

1998

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Damien Murphy

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# Holding Company Liability for Debts of its Subsidiaries: Corporate Governance Implications

## **Abstract**

[extract] This article will attempt to consider the corporate governance implications for groups of companies arising from an analysis of the circumstances in which a holding company may be liable for the debts and obligations of its subsidiaries. I consider this methodology is appropriate because it suggests restraints upon the management or control of a subsidiary by a holding company. If a holding company is responsible also for the liabilities incurred by a subsidiary, then we can expect that circumstance to result in careful consideration by the management or controllers of the holding company of that company's relationship with the subsidiary and how, if at all, the holding company controls or manages the resources of the subsidiary.

## **Keywords**

holding companies, corporate governance, subsidiaries, liability, shadow directors

## HOLDING COMPANY LIABILITY FOR DEBTS OF ITS SUBSIDIARIES: CORPORATE GOVERNANCE IMPLICATIONS

By DAMIEN MURPHY, BEc (Hons), LLB, Monash University, LLM, Melbourne University, General Counsel, Wealth Management, National Bank Limited.

### Introduction

Groups of companies are a modern fact of commercial life. It is common for large publicly listed Australian companies with substantial operations overseas to have literally hundreds of wholly-owned subsidiaries<sup>1</sup>. From a commercial perspective this practice is so prevalent that it is unusual to question the practice or ask why large enterprises conduct their business in this way. But from a traditional legal perspective, each of these corporations is a separate legal person with its own board of directors (or equivalent with overseas subsidiaries) responsible for supervising the operations and affairs of that particular corporation. It is a principle of corporate governance<sup>2</sup> that each of those boards should act in the best interests of that corporation as opposed to the interests of third parties or the group as a whole<sup>3</sup>. Consequently, assuming the principles of corporate governance applied, there is no prima facie reason why the hundreds of subsidiary corporations in a corporate group should act in a co-ordinated manner at all, particularly if the relevant boards were acting in the best interests of each individual corporation as opposed to the interests of other members of the group or the ultimate holding company. Of course the corporations comprising a group do act in a co-ordinated manner because of the imposition of one 'management' and the ultimate commonality of ownership<sup>4</sup>. As a matter of commercial practice, management of the individual corporations is aligned with the interests of the entire group. What then for the principles of corporate governance?

### Approach

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- 1 This can be readily demonstrated by an examination of the published annual reports of large publicly listed Australian companies.
  - 2 The expression 'corporate governance' when used in this article has its plain meaning, being the manner in which corporations are governed. That is, the set of legal rules which determine the relationships between the various interested parties who, and to what extent, control the application of the resources owned by the legal fiction of the incorporated enterprise.
  - 3 *Walker v Wimborne* (1976) 3 ACLR 529 at 532.
  - 4 Large conglomerates with diversified businesses and decentralised line managers may find that individual business units indirectly compete with each other. But in that event the usual result will be for the ultimate management to act so as to maximise the return across the entire group, another form of co-ordination.

This article will attempt to consider the corporate governance implications for groups of companies arising from an analysis of the circumstances in which a holding company may be liable for the debts and obligations of its subsidiaries. I consider this methodology is appropriate because it suggests restraints upon the management or control of a subsidiary by a holding company. If a holding company is responsible also for the liabilities incurred by a subsidiary, then we can expect that circumstance to result in careful consideration by the management or controllers of the holding company of that company's relationship with the subsidiary and how, if at all, the holding company controls or manages the resources of the subsidiary.

Only wholly-owned subsidiaries will be considered. This removes the need to examine the position of minority shareholdings and throws into starkest relief the coincidence of the management and ownership of wholly-owned subsidiaries<sup>5</sup>.

This article will proceed by:

- (a) clarifying key terminology and relationships, ie what is a 'company', a 'group', a 'holding company', a 'subsidiary' and a 'wholly-owned subsidiary' and the legal relationships between those various concepts;
- (b) looking at the economic or commercial reasons which explain why companies expand and the creation of a group of companies;
- (c) setting out the policy rationales for 'limited liability' and assessing their applicability to the situation of a holding company and its relationship with its subsidiary;
- (d) considering when the law will permit the 'piercing of the corporate veil' so that a holding company may be responsible for the debts and obligations of its subsidiary;
- (e) analysing when a holding company will be responsible for the debts of its subsidiary under section 588V of the Corporations Law ('CL');
- (f) examining when a holding company will be a 'director' or 'officer' of a subsidiary for the purposes of the CL under the expansive definitions of 'director' and 'officer' in the CL and the consequential implications for responsibility for the debts and obligations of the subsidiary; and

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<sup>5</sup> We also do not have to consider Chapter 2E of the Corporations Law, Financial Benefits to Related Parties. This is because pursuant to section 243M of the Corporations Law, transactions between wholly-owned subsidiaries and holding companies and other wholly-owned subsidiaries are excluded from the relevant prohibition.

- (g) considering how cross guarantees can effectively operate so that the liabilities of a subsidiary are the commercial responsibility of the relevant group of companies.

I will attempt to draw out some of the implications for corporate governance and make some concluding comments.

### **Key Concepts**

I consider the most useful way to analyse a company is to consider it a personification for legal purposes of a fund devoted to certain objects and in relation to which different classes of persons have different interests, entitlements and responsibilities<sup>6</sup>. The relevant classes include the owners of shares or 'shareholders'; the directors or controllers of the fund referred to as 'management'; employees; creditors; suppliers; customers; and non-consensual participants in the activities of the fund (eg the competitors in the market place or the victims of torts carried out on behalf of the fund). Because the interests, entitlements and responsibilities of these classes may vary conflicts of interest arise and it is the role of the law to resolve those conflicts<sup>7</sup>.

A 'company'<sup>8</sup> is a legal entity or person but that is a legal fiction<sup>9</sup>. It has no separate existence other than in the contemplation of the law. The CL provides that a company comes into existence as a body corporate at the beginning of the day on which it is registered by the Australian Securities and Investments Commission<sup>10 11</sup>. A company is separate and distinct from the individual members of the company<sup>12</sup>. A company's property is not the property of the members, and its debts are not the debts of its members<sup>13</sup>. The combined effect of these two principles is often referred to as the principle of 'limited liability' whereby, subject to fairly limited exceptions<sup>14</sup>, the creditors (whether consensual or non-

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6 See Farrar JH 'The Duties of Controlling Shareholders' in *Contemporary Issues in Company Law* (Farrar JH ed) at 187.

7 I consider that this approach does not conflict with the 'law and economics' approach. This is because the legal framework provides the basis for the participants to contract with each other or act otherwise.

8 In this article I will consider only 'companies' incorporated or deemed to be incorporated under the Corporations Law of an Australian State or Territory. I will only consider companies limited by shares as opposed to companies limited by guarantee, no liability companies and companies with unlimited liability.

9 Sir Edward Coke described corporations as 'invisible, immortal, and resting only in intendment and consideration of the law': *Sutton's Hospital Case* (1612) 10 Co Rep 1 (a) 32.

10 Section 119 of the CL.

11 Prior to 1 July, 1998, the CL (section 121) provided that from the date set out in the certificate of registration, the subscribers to the company's memorandum, together with such other persons as from time to time become members of the company, are an incorporated company by the name stated in the memorandum.

12 *Salomon v A Salomon & Co Ltd* [1897] AC 22.

13 *Salomon v A Salomon & Co Ltd* [1897] AC 22.

14 Generally with a company limited by shares any such liability will be restricted to the amount of any unpaid capital upon the issue of the shares.

consensual) of a company may only look to the assets of the company for the satisfaction of outstanding liabilities owed by the company.

The expressions 'group' and 'corporate group' are not defined in the CL<sup>15</sup>. The expressions are commercial expressions adopted through common usage to describe a collection of companies associated with each other usually through a common ownership or control. There will typically be an ultimate holding company with a widely dispersed public ownership<sup>16</sup>.

In the context of groups of companies the courts in Australia and the UK have consistently emphasised that the separate legal persons of the individual members of the group should be recognised<sup>17</sup>. However, there have been judicial comments and academic writings suggesting that the distinction should not be maintained<sup>18</sup>. In December, 1998 the Companies & Securities Advisory Committee issued a Discussion Paper entitled 'Corporate Groups' (the 'CASAC Discussion Paper') with the aim of stimulating discussion on whether Australian corporate law needs further adjustment to better recognise and respond to the way corporate groups operate in practice<sup>19</sup>.

