation found in cases such as

³⁷ *Ibid.*, at 94, 155 NE at 61.

³⁸ Thompson, *op. cit.*, n 12.

³⁹ Elvin R. Latty, ‘Corporate Entity as a solvent of legal problems’ (1936) 34 *Michigan Law Review* 597 at 630. See also Adolf A. Berle, ‘The Theory of Enterprise Entity’ (1947) 47 *Columbia Law Review* 343, at 345, stating ‘[t]he various reasons, fictions, arguments and important considerations are many, diverse, and frequently inconsistent; but the scheme of these various exceptions is none the less consistent and logical enough.’ See also Thompson, *op. cit.*, n 12 at 1038.

⁴⁰ Blumberg suggests that there is also a third, namely the ‘identity’ doctrine, but recognises that despite the verbal formulations each doctrine is essentially the same. See Blumberg ’89, *op. cit.*, at 34-38; Antunes, *op. cit.*, at 242-248. The ‘identity doctrine’ postulates that if there is such a unity of interest and ownership that the independence of the corporation has ceased or never commenced than adherence to separate personality would defeat justice and equity by permitting one economic entity to escape liability for the conduct or liability of arising from the operations for the benefit of the whole enterprise. See 18 *American Jurisprudence* 2d Corporations, § 52 at 862. *Zaist v. Olsen* 227 A 2d 552 (1967), *Lowendahl v. Baltimore and Ohio Railway Coy* 247 App Div 144 (1936).

Re Bugle Press Ltd,⁴² *Guildford Motor Co. Ltd v. Horne*,⁴³ and *Jones v. Lipman*.⁴⁴ In the English cases there is an attempt to use the corporate form to knowingly conceal or avoid obligations.

The *instrumentality* approach to veil piercing between parent and subsidiary is derived from the work of Frederick Powell in the 1930's⁴⁵ that subsequently gained judicial status when adopted by the court in *Lowendahl v. Baltimore & Ohio Railroad*.⁴⁶ The primary elements are as follows:

1. Control, not merely majority or complete stock control, but complete domination, not only of finances, but of policy and business practices with respect to the transaction attacked so that the corporate entity had at the time no separate mind, will or existence of its own;
2. Such control must have been used by the defendant to commit fraud or wrong, to perpetrate the violation of a statutory or other positive legal duty, or a dishonest and unjust act in contravention of the plaintiff's legal rights
3. The previously mentioned control and breach of duty must proximately cause the injury or unjust loss complained of.⁴⁷

Whereas the *alter-ego* approach is considered a 'two pronged test' that must be negotiated before veil piercing will occur between parent and subsidiary.⁴⁸

First, that the corporation is not only influenced and governed by that person [shareholder], but that there is such a unity of interest and ownership that the individuality, or separateness, of the said person and corporation has ceased; second, that the factors are such that an adherence to the fiction of the separate

⁴¹ Blumberg '85, *op. cit.*, at 385.

⁴² *Supra*, on page 146.

⁴³ *Supra*, on page 145.

⁴⁴ *Supra*, on page 146.

⁴⁵ Frederick J. Powell, Parent and Subsidiary Corporations: Liability of a Parent for the Obligations of its Subsidiaries (Chicago: Callaghan and Company, 1931).

⁴⁶ 247 AD 144, 287 NYS 62 (1st Dept), affirmed 272 NY 360, 6 NE 2d 56 (1936).

⁴⁷ *Ibid.*, 247 AD 157, 287 NYS at 76.

⁴⁸ David H. Barber, 'Piercing the Corporate Veil' (1981) 17 *Willamette Law Review* 371. See also *Automotriz del Golfo de California v. Resnick* 41 Cal 2d 792, 796; 306 P 2d 1, 3 (1957).

existence of the corporation would, under the particular circumstances, sanction a fraud or promote injustice.⁴⁹

Put simply, for the *alter ego* doctrine there must be a 'merger' of interests and ownership such that the separation of personalities no longer exists. Second, if the conduct of the 'merged' personalities is treated as the actions of the company alone then inequity and injustice will follow.⁵⁰ There are essentially two features that the two doctrines share notwithstanding the many subtle differences in expression and nuance. *First*, there must be excessive control or unity of interest.⁵¹ *Second*, there must be inequitable, 'fraudulent', or unjust conduct by the offending party.

Excessive Control – Unity of Interest

The issues of control and separateness are primarily questions of fact. Whilst not comprehensive, the following evidentiary matters have been identified in cases and by commentators as relevant in determining the nature of the control relationship and the level of separateness between parent and subsidiary:

1. The parent corporation owns all or most of the stock of the subsidiary.
2. The parent and subsidiary corporations have common officers and directors.
3. The parent corporation finances the subsidiary.
4. The parent corporation subscribes to all of the capital stock of the subsidiary or otherwise causes its incorporation.
5. The subsidiary has grossly inadequate capital.

⁴⁹ *Minifie v. Rowley*, 187 Cal 481, 202 P 673, 676 (1921).

⁵⁰ *Garden City Co. v. Burden* 186 F 2d 651 (10th Cir, 1951); *Zaist v. Olsen* 227 A 2d 552 (1967); *Barber op. cit.*, n 48 at 376. See also John F. Dobbyn, 'A Practical Approach to Consistency in Veil Piercing Cases' (1971) 19 *Kansas Law Review* 185 at 187.

⁵¹ *Blumberg '89, op. cit.*, at 39-46; *Antunes, op. cit.*, at 245.

6. The parent corporation pays the salaries and other expenses or losses of the subsidiary.
7. The subsidiary has substantially no business except with the parent corporation or no assets except those conveyed by the parent corporation.
8. In the papers of the parent corporation or in the statements of its officers, the subsidiary is described as a department or division of the parent corporation, or its business or financial responsibility is referred to as the parent corporation's own.
9. The parent corporation uses the property of the subsidiary as its own.
10. The directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take their orders from the parent corporation in the latter's interest.
11. The formal legal requirements of the subsidiary are not observed.
12. Intercorporate loan transactions, that is, contracts not at arm's length, benefit the parent at the expense of the subsidiary.
13. The parent and subsidiary file consolidated income tax returns and/or consolidated financial statements.
14. The parent and its principals carry out decision making for the subsidiary.
15. Contracts between the parent and the subsidiary are more favourable to the parent.
16. The two operations are so integrated through the commingling of funds, interactivities; and common direction and supervision that they should be considered as one enterprise.
17. The subsidiary operates without profit.⁵²

⁵² Blumberg '89, *op. cit.*, at 44-45. For points 1 to 11 see *Fish v. East* 114 F 2d 177, 191 (10th Cir, 1940). See also *DeWitt Truck Brokers, Inc v. W. Ray Flemming Fruit Co* 540 F 2d 681 (4th Cir, 1976) where the court introduced a 'laundry list' approach stating that 'gross undercapitalization... , nonobservance of corporate formalities, nonpayment of dividends, insolvency of the corporation at the time of the litigated transaction, siphoning of corporate funds by the dominant shareholders, nonfunctioning of officers and directors other than the [controlling] shareholders, absence of corporate records, and use of the corporation as a façade for the conduct of the shareholders' business' (*Ibid.*, at 685-687) made the relationship between parent and subsidiary susceptible to veil piercing. See

The entire factual arrangement is considered; no one feature is determinative of whether the court will treat corporations as separate from their shareholders.⁵³ Importantly though, these factors initiate a line of enquiry to determine whether separate corporate existence still subsists or whether the notion of separateness has diminished to nothing. The difficulty lies in the combination of these features. We receive no guidance concerning whether certain aspects or combinations of the features mentioned are of particular significance in determining outcomes.⁵⁴ One explanation for the confusion and the need for 'laundry lists' lie in the tension between two cases from the US Supreme Court,⁵⁵ a tension between a willingness to pierce the veil on the one hand and an adherence to the principles of limited liability and separate personality on the other.

In *Bangor Punta Operations, Inc. v. Bangor & Arrostook*,⁵⁶ the US Supreme Court attached great significance to the way in which a subsidiary was directed and controlled by the parent. There is no adherence to the principle that a shareholder owes no duty of care to the company. On the contrary, a controlling shareholder was found to owe a fiduciary duty to the company.⁵⁷ Second, the relations between parent and subsidiary were highly malleable. The court perceives an action on behalf of the subsidiary as the beneficial property of the parent, as opposed to treating the assets of the company and

generally, Henn and Alexander, *op. cit.* n 24 at 355-344. C.f. *Smith, Stone and Knight Ltd. v. City of Birmingham* [1939] 4 All ER 116 at 121 *per* Atkinson J.

⁵³ *Sabine Towing & Transport Co v. Merit Ventures Inc* 575 F Supp 1442 (1983); *In re Rehabilitation of Centaur Insurance Company* 158 Ill 2d 166 (1994). See also, Blumberg '89, *op. cit.*, at 45.

⁵⁴ Dobbyn, *op. cit.*, n 50 at 189.

⁵⁵ David Aronofsky, 'Piercing the Transnational Corporate Veil: Trends, Developments and the Need for Widespread Adoption of Enterprise Analysis' (1985) 10 *North Carolina Journal of International Law and Commercial Regulation* 31 at 35.

⁵⁶ 417 US 703 (1974).

⁵⁷ *Southern Pacific Co v. Bogert* 250 US 483 (1919).

the shares of the company as separate property owned by different entities.⁵⁸ These two points demonstrate immediately the flexibility and ‘suppleness’ of the US law, in diametric opposition to the position in the English courts. Even so, the principles of separateness are adhered to in what are seen as legitimate situations. As in *Cannon Manufacturing Co. v. Cudahy Packing Co.*,⁵⁹ the US Supreme Court confirmed that the mere fact of 100 percent ownership of a subsidiary’s shares and complete control of the subsidiary as if it were a branch or department of the parent were insufficient to pierce the veil provided the parent maintained the formality of separate incorporation.⁶⁰ Further, the presence of a subsidiary in a particular jurisdiction does not immediately expose the parent to the jurisdiction.⁶¹ The formality of the separate personalities was seen as real and not purely a fiction.⁶² This in turn accentuates the need for the ‘second limb’ of ‘inequitable conduct.

Inequitable, Fraudulent or Unjust Conduct

The ‘second limb’ mentioned concerning fraud etc. is the subjective element in the analysis.⁶³ The courts qualitatively assess the facts to analyse the degree of parental control or lack of corporate formalities. This assessment is ‘open textured’ and draws on a wide equitable jurisdiction to determine whether the parents conduct toward the subsidiary is abusive.⁶⁴ In essence there must be some degree of moral culpability on

⁵⁸ *Macaura v. Northern Assurance Co* [1925] AC 619, (HL).

⁵⁹ 267 US 333 (1925).

