

## HOLDING COMPANY LIABILITY FOR THE DEBTS OF AN INSOLVENT SUBSIDIARY: A LAW AND ECONOMICS PERSPECTIVE

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### I. INTRODUCTION

It is a fundamental principle of company law that a company has a legal identity separate from that of its shareholders.<sup>1</sup> Decisions by courts or the legislature to breach this principle are rare.<sup>2</sup> It is therefore not surprising that one of the more contentious amendments introduced as part of the *Corporate Law Reform Act 1992* (Cth) was an amendment that makes a holding company liable for the debts of an insolvent subsidiary.<sup>3</sup>

The objective of this article is to evaluate s 588V from a law and economics perspective. This is appropriate because the purpose of s 588V (to protect creditors) needs to be evaluated by more than just legal criteria. Law is typically

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

2 There are few instances of Australian courts lifting the corporate veil between a company and its shareholders: L Gallagher and P Zeigler, "Lifting the Corporate Veil in the Pursuit of Justice" [1990] *Journal of Business Law* 292. The *Corporations Law* contains several provisions that do so. For example, shareholders are liable for the debts of the company where there are fewer than the prescribed number of shareholders: s 186.

3 *Corporations Law*, s 588V.

concerned with justice and fairness. Economics is typically concerned with efficiency.<sup>4</sup> Section 588V clearly contains within it issues of justice and fairness. Thus, some may regard it as unfair that creditors suffer loss because a holding company operates a subsidiary which is insolvent and creditors lend money to the subsidiary without realising that it is insolvent. Yet this analysis is incomplete. Others might regard it as fair for creditors to contract to protect themselves (for example, by having the holding company guarantee the loan the creditor makes to the subsidiary). Consequently, an analysis of s 588V limited to issues of fairness will inevitably be indeterminate to some degree. This is where an evaluation based upon the criterion of efficiency can assist.

There are two key aspects of efficiency.<sup>5</sup> The first aspect necessitates an inquiry into whether the legal rule (in this case, s 588V) creates incentives for individuals and firms to behave efficiently. More precisely, does s 588V provide incentives to take an appropriate amount of care? When s 588V imposes liability upon a holding company for the debts of an insolvent subsidiary, will this encourage holding companies to monitor their subsidiaries so as to ensure that they do not contract with creditors while insolvent? The second aspect of efficiency involves an inquiry into whether s 588V efficiently allocates risk among relevant individuals and firms. It is desirable to reduce the risk borne by risk-averse individuals and firms.<sup>6</sup> Section 588V shifts the risk of loss that results from insolvency from the creditors of the insolvent subsidiary to the holding company. Is the holding company the best bearer of this risk? These are critical questions that derive from a law and economics analysis of a legal rule such as s 588V.

The analysis undertaken in this article reveals that s 588V largely satisfies these efficiency criteria. However, because the scope of s 588V is limited, it provides only a partial solution to the problem of holding company unaccountability for the debts of insolvent subsidiaries. The section is seriously deficient in that it provides no protection for tort claimants of insolvent subsidiaries. Tort claimants are the least likely of all persons dealing with a company to be able to contract to protect themselves against harmful behaviour or actions by a company. Section 588V is an inadequate response to this problem. In addition, s 588V presents a range of possible evasion strategies. Because the section relies upon the legal definition of subsidiary, business activities that pose a higher than usual risk of failure can be organised in a way that avoids the creation of a holding company - subsidiary relationship. The result is that s 588V has no application.

The structure of the article is as follows. Part II considers whether creditors warrant protection by the legislature or the courts or whether they should be expected to contract to protect themselves. Part III summarises the main

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4 Efficiency has been defined as the relationship between the aggregate benefits of a situation (or legal rule) and the aggregate costs of a situation (or legal rule): AM Polinsky, *An Introduction to Law and Economics*, Little Brown, (2nd ed, 1989) p 7. For discussion of the meaning of efficiency in the context of corporate law, see IM Ramsay, "Company Law and the Economics of Federalism" (1990) 19 *Federal Law Review* 169 at 194-198.

5 These two aspects are derived from AM Polinsky, note 4 *supra*, pp 130-34.

6 *Ibid*, p 132.

provisions of s 588V and briefly outlines the history of the provision. This is followed in Part IV by a survey of the different approaches adopted in other countries. Part V is an economic analysis of the role of limited liability in corporate groups given that the key feature of s 588V is to remove the limited liability of a holding company where a subsidiary is insolvent. The economic analysis is continued in Part VI where an evaluation of particular features of s 588V is undertaken.