<sup>20</sup>The expression 'holding company' is defined in relation to the expression 'subsidiary' in Division 6 of Part 1.2 of the CL. A company is a subsidiary of another body corporate (the holding company) if, and only if:

- (a) the holding company:
  - (i) controls the composition of the company's board of directors; or
  - (ii) is in a position to cast, or control the casting of, more than one-half of the maximum number of votes that might be cast at a general meeting of the company; or
  - (iii) holds more than one-half of the issued share capital of the company (excluding any part of that issued share capital that

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15 Prior to 1 August, 1991, the CL did define the expressions 'group'; 'group accounts' and 'group holding company'. The expression 'group' referred to a holding company and its subsidiaries. The expressions were used in the context of requiring consolidated accounts for such groups for accounting purposes.

16 See *Walker v Wimborne* (1976) 3 ACLR 592 at 532 and *Re Enterprise Gold Mines NL* (1991) 3 ACSR 531 at 540 quoted in the CASAC Discussion Paper at 4.

17 *Salomon v A Salomon & Co Ltd* [1897] AC 22, *Adams v Cape Industries Plc* [1991] 1 All ER 929, *Walker v Wimborne* (1976) 3 ACLR 529 and *Industrial Equity Ltd v Blackburn* (1977) 137 CLR 567.

18 Rogers CJ in *Qintex Australia Finance Ltd v Schroeders Australia Ltd* (1991) 3 ACSR 267 at 269 and Baxt R, 'The Need to Review the Rule In Salomons Case as it Applies to Groups of Companies' (1991) 9 C&SLJ 185.

19 The purpose of the CASAC Discussion Paper is to examine possible legal difficulties for corporate groups and their directors in effectively carrying out their functions and also to consider whether further safeguards are needed for minority shareholders and outsiders who deal with those groups.

20 For a more complete discussion, see the CASAC Discussion paper at 5 to 9.

carries no right to participate beyond a specified amount in a distribution of either profits or capital); or

- (b) the company is a subsidiary of a subsidiary of the holding company<sup>21</sup>.

Section 47 of the CL sets out some circumstances in which the composition of the board of another body is taken to be controlled for the purposes of section 46 of the CL. Section 48 of the CL sets out matters that are to be disregarded in determining whether a body corporate is a subsidiary, dealing with, inter alia, shares held by a fiduciary or nominee, shares controlled under debenture arrangements, and shares held pursuant to security arrangements in connection with the lending of money.

A 'wholly-owned subsidiary' in relation to a holding company means a company none of whose members is a person other than:

- (a) the holding company;
- (b) a nominee of the holding company;
- (c) a subsidiary of the holding company, being a subsidiary none of whose members is a person other than:
- (i) the holding company; or
- (ii) a nominee of the holding company; or
- (d) a nominee of such a subsidiary.<sup>22</sup>

The legal relationship between a holding company and its wholly-owned subsidiary arises from the beneficial ownership by the holding company of all the issued share capital of the subsidiary. In accordance with traditional legal analysis there are two distinct legal persons and the rights that the holding company possesses exist because of its ownership of the shares. Those rights, incidents of the legal chose in action represented by the share, are not qualitatively different because the holding company owns all of the shares. The

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21 Section 46 of the CL.

22 Section 9 of the CL. There are two interesting technical points about this definition. First, it is possible to argue using the language of the provision that if the corporate ownership chain is sufficiently long, after 2 interposed entities, a subsidiary with all its shares held within a group will not be a wholly-owned subsidiary of the ultimate holding company. For example, company A owns all the shares in company B, which in turn owns all the shares in company C which in turn owns all the shares in company D. D is a wholly owned subsidiary of C and B but not A because the definition is concerned to examine only the members in two levels of ownership. Second, arguably a company can be a wholly-owned subsidiary without being a subsidiary! This is because none of the exclusions in section 48 apply to the definition of wholly-owned subsidiary. So for instance, if a company holds all the issued shares in a company as a nominee it is a wholly-owned subsidiary, but not a subsidiary.

rights are to be found in the constitutive documents (the constitution and replaceable rules), the common law and the Corporations Law. The shares are the property of the holding company and may be dealt with by the holding company as and to the full extent permitted by the law<sup>23</sup>. The holding company does not own the assets of the subsidiary and typically the constitution will vest the management of the business of the subsidiary in the board of directors<sup>24</sup>. Of course, the holding company because of its ownership of all the issued shares effectively may appoint or remove any director it is not comfortable with by a resolution in general meeting of the subsidiary<sup>25</sup>.

## Why Groups of Companies?

Economists have considered why 'firms' exist at all in a market economy and what determines the size of the 'firm'. Generally, economics deals with 'firms' without regard to the nature of the entity carrying on the business, whether as a sole trader, partnership, corporation or a corporate group. After considering what determines the size of the enterprise, it will be necessary to consider why the enterprise is divided into separate corporate entities.

<sup>26</sup>In a market economy, the inputs required for the production of goods and services may be allocated and used in the process of production through directions (hierarchical decision making) or through exchange (contracts). Firms represent pockets of hierarchical decision making in a market economy. Decisions about the allocation of resources in the production of goods and services are made by the management of the firm, typically referred to as the entrepreneur. These produced goods and services are then sold in the market place either for further processing or consumption. R H Coase refers to firms, quoting D H Robertson, as 'islands of conscious power in this ocean of unconscious co-operation like lumps of butter coagulating in a pail of buttermilk'<sup>27</sup>.

Firms exist because it is cheaper to produce the goods and services through the direction of management rather than rely upon the market and the exchange of goods and services through contracts. The transaction costs associated with carrying out a market based exchange are greater than the costs of management and organisation incurred by the entrepreneur. Using this insight, *Coase* postulates that:

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23 See *Peters' American Delicacy Company Limited v Heath* (1939) 61 CLR 457.

24 Section 226A of the CL, a replaceable rule.

25 Sections 226E (a replaceable rule for proprietary companies) and 227 of the CL.

26 The following discussion will rely heavily upon two principal sources. The first is Coase RH, *The Firm the Market and the Law* ('Coase'), University of Chicago Press (1998) and the second is Williams PL, 'Corporate Groups: The Management Dilemma' ('Williams') in *The Law Relating to Corporate Groups*, (Gillooly M ed) Federation Press (1993) 30.

27 Robertson DH, 'Control of Industry' at page 85, referred to by Coase at 35.

Firms will tend to expand until the costs of organising an extra transaction within the firm becomes equal to the costs of carrying out the same transaction by means of an exchange on the open market or the costs of organising in another firm.<sup>28</sup> This analysis is intuitively appealing because it addresses when a firm will 'in-source', engage in hierarchical decision making, as opposed to when a firm will 'out-source', enter into a market transaction. It does not however deal with when a firm will 'merge with' or acquire another large organisation.

P L Williams proposes that two firms will only 'merge' if both parties think the transaction will increase their wealth<sup>29</sup>. Each party hopes to gain because the merged entity will be worth more than the sum of the two independent entities. Using the language of business strategy, mergers are motivated by synergy, that the profits generated by the merged entity will be greater than the sum of the profits to be realised by the independent entities<sup>30</sup>.

The manner in which the 'synergies' may arise are varied, but the following are put forward as a useful list for our purposes<sup>31</sup>:

- (a) 'economies of large scale production' so that the unit cost of producing a product decreases as a result of the larger production run. This may require the integration of different plants. Certainly to derive cost savings, management will be required in respect of both previously independent enterprises;
- (b) 'economies of scope' which means that the amount of one input used in two previously distinct activities will be reduced if the input is used in a co-ordinated manner in the two activities. Again, to derive these savings active management will be required;
- (c) 'pricing effects' will yield synergies from the common control of business units where the units are consecutive links in a vertical chain of supply, that is where one unit produces units for an input for another unit. Conceptually, by removing the profit margin from the downstream company, the true costs to the entire group are reduced enabling a better alignment of the marginal cost and marginal revenues for the entire group (involving a higher level of production and lower prices with greater profits);

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28 *Coase* at 44.

29 *Williams* at 33.

30 *Williams* at 33.

31 *Williams* at 34 to 38 and Scherer FM and Ross E, *Industrial Market Structure and Performance* (3<sup>rd</sup> edition) 159 to 169.

- (d) 'increased monopoly power' - horizontal mergers between competitors may be motivated by a desire to reduce competition and create or enhance monopoly profits. It is unlikely that any such motivation will be articulated because of the trade practices and competition law implications;
- (e) 'internal capital function' may yield synergistic benefits because of the information the acquirer possesses as opposed to the market. A successful business will be aware of its sales, margins and production capacities and will be in a better position to assess the relative strengths and weaknesses of its competitors. In these circumstances the imposition of management after acquisition will be directed to correcting the weaknesses and extracting and imposing the strengths across the entire group. The internal capital function will perform better than external capital markets because of its informational advantages. A related explanation for synergies is the presence of weak management in the target ;
- (f) mergers may also confer advantages in marketing through the sharing of a sales force, a better broader product range, and the use of common advertising themes. Complementarities may also arise through the pooling the research and development functions.