⁶⁰ *Ibid.* at 335. Whilst *Cudahy* is no longer a rigid authority it has retained its respect as a guiding principle. See Blumberg ’83 *op. cit.*, at 44 and Aronofsky *op. cit.*, n 55 at 36.

⁶¹ 267 US 333, 336 (1925); see also, *Conley v. Mathieson Alkali Works* 190 US 406, 409-411 (1903); *Peterson v. Chicago, Rock Island & Pacific Ry. Co.* 205 US 364 (1907); and *People’s Tobacco Co Ltd v. American Tobacco Co* 246 US 79, 87 (1918).

⁶² 267 US 333, 336 (1925).

⁶³ Antunes, *op. cit.*, at 248.

⁶⁴ *Ibid.*

the part of the parent to justify holding it liable for the debts of the subsidiary.⁶⁵ This expansive vein of equity, whilst having its detractors, contributes to the utility of the doctrine. The assessment of any commercial arrangement, particularly when in trauma, needs to be flexible if abusive conduct is to be assessed and balanced. As we shall see shortly, such an open textured approach may not lead to veil piercing but rather a lesser remedy such as equitable subordination of a claim made by the parent in the bankruptcy proceedings of a subsidiary.

Consequently, the court is provided with the broad principle set out in *United States v. Milwaukee Refrigerator Transit Co*,⁶⁶ ‘when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime; the law will regard the corporation as an association of persons...’.⁶⁷ Here there is very little guidance other than the rather ethereal obligation ‘to do justice’. Indeed, in some circumstances it is unnecessary to prove fraud. For example, where a subsidiary is used to evade a judicial decree.⁶⁸ Alternatively, where funds and assets have been commingled to such an extent that to honour separate personality would lead to injustice.⁶⁹ Primarily though the strength of this open textured regime is the inherent recognition of the corporation as an abstract notion such that even in the absence of fraud, some circumstances constitute illegitimate uses of the corporation because they produce injustice or inequitable consequences.⁷⁰

⁶⁵ *Mission Bay Campland v. Summer Finance Corp* 731 F 2d 768 (11th Cir, 1984).

⁶⁶ 142 F 2d 247 (1905).

⁶⁷ *Ibid.*, at 255.

⁶⁸ *Pauley Petroleum Inc v. Continental Oil Co* 231 A 2d 450 (1967).

⁶⁹ *Milgo Electronics Corp v. United Business Communications Inc* 623 F 2d 645 (10th Cir, 1980)

⁷⁰ *Krivo Industrial Supply Co v. National Distillers & Chemical Corp* 483 F 2d 1098 (5th Cir, 1973). See generally 18 *American Jurisprudence*, Corporations, § 58 at 869.

Comments

US veil piercing jurisprudence is a huge body of law and this very cursory treatment is all that is possible here. The UK will not emulate the detail and sheer numbers of cases involving veil piercing found in the US. Accordingly, if any flexibility is to be introduced into UK veil piercing then we would need the likes of a modern day Lord Denning to encourage frequent departure from the current strict line. Presently, and given recent decisions the chance of this occurring is very unlikely. Despite this, we can identify a number of core features may be useful to influence a more flexible, fact sensitive approach in the UK, however incremental and modest such future development, if any, may be.

The US law is difficult to reconcile, the general principles are to apply equally to all corporations and there is no differentiation between the closely held and the public corporation. Thus, the definition of any one rule for consistent application makes difficult the task of regular application across a range of different types of corporations and circumstances. Some have even argued that the vitality of the doctrine of piercing the corporate veil lies in its multi-factored and imprecise method of approach and application.⁷¹

The nature of the wrong committed by the officer of corporation is important to the decision whether the entity principle should be discarded. There is a dichotomy between the treatment of contractual and tortious claims. Notably, the courts are less willing to pierce the veil if the parties have had the opportunity to bargain.

⁷¹ James R. Gillespie, 'The Thin Corporate Line: Loss of Limited Liability Protection' (1968) 45 *North Dakota Law Review* 363 at 380.

Control is the core of the relationship that opens the door to the possibility of veil piercing. There must be an overwhelming dependence between parent and subsidiary. The form the control takes is manifest in a number of factually obvious situations such as those previously mentioned. However complete control alone is insufficient to permit disregard without the perpetration of some misdeed that leads to damage.

This is a familiar situation for English lawyers. Just as English courts are prepared to attribute a component of legitimate legal and extra-legal control to the parent subsidiary relationship so too are the US courts. The difference lies in the lower threshold tests necessary in the US to warrant use of the equitable jurisdiction of the court. US courts are not hamstrung by an absolutist notion of corporate personality, which is demonstrated in their willingness to be much more fact sensitive to inconsistencies that reveal the purpose of a transaction or company. It is this purposive or 'realist' analysis that separates US veil piercing from the UK position.

FIDUCIARY DUTIES

Fiduciary duties in the US are the basis of the 'second tier' of remedies that assist in correcting wrongs that are not sufficiently serious to justify piercing the veil. In the UK, corporate fiduciary duties are divided into those dealing with first, good faith and loyalty and second, duties of care and skill.⁷² Historically, directors have exercised a role as 'trustees' in the exercise of their management of the company. By virtue of this position, directors owe duties to the company alone⁷³ even where the company is a wholly owned subsidiary.⁷⁴ Strictly, a director neither owes a duty to a controlling

⁷² Davies, *op. cit.*, at 598-599.

⁷³ *Percival v. Wright* [1902] 2 Ch 421.

⁷⁴ *Bell v. Lever Bros* [1932] AC 161 (HL).

shareholder of a company⁷⁵ nor do the directors of a parent company owe a duty to a subsidiary.⁷⁶ Consequently, we must consider whether there is good reason for the expansion of fiduciary duties to parent companies and their directors. Presently in the UK, the boundaries of the single individual corporation restrict any extension of corporate fiduciary duties for management responsibility. Primarily, the use of fiduciary duties is attractive because it offers a well-developed body of law that focuses on accountability and the fair distribution of business opportunities.

In the US, considerable use has been made of the law relating to fiduciary duties in an endeavour to make parent companies and controlling shareholders accountable to the subsidiary, the subsidiary's minority shareholders, and its creditors. Broadly, the duty to these parties derives from two sources. First, the duty a controlling shareholder owes to minority shareholders is based on the equitable principle that the controlling shareholder holds a position of superiority and influence over the interests of the minority. Second, the parent-subsidary relationship and the potential for abuse have long been a cause of concern in the US.⁷⁷ Accordingly, if a controlling shareholder or parent can exercise influence over the directors and officers of a company then the imposition of a fiduciary duty is the price for such domination. Importantly, the mere fact of a fiduciary relationship between parent and subsidiary does not make them the same enterprise.⁷⁸ As the duty a controlling shareholder owes to minority shareholders has recently received consideration by the Law Commission in their Report on

⁷⁵ *Pergamon Press Ltd v. Maxwell* [1970] 1 WLR 1167.

⁷⁶ *Lindgren v. L & P Estates Ltd* [1968] Ch 572 (CA)

⁷⁷ Adolf A. Berle, 'Promoters' Stock in Subsidiary Corporations' (1929) 29 *Columbia Law Review* 35.

⁷⁸ Henry W. Ballantine, 'Separate Entity of Parent and Subsidiary Corporations' (1925) 14 *California Law Review* 12 at 17.

Shareholders Remedies,⁷⁹ we will explore the question of whether a controlling shareholder or parent should owe a fiduciary duty because they can exercise influence over the directors and officers of a company as a possible and plausible reform in the UK. Our primary concern is with the question: ‘What is the nexus between a parent and a subsidiary sufficient to give rise to the parent owing a fiduciary duty to the subsidiary and in turn its creditors?’

Perhaps the first notable aspect of the US law is the terminology. For instance, rather than confining duties to particular roles, such as in the UK where we use the words *director’s duties*; in the US the scope of application is thematically wider. Regular reference is made to the *duties of management*. Where *management* imports a widely drawn collective term that incorporates directors, officers, policy makers and in some instances controlling shareholders.⁸⁰ Consequently, it is recognised that the controlling shareholders are empowered to elect directors and by their vote, do all the things the company can do.⁸¹ The power of the controlling shareholder places it in the shoes of the company.⁸²

Controlling shareholders (along with the directors and officers) owe a duty to their corporation,⁸³ minority shareholders,⁸⁴ other majority shareholders⁸⁵ and in certain circumstances to the ‘community of corporate interest’.⁸⁶ The latter interests include

⁷⁹ Law Commission, *Shareholders Remedies Report 246* (London: HMSO, 1997). This is available at <http://www.gtnet.gov.uk/lawcomm>

⁸⁰ Henn and Alexander, *op. cit.* n 24, at 611.

⁸¹ 18A *American Jurisprudence* 2d § 762 at 630.

⁸² *Wheeler v. Abiline Nat. Bank Building Co* 159 F 391 (8th Cir, 1908)

⁸³ *Re Reading Co* 711 F 2d 509 (3rd Cir, 1983).

⁸⁴ *United States v. Byrum* 408 US 125, *Pepper v. Litton* 308 US 295 (1939), *Southern Pacific Co v. Bogert* 250 US 483 (1919).

⁸⁵ *Silverman & Sons Realty Trust v. Commission* 620 F 2d 314 (1st Cir, 1980)

⁸⁶ Henn and Alexander, *op. cit.* n 24, at 612.

other shareholders and during periods of doubtful or imminent insolvency, the creditors.⁸⁷ The general scheme of the *duties of management* are of loyalty, diligence and obedience. If the director's or controlling shareholder's use of corporate power is *intra vires* and their actions are within the scope of any defined authority, they will be absolved from attack. This is provided, they exercise due care and regard the appropriate fiduciary duties.⁸⁸ Importantly and more specifically, the breach of fiduciary duties precludes the operation of the business judgement rule which is also available in certain circumstances to protect the controlling shareholder.⁸⁹ The duty is enforceable by the corporation or by a derivative action. However, creditors are limited to having the trustee in bankruptcy pursue their claims.⁹⁰ Let us consider the circumstances when a controlling shareholder or parent owes a fiduciary duty toward a subsidiary and its creditors. Unfortunately, this area is recognised the most complex in US corporations law.⁹¹

The mere existence of the relationship of control does not impose a fiduciary duty on the parent toward the subsidiary. However, it is generally accepted in the US that persons in control of a corporation owe an exacting fiduciary duty to the controlled corporation.⁹² Further that this fiduciary duty is owed not only to the controlled corporation but also the shareholders.⁹³ As a fiduciary, the person in control is bound to act in the interests of the corporation and is prohibited from pursuing any self-interested

⁸⁷ *Ibid.* See also *Superintendent of Insurance v. Bankers Life & Casualty Co* 404 US 6 (1971); *Pepper v. Litton* 308 US 295 (1939).