## II. CREDITOR PROTECTION

Because s 588V is specifically designed to protect creditors, a critical question that must be addressed is whether creditors require protection or whether they should be expected to contract to protect themselves. The starting point is a recognition of the conflicts of interest that exist between a company's shareholders and its creditors. Smith and Warner identify four major sources of conflict:

- the payment of excessive dividends;
- claim dilution (through taking on debt with similar or higher priority);
- asset substitution (for example, substituting saleable for non-saleable assets); and
- excessive risk taking<sup>7</sup>

Although the first three conflicts are straight forward, the fourth warrants elaboration. A conflict arises because payment to a creditor may be jeopardised where the company engages in high-risk investments. Shareholders in a leveraged company have incentives to invest the company's resources in risky projects: if a project is successful, the excess returns will be distributed among the shareholders as dividends but will not be shared with the creditors who are only entitled to a fixed return on their investment. Company losses, however, are shared among both creditors and shareholders.

Given the existence of these conflicts, shareholders may prefer the company to incur some level of debt. Where this occurs, does it benefit shareholders? A number of empirical studies have been undertaken with a view to evaluating the effects of financial restructurings, such as an increase in debt. A survey of these studies has concluded that leverage-increasing restructurings (for example, the issue of new debt or share repurchases) are generally associated with significant positive returns to shareholders (measured in terms of the effect of the restructuring on share prices).<sup>8</sup> Leverage-reducing restructurings on the other hand, are generally associated with significant negative returns to shareholders.<sup>9</sup>

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7 CW Smith and JB Warner, "On Financial Contracting: An Analysis of Bond Covenants" (1979) 7 *Journal of Financial Economics* 177.

8 MC Jensen and CW Smith, "Stockholder, Manager and Creditor Interests: Applications of Agency Theory" in EI Altman and MG Subrahmanyam (eds), *Recent Advances in Corporate Finance*, RD Irvin, (1985) p 113.

9 *Ibid.*

Creditors can generally be expected to contract to protect themselves against actions that reduce the prospect of them being paid. This contracting has two parts to it. First, the interest rate on the loan that is negotiated between the creditor and the company can be expected to reflect the risks that the creditor faces. Second, the contract may contain restrictions on activities of the company. For example, there may be restrictions on the amount that the company can pay out as dividends. There may also be restrictions on the company incurring debt of a similar or higher priority. These types of restrictions are common in debenture trust deeds.<sup>10</sup>

However, this type of contracting may not always be possible. The theory that creditors charge different interest rates for different levels of risk does not work where the costs of the creditor acquiring adequate information about the level of risk are disproportionate to the amount of the transaction.<sup>11</sup> The theory also does not work in the case of involuntary creditors (such as tort claimants).<sup>12</sup> Moreover, dispersed creditors face a collective action problem and may therefore lack the appropriate incentives to undertake joint action to prevent opportunistic behaviour by the company that threatens payment to creditors.<sup>13</sup> Finally, even sophisticated creditors cannot foresee all contingencies and contract for protection against them. Significant corporate restructurings, such as leveraged buyouts, have seen transfers of wealth from sophisticated creditors (namely some bondholders) to shareholders.<sup>14</sup> The result has been a vigorous debate concerning whether directors should owe fiduciary duties to bondholders as a means of protection.<sup>15</sup>