One way of considering how *groups* of companies arise is to examine the reasons why *one* more company may be added to the group. At a conceptual level, a further company may be added, through the acquisition of all the issued shares in the capital of a company, in one of two ways:

- (a) upon a merger or takeover (ie the purchase of the shares from a third party or third parties). In this circumstance it is necessary to consider why the corporate structure is retained; or
- (b) through the creation of a new company, or more likely the purchase of a company off-the-shelf, whereby the group seeks internal expansion or reorganisation of an existing activity.

In this circumstance it is necessary to consider why the corporate structure is desired.

One reason for using an incorporated entity is to take advantage of 'limited liability', insulating the holding company from the liabilities of the subsidiary. In this way high risk ventures may be undertaken through a subsidiary because with the certainty of limited liability, the holding company knows that the maximum loss it can suffer, as opposed to the creditors of the subsidiary (including consensual creditors without the knowledge of the financial position

or prospects of the subsidiary or non-consensual creditors including the victims of torts), is the amount of its equity subscription<sup>32</sup>. I emphasise there is no necessary separation of ownership and control/management in this instance. Merely the use of the artifice of an interposed entity.

Another reason is a reduction in the amount of tax that would otherwise be payable may be facilitated through the use of companies within groups of companies, particularly in the context of operations in various jurisdictions. The existence of an ability to group tax losses within groups of companies<sup>33</sup> merely maintains the status quo ante, and does not affect the decision as to whether to expand the operations of the existing company or incorporate another company or maintain the existence of several companies.

Alternatively, a company may be established with the intention that it is a holding company. That holding company would subsequently incorporate operating subsidiaries which will hold assets and carry out the operations. This, of course, does not explain why the group structure was adopted in the first place. It presumes a motivation for such a structure.

Other reasons or benefits include:

- (a) separate companies may enhance decentralisation of decision-making in large corporate groups;
- (b) flexibility so as to isolate to separate entities and not across the entire group regulatory controls and regimes that would apply if only one corporate entity was used;

(For both of the above circumstances, 'group' strategies and controls may be retained in many aspects, for example, operations, financing, investments and marketing.)

- (c) particular foreign jurisdictions may insist upon a locally incorporated subsidiary;
- (d) the ability to sell the entire company or business through the sale of shares, whether for tax or operational reasons;
- (e) maintaining the 'goodwill', loyalty of employees, or 'brand' name after a takeover which would otherwise be threatened through a complete integration;

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32 This creates a 'moral hazard'. Something a company would not do previously because of the total possible cost of its actions which may be suffered is now undertaken because the consequences of its acts, or the loss resulting therefrom, are able to be limited.

33 Section 80G of the Income Tax Assessment Act 1936 (Cth).

- (f) a separate company may well provide legislative force to maintain a convenient unit for management or accounting; and
- (g) the costs in formally and finally transferring assets, services, employees, contracts with third parties and liabilities may be prohibitive because of the size of administrative costs, financial imposts (eg stamp duties) or tax consequences ( the realisation of capital gains and other taxable events)<sup>34</sup>.

The above discussion is not intended to be comprehensive, but rather illustrative. Its object has been to assess the reasons for the development of groups of companies. It is clear from that discussion that in most instances the primary means for deriving returns from a group of companies is the application of a common management, disclosure of information across companies and the co-ordination of resources. As between the holding company and its subsidiary, the commercial imperative is that there should be no separation between management of the subsidiary and the ownership of the subsidiary.

### **Limited Liability – Its Applicability to Groups**

I suggest important insights may be gained by examining the policy reasons for limited liability and assessing whether those reasons apply with sufficient force to groups of companies so that the principle of limited liability ought to apply to wholly-owned subsidiaries of holding companies. Only the arguments for limited liability will be considered, I will not consider arguments against limited liability.

A Muscat, in *The Liability of the Holding Company for the Debts of its Insolvent Subsidiary*<sup>35</sup> has proffered eight justifications for limited liability. The justifications are that limited liability:

- (a) creates an incentive to invest - increasing the level of economic activity;
- (b) encourages socially desirable high risk projects;
- (b) permits the functioning of an efficient capital market;
- (d) enables the promotion of large projects;
- (e) diminishes agency and social costs and spreads risk efficiently;
- (f) encourages diversified portfolios;

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34 See also the CASAC Discussion Paper at 3 and 4.

35 At 162 to 175.

- (g) reduces costs of contracting around liability; and
- (h) avoids litigation and bankruptcy costs.

The first justification is that limited liability imposes a ceiling upon the amount of loss which may be suffered by an investor (who is likely to be risk averse) to the price of the shares and thereby encourages investment with a consequential increase in the general level of economic activity. Not limiting the amount of the liability would expose the investor to the risk of losing all the investor's assets. Unlimited liability would be a very strong deterrent to investment, particularly where the investor is not managing the investment and so is not controlling the manner and amount of exposure to the risk of losing all the investor's assets. A holding company, however, is unlikely to be risk averse, rather profit maximising and investing in projects with positive risk adjusted returns and does not usually separate management or information flows in respect of its operations through subsidiaries. Accordingly, this justification does not apply in the holding company and subsidiary context.

Limited liability is also argued to encourage socially desirable high risk projects because even risk neutral investors, it is suggested, will not undertake projects at the risk of losing their fortunes. This argument I find unconvincing because the loss has to fall somewhere, usually uninformed consensual creditors or tort victims. Also, there is no prima facie bias which suggests that only socially desirable, as opposed to socially undesirable, high-risk projects will be undertaken. Also, why should profit maximising (not risk averse) investors examining a project with a positive risk adjusted return not invest even if the project is high risk? A holding company is more likely to be profit maximising than risk averse. A holding company will also have more extensive resources and the capacity to diversify such risks because of its greater resources. Further, the 'public' investor at the holding company level still has the benefit of limited liability. For these reasons, I think this argument is not as strong in the context of a holding company and its subsidiary.

A further justification is that limited liability permits the functioning of an efficient capital market because it enhances:

- (a) the ready transferability of shares; and
- (b) the uniform pricing of shares,

by isolating the pricing or investment decision to the prospects of the relevant company alone.

These features arise as a result of a proposed purchaser not having to examine the financial status of other security holders or seek to control the disposal of securities by other security holders which would be the case if the purchaser,

with unlimited liability, was also liable for the debts of the company. The efficiency of the market is also enhanced because limited liability encourages a wide spread of holdings by individual investors and management is able to be replaced by an acquirer of all the shares in the company. None of the above features have any relevance to the investment decision of a holding company to structure its investment through a wholly-owned subsidiary.

It is argued large scale projects are promoted through limited liability because a large number of investors are able to be brought together to invest their funds, these investors would not be available if each was exposed to unlimited liability. Obviously a wide dispersal of shares to raise sufficient funds is irrelevant in the context of a holding company and its wholly owned subsidiary. The wide dispersal of share holdings would continue to exist at the holding company level however.

Accepting a divergence between management and ownership, limited liability is justified upon the basis that it diminishes agency and social costs and spread risks efficiently. Agency costs are the costs of monitoring and assessing the management. With unlimited liability, shareholders and creditors would need to monitor both the financial position of the company and the other shareholders. With limited liability, creditors and shareholders would have the certainty of limited liability and a clear allocation of risk (to the consensual and non-consensual creditors) which would improve the efficiency of the market generally. These considerations are irrelevant to the holding company and subsidiary relationship because of the coincidence of ownership and control and the ready access by the holding company to all relevant information in the possession of the subsidiary.

A further justification is that limited liability encourages diversification of investment portfolios. Given that diversification reduces investor risk, this is to be encouraged. Unlimited liability, however, deters diversification because risk increases with a large number of shareholdings. In the context of the holding company and subsidiary, because the investors may diversify their portfolios at the holding company level, the justification is not applicable also.

Another argument is that limited liability provides standard implied contractual terms which the parties would have negotiated and because they do not have to so negotiate transaction costs are reduced. But the purported justification assumes that limited liability is the desired negotiated outcome. Is this the case with holding companies and their subsidiaries? I doubt it. The closest example we have is the unlimited liability associated with a partnership, and in my experience it is very rare for the partners and creditors to negotiate limited recourse in contractual relationships<sup>36</sup>.