⁸⁸ *Ibid.*

⁸⁹ *Ibid.*, at 628.

⁹⁰ *Pepper v. Litton* 308 US 295 (1939).

⁹¹ Note, 'Corporate Fiduciary Doctrine in the Context of Parent - Subsidiary Relations' (1964) 74 *Yale Law Journal* 338.

⁹² *Banco De Desarrollo Agropecuario, S.A v. Gibbs*, 709 F Supp 1302 (1989).

⁹³ *Borgsmiller v. Burroughs* 134 Ill Dec 774, 542 N E 2d 1281, 187 Ill App 3d 1, appeal

matters when dealing with the property of minority shareholders.⁹⁴ Crucially, a dominating or controlling shareholder has a fiduciary duty to creditors in their dealing with the corporation and with their dealing with creditors. The duty demands good faith and fair dealings.⁹⁵

To invoke the fiduciary duty toward the subsidiary, the parent must actually be involved in the management of the subsidiary. It stands to reason that a parent should be subject to the same fiduciary duties as the directors where it adopts a similar role. Whilst, not dealing specifically with the duty to the subsidiary it has been said: 'The rule of corporation law and of equity invoked is well settled and has often been applied. The majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority, as much so as the corporation itself or its officers or directors'.⁹⁶ This view was fortified in *Pepper v. Litton*⁹⁷ where the Supreme Court held that:

'a director is a fiduciary ... So is a dominant or controlling stockholder or group of stockholders... Their powers are powers in trust ... Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation *and those interested therein*.'⁹⁸

Thus, where a controlling shareholder 'completely dominates' a subsidiary, fiduciary duties are owed to the subsidiary.⁹⁹

denied 139 Ill Dec 510, 548 N E 2d 1066 128 Ill 2d 661.

⁹⁴ *Box v. Northrop Corp*, 459 Supp 540, affirmed 598 F 2d 609 (1975)

⁹⁵ *In re County Green Ltd. Partnership* 438 F Supp 701, reversed 604 F 2d 289 (1977).

⁹⁶ *Southern Pacific Co v. Bogert* 250 US 483, 492 (1919).

⁹⁷ 308 US 295 (1939).

⁹⁸ *Ibid.*, at 306.

⁹⁹ *Taylor v. Standard Gas & Electric Co* 306 US 307 (1939).

Comments

Some care must be taken here because the scope of the word 'fiduciary' in the US is much wider than its ordinary meaning in UK. From our perspective, the attribution of fiduciary duties to majority shareholders with all the other incumbent obligations would be excessive. No English decision has relied on the direct duty of directors or parents to creditors derived from a fiduciary foundation. The possible transposition of any US law to the UK would need to confine itself to the imposition of a well-defined duty between controlling shareholder and company. Either this could be a judge-made duty with fiduciary qualities or a statutory based duty giving rise to specific remedies. The best example of this mechanism is section 1324 of the Australian Corporations Law and the scope of its possible operation in *Airpeak Pty Ltd v. Jetstream Aircraft Ltd*.¹⁰⁰ In *Airpeak*, a creditor used a statute based injunction to prohibit a breach of duty by the directors of a company and to rectify the situation for the benefit of the creditor. With this in mind, let us now examine how US law uses the equitable jurisdiction of the court to derive remedies designed to cope with the problems faced in the bankruptcy of a member or all members of a group of companies.

EQUITABLE SUBORDINATION AND SUBSTANTIVE CONSOLIDATION

Equity looks in all directions. Only in that way can the various interests in the corporate community be adequately protected.¹⁰¹

There is a significant precedent for the introduction of equity into the legal framework of the parent subsidiary relationship and insolvency. The doctrines of equitable

¹⁰⁰ (1997) 23 ACSR 715.

¹⁰¹ Justice Murphy, dissenting, in *Comstock v. Group of Institutional Investors*, 335 US 211, 238 (1948).

subordination and substantive consolidation in United States Bankruptcy jurisprudence have been employed for this purpose since the late 1930's and early 1940's respectively. Consequently, the doctrine of equitable subordination and substantive consolidation provide a body of law and practice from which we can draw experience and seek to improve upon. Professor Hadden described the framework of equitable subordination as a 'settled and reasonably clear rule of law'.¹⁰² Further, the Cork Report contains regular reference to US principles as a source of possible solutions to the problems posed by corporate groups.¹⁰³ We will first consider the nature of the US bankruptcy regime in which these remedies function. This will demonstrate a certain familiarity and show that each doctrine pervades the entire US system of corporate bankruptcy, a system that uses mechanisms recognisable to English lawyers. The detail of each of the doctrines will then be considered.

The US Bankruptcy Regime

In the US, the courts have played an integral and historic bankruptcy function in fixing the order of priority of creditor's claims against debtors outside the formality of the legislative priority scheme. This judicial function is synthesised with the process of collecting the assets, paying the administrative expenses, satisfying creditor's claims in the appropriate order and distributing whatever is left to the shareholders according to their rights.¹⁰⁴ Procedurally, upon filing of the creditors' claims or interests¹⁰⁵ and provided a claim is not challenged it is deemed to be allowed.¹⁰⁶

¹⁰² See Tom Hadden, 'The Regulation of Corporate Groups in Australia' (1992) 15 *University of New South Wales Law Journal* 61 at 69.

¹⁰³ Cork, *op. cit.*, at 436 para1937; at 441-442 paras. 1960-1965.

¹⁰⁴ Henn and Alexander, *op. cit.* n 24, at 1148.

¹⁰⁵ 11 USCA § 501 Filing of proofs of claims or interests.

¹⁰⁶ 11 USCA § 502 Allowance of claims or interests §§(a).

If an objection is made then the court on notice and hearing is given the power to determine whether the claim should be permitted.¹⁰⁷ The first level of scrutiny provides for the potential invalidation of certain transfers and obligations by debtors. This depends on whether the claim can be categorised as a breach of US fraudulent conveyance law including, unperfected securities,¹⁰⁸ preferences,¹⁰⁹ fraudulent transfers and obligations,¹¹⁰ and post petition transactions.¹¹¹ The aim is to resolve the scope of the debtor's assets available for distribution with the purpose of setting aside transfers made or obligations incurred with actual intent to hinder delay or defraud creditors.¹¹²

When the assets have been determined and the first level of scrutiny complete equality of distribution is the primary theme¹¹³ subject to the order of legislative priority regime. At this stage of the bankruptcy process the court's equity jurisdiction may be 'invoked to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done.'¹¹⁴ This power cannot be exercised arbitrarily but only following the 'principles of equitable subordination'.¹¹⁵ It is also at this stage that an application for substantive consolidation of the assets of related entities might be made by the liquidator or creditors.

¹⁰⁷ 11 USCA § 502(b).

¹⁰⁸ 11 USCA § 544 Trustee as lien creditor and as successor to certain creditors and purchasers and including 11 USCA § 545 Statutory liens.

¹⁰⁹ 11 USCA § 547 Preferences.

¹¹⁰ 11 USCA § 548 Fraudulent Transfers and Obligations.

¹¹¹ 11 USCA § 549 Post Petition Transactions.

¹¹² Robert Charles Clark, *Corporate Law* (Boston: Little Brown and Company, 1986) at 43.

¹¹³ *Sampsell v. Imperial Paper Corp* 313 US 215 (1941) referring to a predecessor of the US Bankruptcy Code.

¹¹⁴ *Pepper v. Litton* 308 US 295, 305 (1939).

¹¹⁵ See 11 USCA § 510. which is in the following terms. Subordination.

(a) A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable non-bankruptcy law.

(b) For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages

Equitable Subordination

Equitable subordination is a remedy for the creditors of insolvents in the United States. US Bankruptcy Courts, by virtue of their equitable jurisdiction, are able to subordinate the claims of certain creditors of the debtor in a winding up. This step is taken because payment of the creditor's claim would be inequitable when regard is had to other creditor claims. This remedy recognises that certain claims in a bankruptcy have an 'intrinsic ethical superiority'.¹¹⁶ Factors that have triggered the operation of the equitable subordination remedy range from the misconduct of a parent to the recharacterisation of a parental loan from debt to risk capital. The remedy is primarily utilised where a parent company has dominated a subsidiary and contributed to its demise through managerial abuses involving undue risk to creditor's investment. If there are parental loans to the subsidiary then equitable subordination can reduce their priority of payment for the benefit of other creditors. Bearing these broadly stated features in mind, let us now look at the situations where equitable subordination has had a practical consequence.

arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.

(c) *Notwithstanding subsections (a) and (b) of this section, after notice and a hearing the court may—*

(1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or

(2) order that any lien securing such a subordinated claim be transferred to the estate.

(emphasis added)

¹¹⁶ Asa S. Herzog and Joel B. Zweibel, 'The Equitable Subordination of Claims in Bankruptcy' (1961) 15 *Vanderbilt Law Review* 83 at 83.

The Seminal Cases

The original formulation of equitable subordination derived from the treatment of a shareholders' claims in bankruptcy. In *Taylor v. Standard Gas and Electric Co.* ('Deep Rock')¹¹⁷ a parental loan to a subsidiary was recharacterised as equity and subordinated to the claims of the subsidiary's preferred stockholders. Deep Rock Oil Corporation ('Deep Rock') was a subsidiary of Standard Gas & Electric Company ('Standard'). Deep Rock was organised to purchase certain oil production, refining and distribution properties valued at \$15,580,000 from a vendor. The vendor was to receive a combination of cash, a note, and preferred and common stock in Deep Rock. During the initial two year period of Deep Rock's business the vendor retained some interest and control. Standard later purchased the original vendors interests to remove him from Deep Rock's management. Whilst Standard did not wholly own Deep Rock, Standard had complete control. Standard's officers, directors and agents constituted the majority on the board of directors of Deep Rock. All of Deep Rock's finances were controlled by Standard or obtained through Standard. During the period between 1919 and 1933 Deep Rock required continual financing on an open account by Standard and at the time of Deep Rock's receivership Deep Rock owed Standard \$9,343,000. The accounts reflecting this figure had accurately been recorded by Deep Rock's auditing department which was in turn supervised by Standard's auditors. Standard made a claim to the outstanding moneys which was subsequently objected to by Deep Rock's trustee and other preferred stockholders. The total liabilities were approximately \$11,200,000 and the assets available for distribution were valued at approximately \$5,800,000. By virtue of *pari passu* Standard stood to receive 73 percent of the available assets.

¹¹⁷ 306 US 307 (1939).

The trustee and preferred shareholder argued that Standard ‘could not transmute itself from the status of proprietor of Deep Rock’s business to that of creditor’.¹¹⁸ Whilst the case was brought on the basis of the instrumentality theory, that is, Deep Rock was a mere department of Standard and had no separate personality, the court did not descend into the complexity of the instrumentality cases. Rather, adopting a broader brush, the court relied on Deep Rock’s inadequate capitalisation and mismanagement by Standard ‘with an eye single to its own interests’¹¹⁹ to subordinate Standard’s debt. The difference was that Deep Rock was not a wholly owned subsidiary. Further, precedent suggested that the shareholders were limited to causing the subsidiary’s trustee in bankruptcy to assert a cause of action against the parent for mismanagement.¹²⁰ The court negotiated this procedural barrier by giving the preferred stockholders priority in their claims to Deep Rock’s assets to the disadvantage of Standard. Whilst the clarity of reasoning justifying departure from precedent leaves a little to be desired the case introduces a principle of fairness to the asset distribution process rather than piercing the veil of the corporate form.¹²¹ The court tapped this vein of fairness and ordered equitable subordination of the parental claim relying on, the subsidiary’s inadequate capitalisation, the parent’s indifference to the formality of the corporate form, domination and mismanagement by the parent ‘with an eye single to its own interests’¹²² and the artificial extension of the subsidiary’s life.¹²³

¹¹⁸ *Ibid.*, at 311.

¹¹⁹ *Ibid.*, at 323.

¹²⁰ Carlos L. Israels, ‘The Implications and Limitations of the ‘Deep Rock’ Doctrine’ (1942) 42 *Columbia Law Review* 376 at 378.

¹²¹ Blumberg ‘85, *op. cit.*, at 68.

¹²² 306 US 307, 323 (1939).

¹²³ *Ibid.*, at 322-323.

In *Pepper v. Litton*¹²⁴ a controlling shareholder (Litton) caused a company to confess judgement in favour of himself. Litton's intention was to use this as a shield against another debt owed by the company to Pepper. When Pepper asserted his claim Litton caused the company to go into voluntary liquidation.¹²⁵ *Pepper v. Litton* helped to define the scope of the *Deep Rock* decision by confirming a number of propositions. First, the jurisdictional basis of subordination was equitable¹²⁶ particularly where there is evidence of dominance and exploitation by a creditor.¹²⁷ This permitted two related questions to be raised. (a) Is the disputed claim valid? If not then the court may disallow it.¹²⁸ (b) If the claim was valid, the court could examine all circumstances surrounding the claim. The court was to ensure that the conduct of the claimant toward the creditor had been in 'good faith and good conscience'. Failing this, the court had to see that that injustice and unfairness would not result from observance of the normal priority rules.¹²⁹ In the analysis, Litton's judgement claim was valid because of *res judicata*, but his conduct and insider status justified subordination.¹³⁰ Thus, equitable subordination is not concerned with the existence of debt but rather the order of payment of those debts.¹³¹ Second, equitable subordination may be available where a *fiduciary* such as a director or a dominant or controlling shareholder enters arrangement lacking the indicia of an arms length bargain. Third, the *fiduciary* has the onus of showing that their was both good faith and inherent fairness in the arrangement.¹³²

¹²⁴ 308 US 295 (1939).

¹²⁵ *Ibid.*, at 297-298.

¹²⁶ *Ibid.*, at 308.

¹²⁷ *Ibid.*, at 308-309.

¹²⁸ *Ibid.*, at 305-306.

¹²⁹ *Ibid.*, at 308.

¹³⁰ *Ibid.*, at 310-312.

¹³¹ *Ibid.*, at 310.

¹³² *Ibid.*, at 306-307. The Supreme Court later affirmed: 'equity will not permit a holding

In *Comstock v. Group of Institutional Investors*,¹³³ the court confirmed questions concerning aspects of the controlling shareholders conduct and the way equitable subordination applied if a *fiduciary* had more than one claim. First, inadequate capitalisation may of itself provide grounds for subordination but it was not a necessary condition. Second, the question of fairness was to be restricted to a transactional analysis from the subsidiary's perspective. For example, a transaction may be beneficial to the group as a whole but injurious to the subsidiary, its creditors and shareholders.¹³⁴ Third, the mere fact of a parent - subsidiary relationship did not sanction automatic subordination of the parent's claim. The unconscionable use of the unencumbered power a parent or dominant shareholder has is the mischief at which the doctrine is aimed¹³⁵. The *Comstock* decision highlighted the then inchoate nature of equitable subordination. Many issues were left unclarified particularly the scope of the words 'good faith and good conscience'¹³⁶ and whether 'inequitable conduct' alone was a legitimate ground to subordinate a valid claim.¹³⁷

A Structured Framework

As can be seen from the above, in certain circumstances, 'equals' are not necessarily equals. The widely accepted Fifth Circuit of the Court of Appeals decision in *Benjamin*

company, which has dominated and controlled its subsidiaries, to escape or reduce its liability to those subsidiaries by reliance upon self serving contracts which it has imposed on them. A holding company, as well as others in dominating positions... has fiduciary duties to security holders ... which will be strictly enforced' *Consolidated Rock Products Co. v. Du Bois* 312 US 510, 522 (1941).

¹³³ 335 US 211 (1948).

¹³⁴ *Ibid.*, at 230.

¹³⁵ *Ibid.*, at 228-229.

¹³⁶ *Pepper v. Litton* 308 US 295, 310-311 (1939)

¹³⁷ Scott M. Browning, 'No Fault Equitable Subordination, Reassuring Investors that only Government Penalty Claims are at Risk' (1993) 34 *William and Mary Law Review* 487 at 496 in particular see the references cited in footnote 71.

*v. Diamond (In re Mobile Steel)*¹³⁸ refined and concisely collected the criteria for application of equitable subordination.¹³⁹ In *Mobile Steel* claimants were all ‘insiders’ in that they directly or indirectly occupied control positions in relation to the insolvent company.¹⁴⁰ The issue was whether the claimants violated the ‘rules of fair play and good conscience’¹⁴¹ in their dealings with the corporation and its creditors and in their management of corporate affairs.¹⁴² The court set out three conditions that must be satisfied before equitable subordination of the insider’s claims was an appropriate course of action. *First*, the claimant must have engaged in some type of inequitable conduct. *Second*, the misconduct must have resulted in injury to the creditors of the insolvent or conferred an unfair advantage on the claimant. *Third*, equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act.¹⁴³ In determining whether these conditions were satisfied, the court stated that three further broad concepts were to be borne in mind. (a) Inequitable conduct could relate broadly to any conduct concerning the claim.¹⁴⁴ (b) Claims should only be subordinated to the extent necessary to account for the inequitable conduct.¹⁴⁵ (c) The burden of proof rested with the trustee in bankruptcy who had to show a

¹³⁸ 563 F 2d 692 (1977). The US Supreme Court has recently approved and adopted the *Mobile Steel* formulation of equitable subordination. See *United States v. Noland (Re First Truck Lines)* 134 L Ed 2d 748 (1996).

¹³⁹ The formula in *Mobile Steel* is not a novel statement of the law relating to equitable subordination but rather a distillation of previous case law. *In the Matter of Missionary Baptist Foundation of America* 818 F 2d 1135, 1143 (1987).

¹⁴⁰ 563 F 2d 692, 695 (1977).

¹⁴¹ *Pepper v. Litton* 308 US 295, 310 (1939).

¹⁴² 563 F 2d 692; 695 (1977).

¹⁴³ *Ibid.*, at 700. This may seem a contradiction in terms to English lawyers. This condition ensures that equitable subordination is not used in a way that may itself be an abuse of process.

¹⁴⁴ *Ibid.*

¹⁴⁵ *Ibid.*, at 701.

substantial factual basis in support of the allegation of impropriety¹⁴⁶ against claimant who was also a *fiduciary*.

As a final judicial gloss, three factual situations were emphasised as conducive to the application of equitable subordination.¹⁴⁷ First, where a *fiduciary* of the debtor misuses his position to the disadvantage of other creditors.¹⁴⁸ Second, when a third party controls the debtor to the disadvantage of other creditors.¹⁴⁹ Third, when a third party actually ‘*defrauds*’ other creditors.¹⁵⁰

Comments

Equity is able to justify the subordination of a claim but it cannot disallow a claim. Disallowance negates the validity of a claim because it has no basis in law or fact when it is a sham, illegal or contravenes ‘fraudulent conveyance law’. By contrast, subordination does not nullify a claim but rather qualifies the claim’s priority of payment as against other competing claims. Subordination often has the same effect as disallowance because in most circumstances there will be insufficient assets to meet the secured creditor’s claims let alone unsecured creditors.¹⁵¹ A creditor whose claim is subordinated retains their rights except for *pari passu*. It is ‘remedial, not penal and should be applied only to the extent necessary to offset the specific harm that the

¹⁴⁶ *Ibid.*

¹⁴⁷ *United States Abatement Corp. v. Mobile Exploration & Producing US Inc* 39 F 3d 556 (5th Cir, 1994) and *Holt v. Federal Deposit Insurance Corporation (Re CTS Truss Inc)* 868 F 2d 146 (1989).

¹⁴⁸ *Matter of Multiponics Inc* 622 F 2d 709 (1980); *In re Trimble Co* 479 F 2d 103 (1973).

¹⁴⁹ *Pepper v. Litton* 308 US 295 (1939).

¹⁵⁰ *In re Bowman Hardware & Electric Co.* 67 F 2d 792 (1933).

¹⁵¹ See Herzog and Zweibel, *op. cit.*, n 116 at 85-88; Lydia E. Nyzio, ‘Mobile Steel and Beyond: Trends in Equitable Subordination’ (1986) 37 *South Carolina Law Review* 627 at 630.

creditors suffered on account of the inequitable conduct.¹⁵² Meaning, for example, that if a parent company has a number of claims in the liquidation of a subsidiary then only those that have been tainted by inequitable conduct are liable to subordination.

The availability of equitable subordination pervades the entire priority scheme¹⁵³ to the extent that any claim be it secured or unsecured may be subordinated.¹⁵⁴ In normal winding up cases of Chapter 7 of the Bankruptcy Code, Congress gives first priority to administrative expenses such as postpetition claims for taxes and related penalty claims. However, the priority of these administrative expenses is subject to the power of the courts to subordinate a claim.¹⁵⁵ The Supreme Court has recently put an end to a trend in the Court of Appeals to equitably subordinate US Federal Government post petition tax claims.¹⁵⁶ The court recognised that such claims can be subordinated but the court cannot arbitrarily 'use principles of equitable subordination' to alter the order of

¹⁵² *Fabricators, Inc. v. Technical Fabricators, Inc. (In re Fabricators, Inc)* 926 F 2d 1458, 1464 (1991).

¹⁵³ 11 USCA § 507 Priorities.