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36 One exception to this in my experience has been large scale project finance where sponsors may enter into a partnership but limit the recourse of financiers to the assets of the project. In these cases the financiers price the debt on the basis of the higher risk.

The final justification is that limited liability avoids litigation and bankruptcy costs and so reduces the costs of resolving legal disputes. With unlimited liability creditors would pursue shareholders and those shareholders would pursue other shareholders, not sued previously by the creditors, for contribution. The argument may apply to widely dispersed shareholdings, but in the context of holding companies and wholly-owned subsidiaries, it is not relevant because only one more party is added to the litigation.

The object of the above discussion has been to consider whether the justifications for limited liability apply in the context of the holding company and subsidiary. In my opinion it is clear that in the context of the holding company and the wholly-owned subsidiary, with the coincidence of ownership and control, the considerable force of the justifications for limited liability is much reduced<sup>37</sup>.

### **Piercing the Corporate Veil**

It is necessary to consider the circumstances in which the courts have sought to 'pierce the corporate veil' and disregard the separate corporate entities of the holding company and its subsidiary, treating the activities or operations of the subsidiary as the activities and operations of the holding company. We are not concerned with the separate liability of the holding company which may still arise while recognising the separate corporate entities<sup>38</sup>. We are concerned with those situations where the courts have regarded the distinction between the holding company and the subsidiary as inappropriate, and because of that circumstance, sought to impose liability for the acts of the subsidiary upon the holding company.

It is fair to suggest that there is no broad unifying legal principle which the courts apply to justify the 'piercing of the corporate veil'. Rather, the cases appear to suggest a policy based ad hoc approach to situations as they arise. As Rogers AJA of the New South Wales Court of Appeal said in *Briggs v James Hardie & Co Pty Ltd*<sup>39</sup>:

The threshold problem arises from the fact that there is no common, unifying principle, which underlies the occasional decision of courts to pierce the corporate veil. Although an ad hoc explanation may be offered by a court which so decides, there is no principled approach to be derived from the authorities...

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37 See also the discussion of the rationales for limited liability and their application to corporate groups in the CASAC Discussion Paper and pages 17 - 19.

38 Examples include the tort of inducing a breach of contract or conspiracy. But these forms of liability rely upon the separate identity of the holding company.

39 [1989] 16 NSWLR 549 at 567

The courts have traditionally been very reluctant to disregard separate corporate entities for the purposes of imposing the liability incurred by one entity upon another. This appears to be because one creditor's gain, by exposing the assets of the holding company to the creditors of the subsidiary, is another creditor's loss, the creditors of the holding company being now required to share the proceeds of the realisation of the assets of the holding company. This reluctance is reflected in the comments of Lord Wilberforce in *Ford & Carter Ltd v Midland Bank Ltd*:

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.<sup>40</sup>

Nevertheless, the following categories may be usefully applied to distinguish situations where the courts have disregarded the separate corporate entities:

- (a) an agency or partnership is implied or imputed;
- (b) the separate corporate entities are used for the purposes of fraud or as a cloak for improper purposes;
- (b) the law otherwise requires that the separate entities be disregarded; and
- (d) where assets and liabilities of the two entities in liquidation are inextricably intertwined.

Where a holding company does not provide a subsidiary with the normal means of being a separate entity, the courts may 'identify' the subsidiary with the holding company. If the holding company forms or acquires a subsidiary to do something for which the subsidiary needs a minimum level of resources, but the holding company does not capitalise it adequately, lend it money, equip it to run its own business by the secondment of personnel or otherwise, or give it a reasonable opportunity to independently obtain credit or resources from third persons, the courts may hold that the dominated subsidiary is an agent or partner of the dominating parent<sup>41</sup>.

While agency or partnership relationships may arise through consensual arrangements, in certain situations the courts have implied or imputed such relationships and the holding company may thereby become liable for the acts of its subsidiary. But it is a question of fact in all the circumstances to determine whether such a relationship has come into existence.

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40 (1979) 129 NLJ 543 at 544 Quoted by Walker RJ in *Re Polly Peck International Plc (in administration)* [1996] 2 All ER 433 at 445 and 448.

41 Ford HAJ, Austin RP & Ramsay IM, *Ford's Principles of Corporations Law* (9th ed) at paragraph [4.370].

In the UK case of *Smith, Stone and Knight, Ltd v The City of Birmingham*<sup>42</sup>, Atkinson J held that the law disregarded the separate corporate entities for the purposes of determining to whom, and what amount of, compensation was payable upon the compulsory acquisition of property held by a subsidiary but the holding company of which operated its business through the subsidiary. The judge found that the arrangements between the subsidiary and the holding company were such that the subsidiary was the agent of the holding company for the purposes of carrying on the holding company's business. Atkinson J found that the subsidiary was the 'agent or employee, tool or simulcrum of' the holding company after addressing the following questions:

- (a) were the profits of the subsidiary treated as the profits of the holding company;
- (b) were the persons conducting the business appointed by the holding company;
- (c) was the holding company the 'head and brains' of the venture;
- (d) did the holding company govern the business, decide what should be done and what capital should be embarked on the venture;
- (d) did the holding company make the profits using its skill and direction;
- (f) was the holding company in effective and constant control.

The courts will not allow the separate corporate entities to be used as a means to carry out a fraud or avoid an existing legal obligation. In *Adams v Cape Industries Plc*<sup>43</sup> the Court of Appeal emphasised that it is appropriate to pierce the corporate veil where special circumstances exist indicating that it is mere facade concealing the true facts<sup>44</sup>. In *Gildford Motor Co Ltd v Horne*<sup>45</sup> a former managing director entered into a non-competition agreement with his former employer. To get around this restriction, the managing director incorporated a separate company and commenced trading. The court issued an injunction and restrained the new company from carrying on the breach. The court found that the corporate vehicle was being used for an improper purpose and accordingly could be restrained.

Also, the courts will pierce the corporate veil where it is apparent that a particular law requires that to be done. In *Re Bugle Press Ltd*<sup>46</sup> two shareholders were seeking to compulsorily acquire the shareholding of a third shareholder. They

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42 [1939] 4 All ER 116

43 [1991] 1 All ER 929

44 At 1022.

45 [1933] Ch 935

46 [1961] Ch 270

sought to do this by selling their shares to a new company, incorporated for that purpose, and then requiring that company to take advantage of the compulsory acquisition provisions of the companies law to acquire the outstanding shares held by the third shareholder. The court said the compulsory acquisition provisions of the law could not be used in this way and restrained the procedure, looking behind the separate entities.

In the recent decision of Young J of the New South Wales Supreme Court in *Dean - Willcocks v Soluble Solution Hydroponics Pty Ltd & Anor*<sup>47</sup>, his honour summarised the situations in which the assets and liabilities of companies in liquidation could be consolidated, and thereby 'pierce the corporate veil', as follows<sup>48</sup>:

- (1) That where there is to be consolidation of the assets and creditors of a group of companies, normally that result should be obtained by a formal scheme of arrangement under s 411 or some other appropriate section of the Corporations Law.
- (2) In exceptional cases, the liquidator can obtain approval of a compromise bringing about consolidation which he has entered into under s 477(1)(c).
- (3) The bankruptcy rule that where it is impracticable to keep the assets and liabilities of different companies in a group separate they may be consolidated if the consolidation is for the benefit of creditors generally if no creditor objects, applies in a corporate winding up.
- (4) Where a company has been under administration and the resolution [of creditors to consolidate the affairs and the administration] is passed when Part 5.3A of the Corporations Law is still applicable, the court may make the appropriate directions to the liquidator under s 447A.
- (5) It would be possible for the court to advise a liquidator in a court winding up that he should consolidate debts, but it would be unlikely that the court would do so unless every creditor agreed or a regime was put in place for creditors to object.

In that case the order was made under section 447A of the CL<sup>49</sup>.

## **Section 588v Of The Corporations Law<sup>50</sup>**

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47 (1997) 24 ACSR 79

48 At 13 and 14.

49 For a discussion of this decision and survey of the other recent decisions in other common law jurisdictions, see Whelan S, QC 'Administration of Insolvent Groups - The Present State of 'Pooling' in (1998) 6 *Insolv LJ*, 107.

Division 5 of Part 5.7B of the CL deals with the liability of a holding company for insolvent trading by a subsidiary. This Division is an explicit legislative departure from the principles of limited liability and provides a means for shareholders to be made liable for the debts of a company.