¹⁵⁴ 11 USCA § 726 (a)

¹⁵⁵ The material part of 11 USCA § 726(a)(1) provides:

(a) *Except as provided in section 510 of this title*, property of the estate shall be distributed--

(1) first, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title;

(emphasis added).

Section 507(a)(1) specifies that certain claims and expenses have priority as administrative expenses. Section 507(a)(1) states: (a) The following expenses and claims have priority in the following order:

(1) First, administrative expenses allowed under section 503(b) of this title. . . . ;

Section 503(b) gives the following expenses and claims first priority status as administrative expenses:

(b) After notice and a hearing, there shall be allowed, administrative expenses...including--

(1) (A) the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case;

(B) any tax--

(i) incurred by the estate. . . .

(C) any fine, penalty, or reduction in credit relating to a tax of a kind specified in subparagraph (B) of this paragraph.

¹⁵⁶ *United States v. Noland (Re First Truck Lines)* 134 L Ed 2d 748 (1996).

priorities. There must be some invocation of the equitable jurisdiction of the court. It is not sufficient to subordinate a claim because the court has perceived that the claim 'by its very nature is susceptible to equitable subordination'.¹⁵⁷ Consequently all claims - secured and unsecured - are potentially subject to a subordination order. Historically, Congress intended that the words 'principles of equitable subordination' should reflect the existing case law at the time of its inception in 1978 with the courts retaining latitude to develop the doctrine.¹⁵⁸ The primary academic criticism of this approach has been that the legislation provides no guidelines¹⁵⁹ for a harsh remedy that is imprecise in its application.¹⁶⁰ As the doctrine is not limited simply to the parent subsidiary scenario, a natural consequence for the financial community has been the fear of arbitrary use of precedent by the courts and unpredictable subordination of various financial devices.¹⁶¹

Before the legislative recognition of equitable subordination, the Bankruptcy Code and its predecessors gave no express power or authorisation to the courts to depart from the rigidity of *pari passu*. The power to subordinate was assumed as part of the general

¹⁵⁷ *Ibid.*

¹⁵⁸ 124 Cong. Rec. H 11095, (Sept. 28, 1978) statement of Representative Edwards; and 124 Cong. Rec. S17412 (Oct. 6, 1978) statement of Senator DeConcini.

¹⁵⁹ Nyzio, *op. cit.*, n 151 at 631; Andrew DeNatale and Prudence B. Abram, 'The Doctrine of Equitable Subordination as Applied to Non Management Creditors' (1985) 40 *Business Lawyer* 417; W. Clark Watson, 'Deep Rock in the Deep South - Equitable Subordination of Claims in Fifth Circuit Bankruptcy Proceedings' (1980) 11 *The Cumberland Law Review* 619.

¹⁶⁰ Jeremy W. Dickens, 'Equitable Subordination and Analogous Theories of Lender Liability: Toward a New Model of "Control"' (1987) 65 *Texas Law Review* 801.

¹⁶¹ See generally, Helen Davis Chaitman, 'The Equitable Subordination of Bank Claims' (1984) 39 *Business Lawyer* 1561; Scott M. Browning, 'No Fault Equitable Subordination, Reassuring Investors that only Government Penalty Claims are at Risk' (1993) 34 *William and Mary Law Review* 487; Timothy A. French, 'The Rise and Fall of the Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors' (1995) 4 *Journal of Bankruptcy Law and Practice* 257.

jurisdiction to prevent abuse of process.¹⁶² It follows that courts will prevent the consummation of a course of conduct by a claimant in an insolvency that would perpetuate fraud or inequity.¹⁶³ To be sure, the court may order that the payment of certain creditor's claims be postponed until the claims of other creditors are paid in full from the assets the debtor company. The jurisdictional premise of this notion is that the Bankruptcy Court, as a court of equity, has a broad authority to modify creditor - debtor relationships.¹⁶⁴ The rationale is that certain claims possess an 'intrinsic ethical superiority'¹⁶⁵ by virtue of an abuse, fraud, or inequity that warrant an exception to *pari passu*. Outside the invalidation of claims as 'fraudulent conveyances' they may be subordinated either contractually¹⁶⁶ or under the power of the courts to do equity within the confines of the doctrine of equitable subordination.

The next remedy to be considered is substantive consolidation. Substantive consolidation is a logical progression on from equitable subordination because it deals with the situation where more than one of the members of a group is insolvent.

¹⁶² 11 USCA § 105 provides: (a) The court may issue any order, process, or judgement that is necessary or appropriate to carry out the provisions of this title. *No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.* (emphasis added)

¹⁶³ *Heiser v. Woodruff* 327 US 726, 733 (1946).

¹⁶⁴ *Pepper v. Litton* 308 US 295(1939); *US National Bank v. Chase National Bank* 331 US 28, 36 (1947); *Katchen v. Landy* 382 US 323, 327 (1966).

¹⁶⁵ Herzog and Zweibel, *op. cit.*, n 116 at 83.

¹⁶⁶ For a recent consideration of contractual subordination as a bona fide method of debt subordination in the US see *In re Best Products Co* 68 F 3d 26 (1995). See also 11 USCA § 510(a) 'A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable non-bankruptcy law.'

Substantive Consolidation

Substantive consolidation is an equitable remedy deriving originally from the US Bankruptcy Act of 1898.¹⁶⁷ The purpose of substantive consolidation is ‘to insure the equitable treatment of all creditors’.¹⁶⁸ Upon a motion by either a debtor or a creditor, the court may pool the assets and liabilities of two or more separate, but related entities. The common pool of assets created by the consolidation is then used to satisfy the liabilities of each entity. This eliminates duplicate claims, intercompany indebtedness, and cross-corporate guarantees.¹⁶⁹ The remedy of substantive consolidation is seen as a ‘modern’ or ‘liberal’ judicial trend in reaction to ‘the widespread use of interrelated corporate structures by subsidiary corporations operating under a parent entity’s corporate umbrella for tax and business purposes’.¹⁷⁰

Substantive consolidation is different to *procedural consolidation* where the administration of two or more bankrupt estates is combined merely to reduce costs rather than a consolidation of assets for distribution.¹⁷¹ As we shall see shortly, there are a number of matters the court needs to address before an order of substantive consolidation is justified.

¹⁶⁷ For a recent consideration of substantive consolidation and its application outside the parent subsidiary relationship see *Reider v. Federal Deposit Insurance Corporation (In re Ida V. Reider and James M. Reider)* 31 F 3d 1102, 1106 (1994).

¹⁶⁸ *Eastgroup Properties v. Southern Motel Assoc., Ltd.*, 935 F 2d 245, 248 (11th Cir,1991).

¹⁶⁹ *Ibid.*, at 248.

¹⁷⁰ *Ibid.*, at 249. Approved in *Reider v. Federal Deposit Insurance Corporation (In re Ida V. Reider and James M. Reider)* 31 F 3d 1102, 1106 (1994).

¹⁷¹ See Federal Bankruptcy Rules, P 1015 (b) ‘... [If] a joint petition or two or more petitions are pending in the same court by or against (1) a husband and wife, or (2) a partnership and one or more of its general partners, or (3) two or more general partners, or (4) a debtor and affiliate, [the court may order a joint administration of the estates].’

Alternatively, in a Chapter 11 consolidation case, the creditors of the consolidated entities are combined for the purpose of voting on reorganization plans. See *In re Augie/Restivo Baking Co* 860 F 2d 515, 518 (2d Cir,1988).

There is no specific mention of the power of the US Bankruptcy Court to consolidate claims, but jurisdiction is found in the court's general equitable powers¹⁷² and now derives from Section 105(a) Bankruptcy Code.¹⁷³ In *Sampsell v. Imperial Paper & Color Corp.*,¹⁷⁴ the assets of an individual debtor were consolidated with the assets of the debtor's corporation. The primary concern for the court was the fact that a creditor of the corporation who had knowledge of a fraudulent conveyance from the debtor to the debtor's corporation might unfairly benefit without a consolidation of both entities' estates. Authorising the consolidation, the court explained that the 'power of the bankruptcy court to subordinate claims or to adjudicate equities arising out of the relationship between the several creditors is complete.'¹⁷⁵ *Sampsell* is the only US Supreme Court decision touching on the issue of substantive consolidation. Though a more comprehensive treatment is desirable, the Courts of Appeal have used consistent principles. In deciding whether substantive consolidation is appropriate earlier courts applied an alter ego or piercing the corporate veil standard.¹⁷⁶ Whereas the recent case of *Eastgroup Properties v. Southern Motel Assoc Ltd*,¹⁷⁷ combines recent decisions and

¹⁷² See *Pepper v. Litton* 308 US 295, 304 (1939) where it was held 'this Court has held that for many purposes 'courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity'. *Local Loan Co. v. Hunt*, 292 US 234, 240 (1934).

¹⁷³ 11 USCA § 105 Power of court

(a) The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

See <http://www.law.cornell.edu/uscode/11/105.shtml>

¹⁷⁴ 313 US 215 (1940).

¹⁷⁵ *Ibid.*, at 219.

¹⁷⁶ *Fish v. East* 114 F 2d 177 (10th Cir,1940); *Stone v. Eacho (In re Tip Top Tailors, Inc.)* 127 F 2d 284 (4th Cir, 1942), cert. denied, 317 US 635, 63 S. Ct. 54, 87 L. Ed. 512; *Maule Industries, Inc. v. Gerstel* 232 F 2d 294 (5th Cir,1956).

¹⁷⁷ 935 F 2d 245 (11th Cir,1991).

distills a doctrine that is gaining approval.¹⁷⁸ Let us briefly consider the development of each of these forms of substantive consolidation.

Early Alter Ego Analysis of Substantive Consolidation

If the court is faced with sufficient evidence to pierce the veil between a parent and subsidiary then an order for substantive consolidation may be justified. However, there are a number of other concerns that need to be addressed by the court. In *Soviero v. Franklin National Bank of Long Island*,¹⁷⁹ a corporation had flagrantly disregarded the separateness of an affiliated company and commingled assets. The court relied on the traditional alter ego theory noting that the bankrupt and its affiliates lacked separate existence and were mere instrumentalities.¹⁸⁰ However, central to the inquiry of the court was the potential for injustice to creditors should the companies' assets not be consolidated. This principle applies both ways, in that, if a creditor is aware of the close association between a bankrupt company and an affiliate then the creditor may be estopped from arguing that consolidation is prejudicial.¹⁸¹

In *Chemical Bank New York Trust Co. v. Kheel*,¹⁸² the court faced a group of shipping companies controlled by one person. It was held that the group was operated as a single economic unit with titular common directors and shareholders.¹⁸³ The debtor companies had commingled funds and deficient records of intercompany indebtedness.