A holding company contravenes section 588V of the CL if, at the time its subsidiary incurs a debt:

- (a) the subsidiary is insolvent<sup>51</sup> or becomes insolvent through incurring the debt or other debts at that time; and
- (b) there are reasonable grounds for suspecting that the subsidiary is insolvent or would become insolvent; and
- (c) either:
  - (i) the holding company, or one or more of its directors, is or becomes aware that there are such grounds for suspicion; or
  - (ii) having regard to the nature and extent of the holding company's control over the subsidiary's affairs and to any other relevant circumstances, it is reasonable to expect that:
    - (a) a holding company in the circumstances of the holding company would be so aware; or
    - (b) one or more of such a holding company's directors would be so aware.

Actual knowledge by the holding company of the insolvency is clearly the best evidence of a contravention. But the legislative test of reasonable grounds (an objective test) for suspecting insolvency is very wide. Again actual knowledge of these 'reasonable grounds' by the holding company or any of its directors is sufficient. Alternatively, the relationship between the holding company and the subsidiary is to be examined to determine whether it is reasonable to expect such knowledge to be possessed by the holding company or any of its directors. The law is not examining the degree of control over the operations by the holding company, but rather is considering the knowledge base of the holding company and presumes the ability of the holding company to control the subsidiary!

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50 For an extensive discussion of this section see Ramsay IM, 'Holding Company Liability for the Debts of an Insolvent Subsidiary: A Law and Economics Perspective' (1994) 17 *UNSW LJ* 520.

51 'Insolvent' means not being able to pay all debts when due, and includes deemed insolvency where, in certain circumstances, the company failed to keep accounting records that accurately record and explain its transactions or financial position or the company failed to retain such records - sections 95A and 588E of the CL.

Where a holding company contravenes section 588V of the CL and:

- (a) the creditor to whom the debt is owed suffers loss or damage in relation to the debt because of the subsidiary's insolvency; and
- (b) the debt is wholly or partly unsecured when the loss or damage was suffered; and
- (c) the subsidiary is being wound up,

the liquidator of the subsidiary may recover from the holding company as a debt due an amount equal to the amount of the loss and damage<sup>52</sup>. The proceedings must be brought within six months of the commencement of the winding up<sup>53</sup>. The liquidator would commence proceedings in respect of all loss and damage suffered by the relevant creditors. Unlike the position where creditors may pursue individual directors for a contravention of section 588G of the CL, under sections 588R and 588T of the CL, particular creditors may not commence proceedings directly against the holding company.

One of the most significant aspects of these provisions is that only 'debts' may be recovered and the provisions do not extend to other liabilities such as damages for breach of contract or perhaps more significantly, the damages due to the victims of torts. Recent cases have indicated that liabilities under guarantees may be caught, but a general right to damages is arguably not caught<sup>54</sup>. Another uncertainty is whether a secured creditor who is effectively unsecured because the value of the security is insufficient to cover the outstanding indebtedness falls within the ambit of this provision because the secured creditor was 'partly unsecured' when the loss or damage was suffered (which presumably was when the company went into liquidation).

It is a defence to an action brought by a liquidator under section 588W of the CL if:

- (a) at the time the debt was incurred, the holding company and its relevant directors (that is the directors aware that there are reasonable grounds for suspecting insolvency) had reasonable grounds to expect, and did expect, that the subsidiary was and would be solvent at that time<sup>55</sup>;

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52 Section 588W(1) of the CL.

53 Section 588W(2) of the CL.

54 *Hawkins v Bank of China* (1992) 10 ACLC 588 and Mosley J, 'Insolvent Trading: What is a Debt and When is One Incurred?' (1996) 4 *Insol LJ* 153.

55 Sections 588X(2) and (6) of the CL.

- (b) at the time the debt was incurred, the holding company and its relevant directors (that is the directors aware that there are reasonable grounds for suspecting insolvency):
  - (i) had reasonable grounds to believe, and did believe;
    - (a) that a competent and reliable person was responsible for providing to the holding company adequate information about whether the subsidiary was solvent; and
    - (b) that the person was fulfilling that responsibility; and
  - (ii) expected, on the basis of the information provided to the holding company by the person, that the subsidiary was and would remain solvent at that time<sup>56</sup>;
- (c) the holding company is only liable because of the awareness of a director and that director did not take part in the management of the holding company because of illness or some other good reason<sup>57</sup>; or
- (d) the holding company took reasonable steps to prevent the subsidiary from incurring the debt<sup>58</sup>.

The implications for corporate governance are that if the holding company does not wish to be liable for the debts of its insolvent subsidiary it must pursue a number of strategies. The first strategy is one of 'informational poverty', that is ensuring the holding company knows as little as possible about the activities and financial position of its subsidiary. Because the touchstone of liability is actual knowledge or presumed knowledge arising from the relationship between the holding company and the subsidiary, the holding company must effectively not receive regular updates on the financial position of the subsidiary, share common officers or employees and not control (or arguably be in a position to control) the subsidiary's affairs. This strategy is unlikely to be either practical (particularly in the context of a requirement to prepare consolidated accounts) or desirable. This is because the reasons for creating a separate subsidiary, as we have discussed, usually involve the active management and control of the subsidiary's affairs.

The alternative strategy is to ensure that while the holding company is aware of the financial position and prospects of the subsidiary (or is presumed to be so aware) one of the defences applies so that the holding company is not liable notwithstanding that knowledge. The most practical defence is to ensure that a

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56 Sections 588X(3) and (6) of the CL.

57 Section 588X(4) of the CL.

58 Section 588X(5) of the CL.

reliable and competent person is providing financial information that indicates the subsidiary is solvent. This defence incorporates both sub-sections 588X(2) and (3) of the CL. It is very difficult to consider upon what other basis the holding company and its directors could reasonably consider the subsidiary was solvent.

Another approach is for the holding company to take reasonable steps to prevent the subsidiary from incurring the debt and so seek to rely upon section 588X(5) of the CL. There are a number of concerns about this defence. The first is the supposed separation between the duties and responsibilities of the board of directors and shareholders, so that the board is responsible for the management of the affairs of the subsidiary. How does this principle of corporate governance sit with the requirements of this defence? Does it affect what is reasonable for a holding company to do to prevent the incurring of the liability? How is the holding company to actually prevent the incurring of the liability? Does it require the holding company to replace the board of directors? It is not clear that setting up authorities and restraints which seek to impose limits upon the activities of subsidiaries in incurring debts when insolvent would be adequate for the defence. The defence in its terms refers to 'the debt' singular, rather than preventing insolvency and suggests the actual contemplation of a debt which it is sought to prevent from being incurred. In any event, action could only be taken if the holding company was aware that the relevant debt was about to be incurred and that insolvency was an issue for the subsidiary. The required knowledge about the incurring of the debt is a significant assumption. The more the detail of this provision is considered, the more it becomes apparent that it is conceptually very difficult to avoid liability in the 'controlled subsidiary' situation, which is most likely where the subsidiary is a wholly-owned subsidiary.

## Shadow Directors or Officers

A holding company may also be responsible for the liabilities and obligations of its subsidiary because it is a 'director' or 'executive officer' of the subsidiary for the purposes of the CL. Only an individual can be appointed a director of a company<sup>59</sup>. However, a person, whether incorporated or not, may still be a director of a company even though not appointed<sup>60</sup>. Section 9 of the CL provides the expression 'director' has the meaning given by section 60. Section 60 provides a reference to a director, in relation to a company, includes a reference to:

- (a) a person occupying or acting in the position of a director of the company, by whatever name called and whether or not validly appointed to occupy, or duly authorised to act in, the position (a 'de-facto director') ; or

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<sup>59</sup> Section 221(3) of the CL provides that a body corporate cannot be appointed as a director.

<sup>60</sup> See *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd.* [1991] AC 187 and *Standard Chartered Bank of Australia v Antico* (1995) 18 ACSR 1 ('Standard Chartered').

- (b) a person in accordance with whose directions or instructions the directors of the company are accustomed to act (a 'shadow director')<sup>61</sup>.

The expression 'officer' does not have a generally applicable definition in the CL. It varies between contexts<sup>62</sup>. However, the expression 'executive officer' is defined in relation to a company as a person by whatever name called and whether or not a director of the body or entity, who is concerned, or takes part, in the management of the body or entity<sup>63</sup>.

The definition of a 'de-facto director'<sup>64</sup> was the subject of consideration by the Federal Court in *Beach Petroleum N L v Johnson*<sup>65</sup> ('*Beach Petroleum*'). His honour von Doussa J considered there were two limbs to be analysed. First, where a person *occupies* an office and is discharging functions attaching to that office of the kind normally performed by a director. The second is where a person *acts* in the position of a director. In the circumstances of *Beach Petroleum* the relevant person did *not* hold himself out as a director in his dealings with third parties or with the management of the company. The relevant conduct was to give instructions which the formally appointed directors followed. His honour considered it was no part of any recognised office (including that of a director) in a company for one person to dictate how the formally appointed directors of a company should act<sup>66</sup>. Accordingly, the provision did not apply.