¹⁷⁸ *Reider v. Federal Deposit Insurance Corporation (In re Ida V. Reider and James M. Reider)* 31 F 3d 1102, 1107 (1994). *Rieder* deals with the issue of consolidation between husband and wife but the law used is essentially the same as for the parent and subsidiary.

¹⁷⁹ 328 F 2d 446 (2d Cir,1964).

¹⁸⁰ *Ibid.*, at 448.

¹⁸¹ *Stone v. Eacho (In re Tip Top Tailors, Inc.)*, 127 F 2d 284; 288 (4th Cir, 1942). Here the parent had received all income generated by its subsidiaries and, amongst other things, paid all of the subsidiaries bills including employees. It was clear that creditors dealing with the subsidiary knew they were effectively dealing with the parent.

¹⁸² 369 F 2d 845 (2d Cir,1966).

This created a complicated web of arrangements for the court to untangle. Thus, in addition to the ‘injustice to creditors’ criteria introduced in *Soviero*, the court upheld consolidation of the groups assets because ‘the interrelationships of the group are [so] hopelessly obscured and [the] expense necessary even to attempt to unscramble them so substantial as to threaten the realisation of any net assets for all the creditors.’¹⁸⁴ The consequence being, that the expense and difficulty of reconstructing the financial record of each company to determine the inter-corporate indebtedness and ownership of assets amounted to a practical impossibility.¹⁸⁵ *Soviero* and *Kheel* demonstrate two central themes of substantive consolidation:

First, disregard of corporate formalities and commingling of assets may indicate substantive consolidation is appropriate. This follows from the recognition that there is a substantial identity between the debtors, with one entity exercising ultimate control over the assets and the other entities operating as mere instrumentalities. Second, consideration of possible harm or injustice to the creditors is determinative of the propriety of ordering substantive consolidation. Harm or injustice to the creditors may result where unscrambling the affairs of the debtors would threaten the realization of assets. On the other hand, a creditor may demonstrate that injustice would result in the form of a diminished share of the assets were consolidation ordered, due to the creditor's reliance upon the separate credit and assets of one of the entities.¹⁸⁶

The last point concerning a creditor’s reliance on the separate assets of the entity emphasises the careful balance between ‘doing equity’ for creditors and ordering consolidation. If a creditor has assessed the assets of a subsidiary to be adequate and then finds that their dividend on distribution in bankruptcy is threatened, the creditor will no doubt seek to oppose any order for consolidation. As the corporations in a group will invariably have different debt to asset ratios, there is often a redistribution of

¹⁸³ *Ibid.*, at 846.

¹⁸⁴ *Ibid.*, at 847.

¹⁸⁵ *Ibid.*

¹⁸⁶ *Reider v. Federal Deposit Insurance Corporation (In re Ida V. Reider and James M. Reider)* 31 F 3d 1102, 1106 (1994).

wealth between creditors across the range of consolidated companies.¹⁸⁷ Consequently, consolidation is ‘no mere instrument of procedural convenience’ because it affects substantive rights.¹⁸⁸ Thus, ‘[t]he power to consolidate should be used sparingly because of the possibility of unfair treatment of creditors of a corporate debtor who have dealt solely with that debtor without knowledge of its interrelationship with others.’¹⁸⁹ The potential for unfairness to creditors is an integral aspect of the inquiry because the harm caused to a group of creditors may outweigh the any advantage to other creditors.¹⁹⁰

¹⁸⁷ *In re Auto-train* 810 F 2d 270, 276 (1987); *Eastgroup Properties v. Southern Motel Assoc., Ltd.*, 935 F 2d 245, 248 (11th Cir,1991).

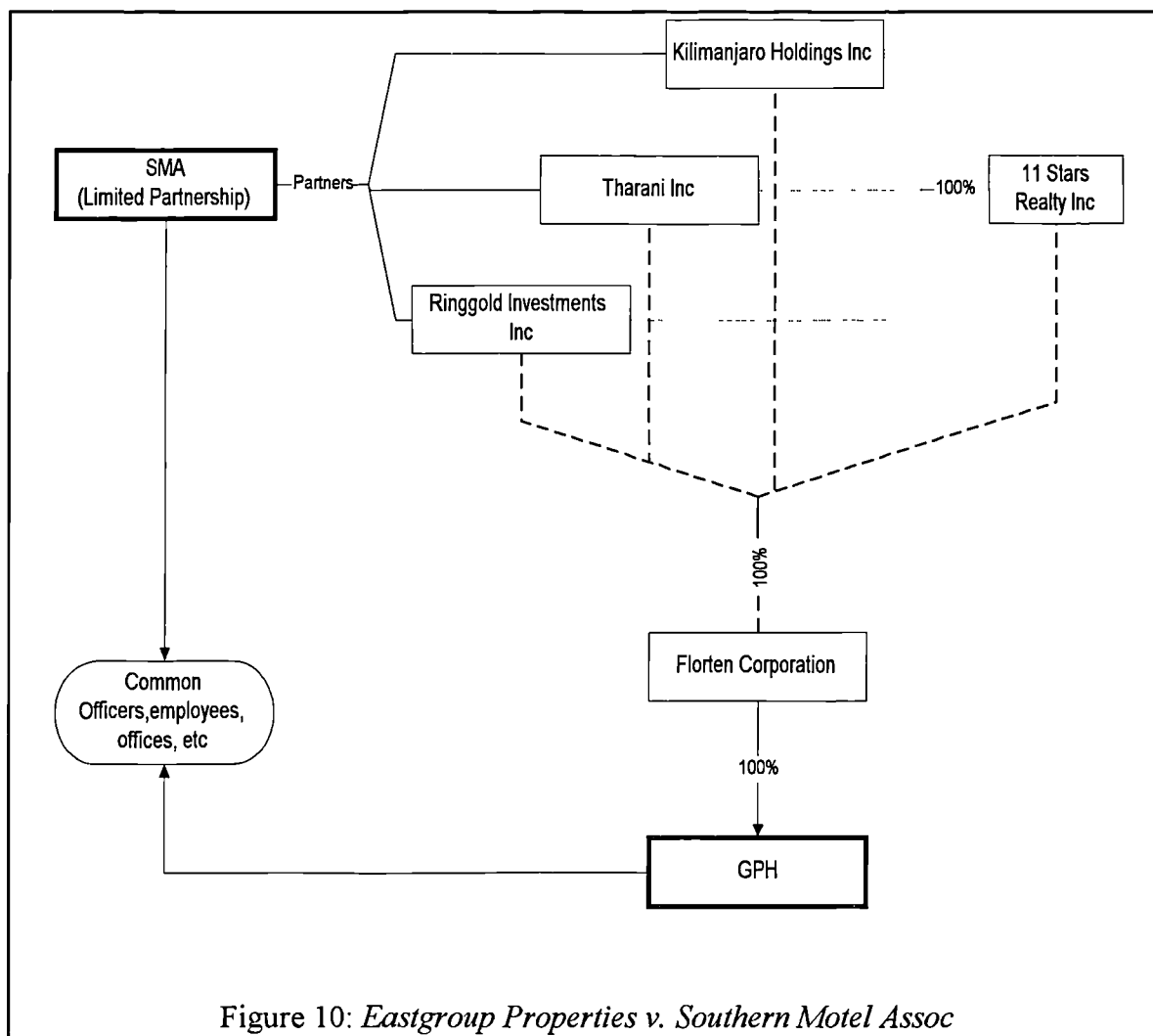
¹⁸⁸ *In re Flora Mir Candy Corporation* 432 F 2d 1060, 1062-63 (2nd Cir, 1970).

¹⁸⁹ *Ibid.*; *Chemical Bank New York Trust Co. v. Kheel* 369 F 2d 845, 847 (2d Cir, 1966). More recently, *Reider v. Federal Deposit Insurance Corporation (In re Ida V. Reider and James M. Reider)* 31 F 3d 1102, 1106 (1994).

¹⁹⁰ *In re Continental Vending Machine Corp.* 517 F 2d 997 (2d Cir,1975).

The Eastgroup Analysis of Substantive Consolidation

*Eastgroup Properties v. Southern Motel Assoc. Ltd*¹⁹¹ is the most sophisticated recent consideration of substantive consolidation. As we shall see, the complex nature of the relationships between the entities being consolidated and their creditors necessitates a very detailed level of analysis. Eastgroup Properties and two individuals, as creditors, objected to the substantive consolidation of two related companies, Gainesville P-H Properties ('GPH') and Southern Motel Association ('SMA'). The structural relationship between GPH and SMA is illustrated as follows:



¹⁹¹ 935 F 2d 245, 249 (11th Cir, 1991).

SMA and GPH were commonly owned via the above corporate structure. SMA was a limited partnership formed for acquiring and holding certain fee simple and leasehold interests in motel properties. GPH corporation's sole business was the operation of SMA's motel businesses. SMA and GPH worked out of the same offices and GPH employees regularly provided services to SMA for no cost. Funds were often transferred from one entity to another and each entity had occasionally paid unsecured debts of the other. Despite the formal contractual relationship between SMA and GPH there were regular defaults in performance of their contractual obligations that had no effect on their existing and continuing relationship. Representations made by each entity led to confusion amongst creditors as to the ownership of certain assets.

Eastgroup Properties ('Eastgroup') leased five properties to SMA, which were subleased to GPH. The two individual creditors mentioned (Olshan and Macy) had sold certain properties to SMA and partially financed SMA's purchase by providing 'an inferior purchase money mortgage note'.¹⁹² Eastgroup's claim against SMA comprised rent for the leased properties. Whereas, after liquidation and partial payment of SMA's obligation to them Olshan and Macy had an unsecured claim of approximately \$ 8,000,000 against SMA. When compared, GPH had a much higher debt to asset ratio than SMA. Consequently, consolidation of the claims and assets of SMA and GPH would result in a lessening of the dividend paid to SMA's creditors such as Eastgroup, Olshan and Macy. Eastgroup argued that:

'... absent consolidation, SMA's equity holders might receive a distribution after all claims were paid, while GPH's unsecured creditors (who might receive a distribution if the estates were consolidated) would not receive anything -- is disproved by the mathematics of the cases: that, regardless of consolidation, GPH's unsecured creditors will receive no distribution and SMA's equity holders

¹⁹² *Ibid.*, at 247.

will receive nothing. [Eastgroup] also argue that the bankruptcy court gave inadequate weight to the fact that consolidation would prejudice them because their unsecured claims would not be paid if the estates are consolidated'.¹⁹³

The Legal Analysis

In *Eastgroup Properties*, the court delineated a general equitable threshold to be overcome under the general power conferred by section 105 of the Bankruptcy Code.¹⁹⁴

The essential standard used to determine the adequacy of substantive consolidation is whether 'the economic prejudice of continued debtor separateness' outweighs 'the economic prejudice of consolidation.'¹⁹⁵ The purpose being to 'conduct a searching inquiry to ensure that consolidation yields benefits offsetting the harm it inflicts on objecting parties.'¹⁹⁶ The applicant for substantive consolidation must show that:

- A. There is substantial identity between the entities to be consolidated; and
- B. Consolidation is necessary to avoid some harm or to realise some benefit.¹⁹⁷

Whilst no single factor is likely to be determinative in the court's inquiry, examples of useful evidence needed to satisfy the above criteria include:

1. The presence or absence of consolidated financial statements.

¹⁹³ *Ibid.*, at 248.

¹⁹⁴ *Supra*, n 173.

¹⁹⁵ *Eastgroup Properties v. Southern Motel Assoc Ltd* 935 F 2d 245, 249 (11th Cir,1991) quoting *In re Snider Bros Inc* 18 Bankr. 230, 234 (Bankr.D.Mass.1982))

¹⁹⁶ *Drabkin v. Midland-Ross Corp. (In re Auto-train Corp.)* 810 F 2d 270, 276 (D.C.Cir,1987).

¹⁹⁷ *Eastgroup Properties v. Southern Motel Assoc Ltd supra*, at 249; *In re Murray Industries* 119 Bankr 820, 829 (1990). Similar formulations can be found in other Circuits. For example, *In re Giller* 962 F 2d 796, 799 (8th Cir,1992) the court provided: (1) the necessity of consolidation due to the interrelationship among the debtors; (2) whether the benefits of consolidation outweigh the harm to creditors; and (3) prejudice resulting from not consolidating the debtors. *In re Augie/Restivo Baking Co Ltd* 860 F 2d 515, 518 (2d Cir,1988), the court focuses on two factors: (1) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit; or (2) whether the affairs of the debtors are so entangled that consolidation will benefit all

2. The unity of interests and ownership between various corporate entities
3. The existence of parent and intercorporate guarantees on loans.
4. The degree of difficulty in segregating and ascertaining individual assets and liabilities.
5. The existence of transfers of assets without formal observance of corporate formalities.
6. The commingling of assets and business functions.
7. The profitability of consolidation at a single physical location.¹⁹⁸

Additional factors include:

8. The parent owning the majority of the subsidiary's stock;
9. The entities having common officers or directors;
10. The subsidiary being grossly undercapitalised;
11. The subsidiary transacting business solely with the parent; and
12. Both entities disregarding the legal requirements of the subsidiary as a separate organisation.¹⁹⁹

creditors. If either element is present then consolidation is justified. See also *FDIC v. Colonial Realty Co* 966 F 2d 57, 61 (2nd Cir, 1992).

¹⁹⁸ *In re Vecco Construction Indus 4 Bankr* 407, 410 (1980) and also *Eastgroup Properties v. Southern Motel Assoc Ltd supra*, at 250. *In re Murray Indus* 119 Bankr 820, 830 (1990); *In re Holywell Corp* 59 Bankr 340, 347 (1986).

¹⁹⁹ *Eastgroup Properties v. Southern Motel Assoc Ltd supra*, at 250 also *Pension Benefit Guarantee Corp v. Ouimet Corp* 711 F 2d 1085, 1093 (1st Cir, 1983).

Thus, many factors draw on veil piercing jurisprudence and the administrative advantages to be gained from consolidation. If the matters in A and B above are established by the court then the presumption arises 'that creditors have not relied solely on the credit of one of the entities involved.'²⁰⁰ If this is established then a prima facie case for consolidation exists. The objecting creditor then has the onus of showing that

C. it has relied on the separate credit of one of the entities to be consolidated; and

D. it will be prejudiced by substantive consolidation.

If the objecting creditor is successful then, 'the court may order consolidation only if it determines that the demonstrated benefits of consolidation 'heavily' outweigh the harm.'²⁰¹ Returning to the decision in *Eastgroup Properties*, the court held that the relationship between SMA and GPH warranted consolidation.²⁰² Creditors faced a number of potential harms that could be avoided by the use of the order. First, consolidation would remove any question of intercorporate indebtedness and obligation between SMA and GPH. Second, with out any obligation to do so, GPH had paid several of SMA's debts. Third, a number of creditors had relied on the combined credit of both companies because of their lack of separateness. Finally, consolidation would result in a large number of GPH's creditors receiving a dividend.

In accordance with the formulation of the court, this finding placed the onus on Eastgroup to demonstrate the matters set out in items C and D above. Although it was clear that Eastgroup would suffer the prejudice of a substantially reduced dividend,

²⁰⁰ *Eastgroup Properties v. Southern Motel Assoc Ltd supra*, at 249; *Matter of Lewellyn* 26 Bankr 246, 251-52 (1982).

²⁰¹ *Drabkin v. Midland-Ross Corp. (In re Auto-train Corp.)* 810 F 2d 270, 276 (D.C.Cir,1987)

²⁰² *Eastgroup Properties v. Southern Motel Assoc Ltd supra*, at 250.

evidence produced to the court concerning Eastgroup's conduct demonstrated it had not solely relied on SMA's separate credit.

Substantive Consolidation and Contribution from Solvent Entities

One cause for concern in the US has been the extension of substantive consolidation to combine the assets of a bankrupt entity with the assets of a solvent entity.²⁰³ The US law here seems confused and certainly lacks the benefit of any certain criteria such as those employed in section 272 Companies Act 1993 of New Zealand. Without the benefit of such certainty the law in this area has the familiar feel of veil piercing in the context of bankruptcy but under another name and further discussion is not warranted.

Comments

Substantive consolidation is a remedy that significantly abrogates the rules of separate personality and limited liability amongst the members of a group that are in bankruptcy. In many situations, the bankruptcy process is no more than an identification of assets with an orderly distribution of a dividend to creditors. The complexity of a corporate group, with complex relationships and asset holdings between members places this process under considerable strain. Substantive consolidation is a remedy applied by the courts with analytic caution with respect for basic corporate principles. However, when the threshold of bankruptcy is negotiated, substantive consolidation assists in the process of allocating the resources of a company as equitably as possible. Initially, substantive consolidation relied on the strictness of veil piercing jurisprudence but now combines this with a broader notion of 'economic prejudice' to creditors. Economic

²⁰³ Christopher J. Predko, 'Substantive Consolidation Involving Non-Debtors: Conceptual and

prejudice necessitates the use of criteria that look beyond the confines of entity theory and introduce the pragmatic principles of enterprise analysis. Importantly, many thresholds must be negotiated before the court is willing to overcome the force of entity theory, as is demonstrated by the detailed analysis found in *Eastgroup*.²⁰⁴ In essence, the courts recognise that when the damage is done and the group structure has caused harm then there is little to be lost from equality of distribution amongst all creditors of the enterprise. In doing so, many of the costs involved with determining complex intercorporate claims are dissolved improving the final asset pool for creditors overall.

Jurisdictional Difficulties in Bankruptcy' (1995) 41 *Wayne Law Review* 1741.

²⁰⁴ Though some commentators believe that there is a developing liberal trend toward the substantive consolidation of groups. See Christopher W. Frost, 'Organizational Form, Misappropriation Risk, and the Substantive Consolidation of Corporate Groups' (1993) 44 *Hastings Law Journal* 449 at 456.

Conclusion – The Way Forward

Each company in a group of companies is a separate legal entity, each bearing its own rights and responsibilities. This reasoning extends to the incorporators. The judiciary allocates separate roles to each of the actors in a company. Each role attracts certain liabilities and obligations. One person may fulfil a number of roles however; the liabilities and obligations are kept discrete. This has perpetuated an artificial analysis of the role a parent company plays in a group of companies. In English law, a parent is merely a shareholder, yet is permitted total control of its subsidiaries. The total control a parent has derives from the prerogatives of share ownership. These prerogatives attract their greatest efficacy in majority or wholly owned subsidiaries. How then does a parent gain total control of a subsidiary? This thesis argues that there is a *legitimate control model*.

The *legitimate control model* asks how a share can import total control. There is a clear dissonance between the degree of control a parent is permitted through shares in a subsidiary and the parent's actual control of the subsidiary. This thesis argues that not only does the beneficial ownership of shares in a subsidiary import legal control, but also imports a degree of *legitimate extra-legal control*. There are measures available to regulate the abuse of legal control. There are no measures in English law that provide accountability for abuse of extra-legal control. In short, there are no mechanisms that

permit an aggrieved person, such as a creditor to seek redress for damage suffered as a consequence of abuse of extra-legal control.

SUMMARY OF THE ENGLISH LEGAL POSITION

Under English law, during solvency, neither a subsidiary nor its creditors have a legislative cause of action against a parent.

The subsidiary as the proper plaintiff has a number of potential causes of action against a parent for abuse of the parent's extra-legal control. First, *interference* by the parent in the management of a subsidiary may impose a direct duty to the subsidiary that is actionable in tort. Such interference can occur independently of the parent having a nominee employee-director on the board of a subsidiary. Second, *interference* may implicate a parent as a joint tortfeasor with a director's commission of a tort. A director can be personally liable for torts committed during the execution of their duties,¹ though care must be taken to determine whether the director's actions are his own or correctly attributable to the subsidiary.² Third, the parent may be vicariously liable for the actions of its employee director. Only when the parent's actions override the director's duties to the subsidiary can it be said that the parent has 'interfered' with the affairs of the company to the extent that a duty is owed by a parent to the subsidiary.³ Vicariously liability also attaches to the parent where the tortious conduct of the

¹ See Chapter 1, Interference and Its Relationship with Tort at page 110 ff above. See also, *New Zealand Guardian Trust Co Ltd v. Brooks* [1995] 2 BCLC 242 (PC).

² Ross Grantham, 'Liability of parent companies for the actions of the directors of their subsidiaries' (1997) 18 *Company Lawyer* 138 at 142. See also *Williams v. Natural Life Foods Ltd* [1998] 2 All ER 577 (HL) for a recent discussion of the notion of "assumed responsibility".

³ *Dairy Containers Ltd v. N.Z.I. Bank Ltd* [1995] 2 NZLR 30 at 87-90 *per* Thomas J. and *Kuwait Asia Bank E.C. v. National Mutual Life Nominees Ltd*, [1991] 1 A.C. 187 (PC) at 223-224 for a discussion of the notion of a parent's 'interference' with a subsidiary. For

director is performed in the director's capacity as an employee and is not attributable to the subsidiary.⁴

A creditor is constrained by the rule in *Foss v. Harbottle* from taking any of these actions. Arguably though, a creditor, in rare situations, has the right to have the court exercise its equitable jurisdiction to protect, for example, a judgement creditor from the parent's dissipation of a subsidiary's assets by the use of a Mareva injunction.⁵ Further, the principle from *Woolfson v. Strathclyde Regional Council* that the corporate veil can be pierced where there are *special circumstances* that show the subsidiary was a mere façade of the parent is not restricted in its operation and is also available to creditors before liquidation. The creditor has unlikely chances of success in each of these situations because of the difficulty of uncovering evidence to support the allegations.