In analysing whether a holding company is a 'de-facto' director in any particular case it will be necessary to determine the function, role and responsibilities of properly appointed directors. This will involve an examination of the Constitution, the relationship between the board of directors (and individual directors) and senior management, and perhaps third parties, past history and industry practice. Then the actions of the holding company must be carefully considered to determine whether the holding company has occupied or acted in the position of a director as so examined. While in any particular instance it will depend on all the relevant circumstances, it is unlikely that a holding company will *occupy or act in the position* of a director. This is because of its corporate form. It cannot act in common with properly appointed directors or hold itself out as a director. However it may direct or instruct senior management in the place of

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61 Section 60(1) of the CL. Under section 60(3) of the CL, if there are no positions of director (by whatever name called) in relation to a company, the reference in section 60(1) of the CL to a position of director of the company is a reference to a position the holder of which has control, or shares control, over the general conduct of the affairs of the company. This is an extreme case and will not be considered further. If all the directors of a subsidiary resigned, the holding company would either appoint new directors or place the company in liquidation.

62 See sections 9 and 82A of the CL. In section 232 of the CL, the expression 'officer' is defined to include both a director and an executive officer.

63 Section 9 of the CL.

64 Section 60(1)(a) of the CL.

65 (1993) 11 ACSR 103

66 At page 109.

the directors or in the same way as the board has, or deal with third parties as if controlling the company or able to bind the company. But these factors in themselves are unlikely to satisfy the requirements of the provision if the principles of *Beach Petroleum* are applied.

A holding company will be a 'shadow director' if the holding company is a person in accordance with whose directions or instructions the directors of the company are accustomed to act<sup>67 68</sup>. Considering the language of the definition the following points can be made:

- (a) there must be identifiable directions or instructions to the directors<sup>69</sup>. Mere suggestions are not sufficient. Nor are directions to management or employees. Obviously it is a question of fact as to whether there is a 'direction' or 'instruction'. But in the circumstances of a holding company it is possible that there will be instructions to management or indeed provision in the articles for the direction by the holding company;
- (b) the 'directors' as a whole must act. Where one or some of the directors act in an accustomed fashion it is not sufficient. It is necessary that the 'board' act in a customary fashion<sup>70</sup>. This is likely to be the case with a holding company instruction;
- (c) the directors must be *accustomed* to so act, which denotes a regularity or repeated following of directions or instructions. If there was only *one* direction or instruction, then there can be no custom or established pattern of conduct. Again, with a holding company it is likely that there will be repeated instructions.

In *Bluecorp Pty Ltd (in liq) formerly Lloyds Ships Holdings Pty Ltd (In liq) v ANZ Executors Trustee Co Ltd*<sup>71</sup> the Queensland Supreme Court (Mackenzie J) considered the operation of the predecessor of section 60(1)(b). The issue was whether the operators of the Qintex group of companies had so directed the officers of Bluecorp (then a subsidiary) that the board was accustomed to act in accordance with those directions. Mackenzie J, at pages 403 and 403, relied upon the analysis set out in *Harris v S*<sup>72</sup>. The analysis required that in being accustomed to act in accordance with the direction or instructions of a third party:

- (a) the directors must act as directors;

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67 Section 60(1)(b) of the CL.

68 In *Beach Petroleum*, his honour von Doussa J found, as a matter of fact, that the directors of the relevant company had become accustomed to act in accordance with a third party's directions. Hence that person was a 'director' of Beach Petroleum within the meaning of the Companies (South Australia) Code.

69 *Dairy Containers Ltd v NZI Bank Ltd* (1995) 13 ACLC 3,211.

70 *Re Lo-Line Electric Motors Ltd* [1988] 2 ALL ER 692 at 699.

71 (1994) 13 ACSR 386

72 (1994) 13 ACSR 386

- (b) the directors must commit positive acts, not only forbear; and
- (c) that the will of the third party (not the will of the board) determined the resolutions of the board.

In *Standard Chartered*, Hodgson J of the Supreme Court of New South Wales found that Pioneer International Ltd. was a 'director' of Giant Resources Ltd within the meaning of section 5 of the Companies (New South Wales) Code. That provision was the predecessor of section 60(1) of the CL. Hodgson J acknowledged that the circumstances of effective ownership by Pioneer of Giant (42%)<sup>73</sup> and the three nominees on the board of Giant were *not* sufficient to establish Pioneer was a director. However, a detailed examination of the relevant circumstances established that: Pioneer had effective control of Giant; major asset sales and financial decisions were made by Pioneer on behalf of Giant; Pioneer negotiated with third parties on behalf of Giant; decisions made by Pioneer were accepted as a *fait accompli* by Giant. His honour found that the Giant directors, who were also Pioneer directors, had exercised decisions on behalf of Giant in the context of Pioneer's interests only, albeit there were no instructions from Pioneer to those directors. Hodgson J does not state whether the basis of his decision was of the application the equivalents of section 60(1)(a) or section 60(1)(b). It is this situation in which the holding company is clearly most at risk.

An exception to section 60(1)(b) of the CL arises from the operation of section 60(2) of the CL where the directors act on or in accordance with advice given by a person in the proper performance of the function attaching to the person's professional capacity or business relationship with the directors of the company. In the context of a holding company it is not possible to say that the holding company is acting in a professional capacity. While there may be a business relationship, it is unlikely that the courts will accept a 'shareholder relationship' as falling within such a description. In any event, if the 'shadow director' acts in the place of the board or exercises effective decision making power, whether through the medium of advice or instruction, the defence of section 60(2) is not available<sup>74</sup>.

There have been no reported decisions on the meaning of the definition of 'executive officer' in this context. The words 'concerned' and 'take part' 'in the management' of a company can have a very wide operation given their usual meanings. Further, there is no exception of or 'carve out' from the operation of the provision which is similar to section 60(2) of the CL. At first glance this appears to be a glaring omission.

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73 His honour explicitly stated that a holding company, merely because it had control over how the board of its subsidiary are constituted, is not a director of the subsidiary.

74 *Australian Securities Commission v AS Nominees Ltd* (1995) 18 ACSR 459 at pages 508 - 510.

In *Commissioner for Corporate Affairs v Bracht*<sup>75</sup>, Ormiston J of the Victorian Supreme Court considered the meaning of the words ‘concerned in the management’ for the purposes of the prohibition of an ‘undischarged bankrupt’ from being ‘concerned in the management’ of the company. His honour favoured a relatively broad approach requiring an involvement in decision making of some significance for the company whereby some control (not necessarily ultimate) is exercised over the affairs of the company<sup>76</sup>. In *Holpitt Pty Ltd v Swaab & Ors*<sup>77</sup> (*‘Holpitt’*), Burchett J of the Federal Court considered the meaning of the expression ‘take part in the management of the company’ for the purposes of insolvent trading provisions of the Companies (New South Wales) Code. Burchett J did not follow the approach of Ormiston J in *Bracht*, referring to the specific context of that decision. *Holpitt* was concerned with a different context, a context in which ‘criminal implications’ and a different statutory purpose applied. Burchett J emphasised a management role similar to that of a director. The approach of Burchett J in *Holpitt* has been followed in other insolvent trading cases. In particular Hodgson J in *Standard Chartered* and Gummow J in *Re New World Alliance Pty Ltd (Rec & Mgr Appointed); Sycotex Pty Ltd v Baselar*<sup>78</sup>.

The difficulty with the definition of ‘executive officer’ is that it has no specific context. It is a definition which, prima facie, is to apply for all the relevant provisions of the CL. Accordingly, the approach of the court in both *Bracht* and *Holpitt*, developing the meaning of the words by reference to the context, is not apparently available<sup>79</sup>. In the absence of judicial authority it would be prudent to regard the provision as having an extensive operation. So if the holding company is involved in the decision making for the subsidiary, or the implementation of those decisions, and the relevant decisions or implementation are significant for the subsidiary, the holding company may be an ‘executive officer’ of the subsidiary for the purposes of the CL.

There are significant implications for a holding company falling within the extended statutory definition of ‘director’ or ‘executive officer’. Those implications include;

- (a) the existence of statutory duties owed to the subsidiary; and
- (b) possible liability for insolvent trading by the subsidiary.

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75 (1989)7 ACLC 40 (*‘Bracht’*)

76 At 48 and 49.

77 (1992) 10 ACLC 64

78 (1994) 122 ALR 531

79 Arguments to the contrary would be based upon either:

- (a) the introductory words of section 9 which are: ‘Unless the contrary intention appears’; and
- (b) presumed statutory intent arising from the purpose or context of each relevant provision.