On liquidation, problems with the proper plaintiff principle are removed because the liquidator has the right to pursue actions on behalf of creditors. The liquidator gains the benefit of access to company documents for the purposes of evidence of wrongdoing by directors etc. This means that in addition to the common law remedies mentioned above, a liquidator may seek to obtain redress for the benefit of creditors for abuses of a parent's extra-legal control through either section 212 or 214 of the Insolvency Act 1986. Each legislative section poses very difficult procedural and substantive barriers to a liquidator's success.

example, in *Ryde Holdings Ltd v. Sorrenson* [1988] 2 NZLR 157 a director's employer instructed the director to sell the assets of a company to a subsidiary at undervalue.

⁴ Grantham, *op. cit.*, n 2 at 141.

⁵ See I. C. F. Spry, *The Principles of Equitable Remedies* 5th ed (London: Sweet & Maxwell, 1997) at 515. See also *Siskina (Cargo Owners) v. Distos Compania Naviera SA* [1979] AC 210 (HL) at 260-1 *per* Lord Hailsham.

For section 212 Insolvency Act 1986 it is necessary to show that a parent is a 'shadow director' of subsidiary, thus permitting the enforcement the fiduciary duty owed by a director to a subsidiary for the benefit of creditors. However, the courts willingness to dissociate the actions of creditors, such as banks, or parents funding subsidiaries, to act legitimately in their interests from other action that usurps management of the company prevents proper application of section 212.⁶ This is because courts focus on the allocation of roles such as creditor and shareholder, attributing the predetermined standard of liability associated with the role. Presently, a parent's position as the complete controller of a subsidiary is safe from the allegation that the parent falls within either section 212(1)(a) as an *officer* or under section 212(1)(c) as involved in the management of the company. The section provides little support for the argument that a parent is a 'shadow director' or a person that has taken part in the management of a subsidiary.

Further, it is also arguable that as a 'shadow director' a parent owes the subsidiary the statutory standard of care set out in section 214(4). Section 214 Insolvency Act 1986 offers an opportunity for a liquidator to hold a parent liable for wrongful trading if it can be demonstrated that the parent is a 'shadow director' of the subsidiary. To be a shadow director a parent must be *a person in accordance with whose directions or instructions the directors of the subsidiary are accustomed to act*. Given that a parent is entitled to exercise complete control over a subsidiary, it seems the threshold of shadow directorship can easily be negotiated. Though a parent need only show that the board of the subsidiary had an independent director or that it was not always customary for the board to comply with the directions of the subsidiary.

⁶ *Re Ayala Holdings Ltd* [1993] BCLC 256, ChD *per* Chadwick J at 262-263.

English law has no specific means of holding a parent accountable for the abuse of extra-legal control over a subsidiary. This means that the creditors of subsidiaries are vulnerable to the parents abuse of the subsidiary.

SUMMARY OF SURVEY JURISDICITONS

The German *Konzernrecht* demonstrates that the internal structure of a company can play a significant role. The presence of a supervisory board overseeing the decisions of the management board provides internal checks and balances that may minimise the risk of corporate abuses overall. Any legislation designed to regulate groups must apply across the board to all forms of legal entity. The ability of German enterprises to avoid operation of the *Konzernrecht*, for example by using a private company, is a serious flaw that makes the law almost valueless. Germany through historical pressure realigned their philosophical approach to the parent subsidiary relationship. UK jurisprudence is unyielding in its approach that the parent is no more than a shareholder notwithstanding its complete domination over a subsidiary. There is no change in the legislative philosophy of the Companies Act 1985 or the Insolvency Act 1986 in these circumstances. The *Konzernrecht* demonstrates that with control comes accountability. In Germany, the legislation focuses on the dependence of a subsidiary on a parent rather than the issue of whether the parent can exercise complete control over the subsidiary. Where dependence exists then it is recognised that the ‘unconnected parties’ or outsiders such as creditors need to have mechanisms to bring the controlling shareholder’s influence into question where necessary.

The experience in the European Union demonstrates that measures drawing on the experience of one jurisdiction as the template for reform are counter-productive. The

Proposed Draft Ninth Company Law Directive was doomed because it failed to recognise particularities and institutional constraints of the respective legal systems of different member states. This lack of sensitivity was evident in the radical nature of the proposed reforms and the current removal of the reform package from the agenda of the EU.

Australia and New Zealand provide a number of comparisons that the UK can draw on. Importantly, both jurisdictions have sought to retain the strict operation of limited liability and separate personality, but provide legislative enhancements in certain circumstances to improve the position of creditors. The differences between each jurisdiction demonstrate slight philosophical variations concerning the regulation of groups. Australia has a system that permits a controlled intervention in the management of a company during solvency via a mechanism that permits creditors to pursue directors and shadow directors for breaches of duties to the company. Whereas, New Zealand has shown a reluctance to permit such incursions into the management of a company during solvency but provides mechanisms to test the probity of group arrangements on the liquidation of a group company. Australia and New Zealand demonstrate a desire to provide accountability for control. Each experience shows the value of mechanisms that are fact sensitive rather than reliant on strict application of separate corporate personality.

In Australia, before liquidation a creditor has a number of remedies available to prevent a parent participating in transactions with a subsidiary that increase the risk of non-repayment to creditors. These remedies can take the form of orders preventing certain conduct, injunctions, and the possibility of damages.

After the liquidation of a group company, Australia and New Zealand offer a range of legislative creditors' remedies. Australia's provision concerning the liability of a holding company for the debts of a subsidiary is a good example of how the principles of wrongful trading, logically, can be modified to deal with the parent subsidiary relationship. The Australian provision imposes a clear duty on a parent to monitor the financial position of a subsidiary, thus establishing a minimum standard of conduct.

New Zealand on the other hand has two 'open textured' remedies that seek to balance the equities between related companies during the course of their dealing prior to liquidation. This may take the form of a remedy that orders the related company to contribute to the liquidation or alternatively to order the consolidation of assets for distribution where both the parent, related company or subsidiary go into liquidation.

Finally, the United States demonstrated both the power and the uncertainty of unleashing the operation of the equitable jurisdiction of the court to deal with the group of companies. The reform value of the US is its willingness to use 'open textured' equitable remedies to mediate between the inherent commercial advantages of a group of companies and the potential for abuse. The structure of the remedy regime during liquidation has merit and offers a degree of elegance. At the basic level we have the familiar remedies designed to overcome 'fraudulent conveyances'. At the intermediate level, the remedies are aimed at curbing abuses of extra-legal control. Here remedies such as equitable subordination and substantive consolidation arguably do not pierce the veil but rather modify the strict operation of *pari passu*. At the top tier is veil piercing combating serious abuses such as *fraud*. The US treatment of fiduciary duties in relation to the role of a controlling shareholder recognises that it is artificial to confine

the responsibility of a parent to that of a mere shareholder. Rather, there is a responsibility to the 'community of interests' that includes creditors. Thus, the desire to regulate extra-legal control must focus on the establishment of a basic duty of fairness and good faith toward a subsidiary.

THE WAY FORWARD

The question of how to shape a rational law of groups will probably have to be answered by adopting an approach which is intermediate between the use of philosophical and of legal and economic concepts.⁷

Reform of the law in the United Kingdom concerning groups of companies may take two possible forms. Jurisprudential reform seeks to extend the capacity of veil piercing jurisprudence to deal with the group of companies and any associated complex transactional structures. The route of such reforms is to revert to a first principles analysis of the company by treating it as a cluster of rules. If we accept that the law recognises a company when it is used in legitimate factual circumstances then criteria for application of each rule in the cluster must be the same. If the application of one rule is illegitimate then maintenance of corporate personality must fail. Such a measure will facilitate the improvement of veil piercing jurisprudence. The next step is to consider what tools are available to conduct this testing process. The doctrine of the sham as derived from *Woolfson v. Strathclyde Regional Council* is the starting point. However, the structural and transactional complication of modern corporate groups, simply overawes a test designed to analyse one entity and one transaction. If the judiciary is to meet the challenge of the group then it must be recognised that the

⁷ Klaus J. Hopt, 'Legal Elements and Policy Decisions in Regulating Groups of Companies' in Clive M. Schmitthoff and Frank Wooldrige eds, Groups of Companies (London: Sweet & Maxwell, 1991) at 89.

doctrine of the sham alone is unable to provide adequate remedies. A hybridisation of the company law must occur by the introduction of an interpretative tool. The template for such an interpretative tool can be fashioned from the *Ramsay Principle* found in tax law. In this way, not only is each transaction tested for legitimacy, but also the purpose of the entire structural and transactional arrangement is tested for legitimacy. When the court has analysed the structure and the commercial relationships between parent and subsidiary can we consider the general question 'is it a legitimate use of the corporation'? Only then will English Law respond to the inadequacies demonstrated in *Adams v. Cape Industries Plc* and *Multinational Gas Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd & Ors.*

There is a clear need for an effective but measured legislative response to the group phenomenon. The work of the Cork Committee on groups of companies needs to be completed. Reform must focus on the regulation of a parent's extra-legal control because there is a real risk of abuse to the disadvantage of creditors. The first theoretical hurdle concerns the degree of intervention the law will permit to creditors during solvency of a company. Following the New Zealand experience and the recommendation of the Cork Committee seems sensible. Such a proposition advocates a strict contractarian line, leaving the creditor and the subsidiary to their own contractual devices before liquidation. In addition, there is real merit in providing a clear pre-insolvency cause of action to creditors. This need not be a departure from the contractarian line, but be limited to those circumstances where there is evidence of parental interference threatening the existing contractual rights of creditors. The interference of the parent is indicative of it inducing the subsidiary to renege on freely negotiated contractual obligations.

On liquidation, the courts should have a wide equitable jurisdiction to assess the range of corporate conduct and offer remedies where necessary. Such remedies should be spelt out and enable contribution from the parent company together with appropriately modified versions of equitable subordination and substantive consolidation. Sections 212 and 214 of the Insolvency Act 1986 demonstrates a lack of attention by policy makers and the legislative draftsman to the nuances of the group of companies. There needs to be a complete reconsideration of the rationale and scope of each remedy with the group of companies in mind. In short, a separate regime needs to be established to deal with the liability of the parent company for wrongful trading and for breaches of duty in its capacity as a director. The parent should enjoy the same defences as directors in these situation. Only then will English law recognise the inequity of a parent company abusing extra-legal control by acknowledging the principle of accountability for control.

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