The arguments would receive some support from the attempts made by the judges in the cases mentioned above to restrict their comments about the meaning of the words to the specific statutory context.

Section 232<sup>80</sup> of the CL imposes duties and liabilities upon an ‘officer’ of a corporation. ‘Officer’ is defined to include ‘directors’ (including ‘de-facto’ and ‘shadow’ directors) and ‘executive officers’. In summary, the duties imposed are:

- (a) to act honestly in the exercise of the officer’s powers and the discharge of the duties of office;
- (b) to exercise the degree of care and diligence a reasonable person in a like position would exercise;
- (b) not to make improper use of information acquired by an officer by virtue of his or her position; and
- (d) not to make improper use of his or her position as an officer to gain, directly or indirectly, an advantage for himself or herself or any other person or to cause detriment to the corporation. If the above provisions are contravened by the holding company (or alternatively if the holding company is involved in a contravention of the provision by third parties), there may be civil and/or criminal consequences<sup>81</sup>.

If a holding company is a ‘de-facto’ or ‘shadow’ director, the holding company has a duty to prevent insolvent trading by the subsidiary<sup>82</sup>. The provision *does not* apply to ‘executive officers’ (compare with section 232). Under section 588G of the CL the holding company has a responsibility to prevent an insolvent company of which it is a ‘director’ from incurring debts when the holding company is *aware*<sup>83</sup> that the subsidiary is insolvent or there are reasonable grounds for suspecting the company is now or will become *insolvent*<sup>84</sup> (whether by incurring that particular debt or otherwise).

If a subsidiary incurs a debt in these circumstances:

- (a) a holding company ‘director’ may be subject to a civil penalty order<sup>85</sup>;

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80 This analysis will not be developed further because I consider it is outside the scope of this article.

81 The provisions are ‘civil penalty provisions’ for the purposes of Part 9.4B of the CL (sections 232(6B) and 1317DA). Civil orders made by a court in relation to a contravention may include:

- (a) barring those persons from managing a corporation in Australia;
- (b) a fine or penalty; and/or
- (c) compensation to the affected corporation for loss or damage suffered as a result of the contravention (sections 1317EA, 1317HA and 1317HB).

82 Division 3 of Part 5.7B of the CL.

83 Being ‘aware’ refers to a situation where the holding company is aware that there are grounds for suspecting insolvency or a reasonable person in a like position in the subsidiary in the subsidiary’s circumstances would be so aware - section 588G(2) of the CL.

84 ‘Insolvent’ means not being able to pay all debts when due, and includes deemed insolvency where, in certain circumstances, the company failed to keep accounting records that accurately record and explain its transactions or financial position or the company failed to retain such records - sections 95A and 588E of the CL.

85 Part 9.4B of the CL.

- (b) a court may order the holding company ‘director’ to compensate unpaid creditors<sup>86</sup>;
- (c) a subsequently appointed liquidator of the company may recover from the holding company ‘director’ the amount of loss or damage suffered by *all* unsecured creditors of the subsidiary who have suffered loss or damage<sup>87</sup>; and
- (c) in certain circumstances an unpaid creditor may pursue the holding company ‘director’ directly;<sup>88</sup>; and
- (e) here may also be accessorial liability for the holding company<sup>89</sup>.

There are certain defences available to a holding company ‘director’. In particular:

- (a) if at the time the debt was incurred, the holding company had reasonable grounds to expect, and did expect, the subsidiary was, and would remain solvent; or
- (b) if at the time the debt was incurred the holding company had reasonable grounds to believe, and did believe, a reliable and competent person was responsible (and fulfilling the responsibility) for providing adequate information to the holding company about whether the subsidiary was solvent and the holding company expected, on the basis of the information provided, that the subsidiary was solvent;
- (b) if because of illness or other good reason, the director did not take part in the management of the company (which is not relevant in the context of a holding company); or
- (d) the holding company took all reasonable steps to prevent the subsidiary from incurring the debt.

Holding companies which are ‘de-facto’ or ‘shadow’ directors are liable to indemnify the Commissioner of Taxation if payments to the Commissioner with

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86 Sections 588J and 588K of the CL.

87 Section 588M of the CL.

88 Sections 588R - 588U of the CL.

89 If the holding company is a person ‘involved in’ a contravention of section 588G (that is, not only the person who is directly responsible for such a contravention but also a person who has only an ancillary responsibility- see sections 1317DB and 79 of the CL- the holding company may, in addition, be subject to a civil penalty order. Further, if section 588G was knowingly, intentionally or recklessly contravened and was contravened dishonestly, criminal proceedings may be brought (ie the penalty may be up to \$2 million or imprisonment for five years or both)- section 1317FA. Of particular concern to a holding company, if the holding company knew of the insolvency, a court, in ordering a ‘director’ to pay moneys by way of compensation because of insolvent trading, may order that the knowing holding company’s unsecured debts owed by the subsidiary be deferred until all other unsecured debts have been paid in full - section 588Y of the CL.

respect to certain provisions of the Income Tax Assessment Act 1936 (including group tax payments) are subsequently set aside by a court as voidable references<sup>90</sup>. Certain defences are available being essentially the defences available to directors for insolvent trading<sup>91</sup>.

The corporate governance implications of 'shadow directors' and 'shadow executive officers' are relatively straightforward, and can be assessed at two levels. First the holding company can seek to avoid becoming a shadow director or officer of the subsidiary in the first place. This involves avoiding the situations described above. Essentially, the board of the subsidiary must not be overruled or supplanted by the holding company. This should remove the shadow directorship concerns. With concerns about being a shadow executive officer, the position is less clear and may be more onerous. If the holding company seeks to ensure that the subsidiary has adequate resources to carry on business and operate as a stand alone entity and does not involve itself in the decision making or the implementation of decisions then it is unlikely that the holding company should be an executive officer for the purposes of the CL.

The second corporate governance implication arises if notwithstanding the foregoing, the holding company acts as a 'shadow director' or as a 'shadow executive officer'. Then the holding company should seek to ensure that it does not breach any of its statutory duties under section 232 of the CL and that the subsidiary is either not insolvent or that one of the defences to insolvent trading applies. The earlier discussion in the context of section 588V of the CL is relevant.

### **Cross Guarantees And Groups<sup>92</sup>**

The Australian Securities and Investment Commission (the 'ASIC') in Instrument 98/1418 issued a Class Order pursuant to section 341(1) of the CL under which certain wholly-owned subsidiaries are provided with accounts and audit relief. There are several restrictions to the operation of the relief, including the provision of a Deed of Cross Guarantee. The objective of the relief and the operation of the deed were discussed by Mc Lelland J in *Westmex Operations Pty Ltd (in liq) and Ors v Westmex Ltd (in liq) and Ors*<sup>93</sup> as follows:

Each deed was, as its recitals confirm, executed to fulfil a condition of an order having statutory effect, for the purpose of obtaining relief from compliance with statutory requirements for the preparation and lodgement with the [ASIC] of individual audited financial statements for

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90 Section 588FGA of the CL.

91 Section 588FGB of the CL.

92 An excellent article on this area is by Hill J, 'Corporate Groups, Creditor Protection and Cross Guarantees: Australian Perspectives' (1995) 24 *The Canadian Business Law Journal* 321.

93 (1992) 8 ACSR 146 at 151-152

each of the subsidiaries, where there was a requirement to prepare and lodge audited financial statements for the group as a whole. It is reasonable to infer that the primary purpose of the imposition of a condition of that kind was to give creditors of an insolvent subsidiary (indirect) access to the assets of the holding company, thus diminishing the significance of the unavailability of audited financial statements of individual subsidiaries to persons contemplating investment in, or the extension of credit to, such individual subsidiaries. Reciprocally the creditors of the holding company were to be given (indirect) access to the assets of each subsidiary, over and above the benefit deriving from ownership (direct or indirect) of the shares in such subsidiaries.<sup>94</sup>

Subject to certain conditions a wholly-owned subsidiary and its directors are relieved from the obligations, inter alia:

- (a) to prepare a financial report and directors report;
- (b) to appoint an auditor (in certain cases);
- (b) to distribute the financial report, directors report and auditors report to members; and
- (d) to include certain financial information in the annual return.

The conditions for the relief include, inter alia:

- (i) the wholly-owned subsidiary, its holding company and every company in a 'closed group' must become parties to a Deed of Cross Guarantee substantially in a prescribed form. The expression 'closed group' refers to the wholly-owned subsidiary and its members (and their members) who must in turn be wholly-owned subsidiaries of the ultimate holding company;
- (ii) the holding company describing the existence, parties to and nature of the Deed of Cross Guarantee in its consolidated accounts for the relevant economic entity, which might include companies other than the members in the relevant closed group;
- (iii) disclosure by the directors of the subsidiary of the entry into a Deed of Cross Guarantee in an annual notification lodged with the ASIC; and
- (iv) a statement by the directors of the wholly-owned subsidiary in the application for the relief that there are reasonable grounds to believe the company would be able to pay its debts as and when they fell due.

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94 Mc Lelland J was considering in that case a different form of cross guarantee to that now required by the ASIC. However, I believe his comments are appropriate in the context of the new form of guarantee as well.

The parties to the Deed of Cross Guarantee are the holding company, the other group companies seeking relief (which must be wholly-owned subsidiaries) and a trustee (there must be a further trustee if the first trustee is a related company to the group of companies).

Each wholly-owned subsidiary and the holding company covenants with the trustee for the benefit of each creditor that the company guarantees to each creditor of any group company payment of any debt in accordance with the Deed of Cross Guarantee. A 'creditor' means a person, other than a group company, to whom a debt is or may become payable. A 'debt' refers to any debt or claim which is or may become admissible to proof in the winding up of the group company<sup>95</sup>. The guarantee to the trustee is held for the benefit of each creditor. The deed is enforceable, depending upon the type of winding up, upon the commencement of the winding up or six months thereafter.

The Deed of Cross Guarantee may be revoked or released in certain circumstances. If all the shares in a group company are sold by an insolvency administrator, upon the enforcement of a security interest or in the course of a bona fide sale for fair and reasonable consideration, it is as though the Deed of Cross Guarantee had never been signed by the sold company and its subsidiaries. The Deed of Cross Guarantee permits a group company which is a party to the deed and which is sold, and all its wholly-owned subsidiaries, to be released from all their obligations under the Deed of Cross Guarantee. Each other group company is also released at the same time from all liability under the Deed of Cross Guarantee in respect of any debts which the sold entity and its subsidiaries may have incurred. This result is dependent however upon certain procedural steps and notification to the ASIC and the sale to a person or persons who are not associates of any group company.

This is a very significant 'carve out'. In one sense it is very practical because it permits a corporate group to readily dispose of assets (shares in subsidiaries) and the purchaser of those shares may rely upon the creditors of the purchased entity being only those creditors who in the first place were creditors of the purchased entity, and without regard to the entity's responsibilities under the Deed of Cross Guarantee. But in another sense it cuts across the entire purpose of the Deed being to provide creditors of all group companies access to all the assets of all group companies. It may be argued that the remaining creditors have access to the proceeds of the sale. But this misses the very point. The creditors of the purchased entity will more than likely now be fully paid out, a person does not usually buy a company with the view of letting it fail in the short time. The purchase price of the shares in the entity will reflect this expectation and will be reduced to take account of existing liabilities. Accordingly, the proceeds of the

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95 This now includes the damages suffered by a victim of a tort. See section 553 of the CL.

sale will be 'net' the liabilities of the existing creditors. So in the very circumstances that the Deed of Cross Guarantee was to operate (the insolvency of the group of companies) and improve the position of all creditors, it is able to be frustrated. With respect, the ability to be released upon a sale of the entity reflects a conceptual confusion. The class order sought to replace regard to the financial position of separate entities with regard to the financial position of the entire group, hence there was no longer any reason to have individual accounts. Yet from the discussion set out above, it is clear that for a creditor to accurately assess their financial position access to the individual accounts is required. I stress it is not the position of the creditors of the entity being sold, they in all likelihood are in a better position. Rather, it is the position of the remaining creditors who may be left with a much reduced asset base to access for payment. At the time of extending credit, notwithstanding the existence of a Deed of Cross Guarantee, they need to assess the financial position of the group and its prospects as well as assess which companies in the group may be sold in their entirety, and so reduce the assets available upon a group insolvency. This is a very complicated assessment and probably represents a backwards step. It must be remembered that, conceptually at least, most businesses may be sold by way of assets<sup>96</sup>, and not necessarily by way of a share sale, so that the result set out above was, I believe, avoidable. The position of the creditors of other group companies is thrown into relief when emphasis is given to there being no notification requirement upon a sale. This should be contrasted with the position when a Deed of Cross Guarantee is revoked<sup>97</sup>.

A party also may be released from its obligations under a Deed of Cross Guarantee by executing a revocation deed. But the deed must be executed by all parties to the Deed of Cross Guarantee. The revocation is not effective unless certain conditions are met. These include each party to the Deed of Cross Guarantee, including the company to be released, giving notice by public advertisement to its creditors and no winding up of any group company occurring within six months after the revocation deed is executed.

The corporate governance implications of the execution of a Deed of Cross Guarantee should be assessed in two stages. The first is whether and if a company should execute such a Deed. The second is how the execution of such a deed should affect the duties and responsibilities of the directors of the company after the execution of such a Deed. The first issue also goes to the enforceability of the Deed. As a general principle, a corporate guarantee may not be enforceable if it is not for the benefit of the guarantor<sup>98</sup>. Particularly in a case

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96 It must be recognised that an asset sale will, in general, require more work in a transaction sense, and may have different tax consequences and different stamp duty implications.

97 See also the discussion of the position of creditors of the company sold in the CASAC Discussion Paper at 43.

98 *Charterbridge Corporation Ltd v. Lloyds Bank Ltd* [1970] 1 Ch 62, *Farrow Finance Co. Ltd (in liq) v Farrow Properties Pty Ltd (in liq)* (1997) 26 ACSR 544, *Japan Abrasive Materials Pty Ltd v Australian Fused Materials Pty Ltd* (1998) 16 ACLC 1,172 and *ANZ Executors and Trustee Co Ltd v Qintex Australia Ltd (receivers and managers appointed)* (1990) 8 ACLC 980.

like the present where the only benefit on the face of the guarantee is the relief from preparing accounts, a not particularly onerous task, and the liability assumed may be unlimited.

When you consider the corporate governance implications after the execution of the Deed of Cross Guarantee the outstanding issue is that the company may now be liable for the debts incurred by a related company. What should its directors do in this instance? At one level the directors have the comfort that all the other companies are also liable for those debts, at least until that liability is released or revoked. I suggest it is the circumstance that other members of the group may be released from their obligations under the Deed of Cross Guarantee ( and thereby removing the 'jewel asset') that should be the source of the directors desire to monitor the performance of the group and the position of their own company. Of course the directors have no role in the management of the business and affairs of the other group members, but as a potential guarantor they should monitor and counsel, or at least be confident that appropriate systems are in place to ensure that the assets of *their* company are not unduly put at risk. I suggest the directors cannot simply wash their hands of the affairs of other entities in the group because now their company is potentially a guarantor of those liabilities. The directors become, if not their brothers' keeper, at least their brothers' watcher.

## Concluding Comments

This article commenced by commenting upon the apparent co-ordination of the activities of corporate groups and asking 'What then for corporate governance?'. The methodology adopted in attempting to answer this question has been to assess when a holding company may be liable for the debts and obligations of its wholly-owned subsidiaries, and in view of this circumstance, how that may affect the manner in which the holding company deals with its subsidiaries.

It is tolerably clear that commercial considerations dictate that the activities of the members of a corporate group be co-ordinated. But an analysis of the circumstances where the holding company might be liable for the debts of its subsidiary, whether based upon the common law ('piercing the corporate veil' and 'pooling'), specific statutory bases for such liability (section 588V of the CL and the 'deemed director or officer' approach), or by regulatory fiat and consensual arrangement (the Deed of Cross Guarantee), demonstrate that the more comprehensive the co-ordination, the more likely that the holding company will be liable for the debts of the subsidiary. There is a fundamental mismatch between the commercial imperatives and the approach of the law.

The discussion of the policy reasons for the existence of 'limited liability' for companies attempted to demonstrate that the reasons for limited liability simply were not relevant in the context of the relationship between a holding company

and its wholly-owned subsidiary. I suggest that it is this insight that will clear the way for the law to address the obvious mismatch between commercial expectations and the expectations of the law when considering the corporate governance implications of groups of companies. If the holding company was liable for the debts of its subsidiaries, then specific statutory provisions should apply to clarify that the directors of the subsidiaries may have regard to the interests of the corporate group when making decisions for the subsidiaries. In this way the law would follow commercial practice. To the extent that the law does not deal with commercial imperatives and incentives, it will be disregarded. This area is a clear instance of where action should be taken to align the law with commercial expectations.