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- 10 R Sappideen, "Protecting Debenture Holder Interests: A Delicate Art" (1991) 4 *Corporate and Business Law Journal* 36. For an empirical study of the restrictive covenants contained in Australian trust deeds, see G Whittred and I Zimmer, "Accounting Information in the Market for Debt" (1986) 26 *Accounting and Finance* 19.
- 11 JM Landers, "Another Word on Parents, Subsidiaries and Affiliates in Bankruptcy" (1976) 43 *University of Chicago Law Review* 527 at 529. However, creditors are expected to "price protect" in this situation. In other words, they will require a higher interest rate as compensation for risk which they are unable to ascertain.
- 12 *Ibid.*
- 13 V Brudney, "Corporate Bondholders and Debtor Opportunism: In Bad Times and Good" (1992) 105 *Harvard Law Review* 1821. For elaboration of the collective action problem in the context of shareholder action, see note 85 *infra*.
- 14 This has mainly occurred in the United States: WW Bratton, "Corporate Debt Relationships: Legal Theory in a Time of Restructuring" (1989) *Duke Law Journal* 92. A leveraged buyout occurs where existing shareholders of a company transfer control of the company to an outsider. A high level of debt is used to fund the acquisition. As this debt will be serviced by the acquired company (by cash flows of the business or by disposal of assets) this increases the risk of existing creditors of the company not being paid.
- 15 MW McDaniel, "Bondholders and Stockholders" (1988) 13 *Journal of Corporation Law* 205 (arguing that directors should have a fiduciary duty to deal fairly with all investors in a company - bondholders as well as shareholders because "leveraged takeovers, buyouts and recapitalizations are having a devastating impact on existing bondholders. Stockholders are getting rich in part at bondholder expense"); LE Mitchell, "The Fairness Rights of Corporate Bondholders" (1990) 65 *New York University Law Review* 1165 (supporting fiduciary duties to bondholders on the basis that this would enhance corporate social responsibility); K Lehn and A Poulson, "The Economics of Event Risk: The Case of Bondholders in Leveraged Buyouts" (1990) 15 *Journal of Corporation Law* 199 (arguing against fiduciary duties to bondholders for two reasons. First, such duties would induce additional litigation and more resources would be expended in redistributing wealth among holders of different securities, thereby reducing the documented wealth gains created by leveraged buyouts. Second, market forces compensate bondholders for the risk of leveraged buyouts. If leveraged buyouts increase the riskiness of bonds, then this is reflected in a higher interest rate for the bondholders. In addition, investors can mitigate risk by diversifying and holding both bonds and stocks in their portfolios); and TR Hurst and LJ McGuinness, "The Corporation, the Bondholder and Fiduciary Duties" (1991) 10 *Journal of Law and Commerce* 187 (arguing against fiduciary duties on the basis that directors would have the

In addition to contractual protections, there are constraints upon companies which operate to protect the interests of creditors. First, there is the maintenance of share capital doctrine. This doctrine has been described in the following way:

Creditors accept the risk that a company whose members enjoy limited liability may lose money in the ordinary course of its business... But they are entitled to protection against reduction of the company's net assets in other ways such as return of paid-up capital to shareholders either by way of purported but improper dividend, by unregulated buying-back of shares before a winding up, or by giving its assets away in a manner not incidental to its business.<sup>16</sup>

However, the effectiveness of the legal rules underpinning the maintenance of share capital doctrine has been questioned by a number of commentators.<sup>17</sup>

A second constraint which operates to protect the interests of creditors is the reputations of the shareholders and the managers of the company with which the creditors are contracting. Shareholders and managers will be reluctant to undertake actions which harm their reputations and which may make it difficult to raise capital in the future. However, as one commentator observes, this constraint applies only when the present value of maintaining the company as a going concern exceeds the value of the benefits derived from taking action that adversely affects creditors (for example, the payment of excessive dividends).<sup>18</sup> A final constraint is that, although shareholders may want to take actions which adversely affect creditors, the shareholders may lack effective control over the management of the company because of a separation of ownership and control.<sup>19</sup> However, whether the separation of ownership and control adequately protects creditors is open to question. First, as managers increase the percentage of shares that they own in the company, their incentive to act in the interests of shareholders increases. Second, there is evidence that the ownership concentration of Australian companies is increasing. A recent study of 100 Australian companies found that the five largest shareholders held, on average, 54 per cent of the issued shares of these companies.<sup>20</sup> Consequently, the degree to which the separation of ownership and control in Australian companies operates to protect creditors of these companies is an open issue.<sup>21</sup>

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difficulty of serving two masters - bondholders and shareholders - which would undercut their existing fiduciary duty to maximise shareholder returns).

16 HAJ Ford and RP Austin, *Ford's Principles of Corporations Law*, Butterworths, (6th ed, 1992) at [829].

17 See, for example, JA Farrar, NE Furey and BM Hannigan, *Farrar's Company Law*, Butterworths, (3rd ed, 1991) pp 169-177.

18 W Frost, "Organizational Form, Misappropriation Risk, and the Substantive Consolidation of Corporate Groups" (1993) 44 *Hastings Law Journal* 449 at 483.

19 "This separation of ownership from control redounds to the benefit of creditors. Because managers are heavily invested in the firm and are unable to diversify their firm-specific skills, they are likely to be risk-averse. Thus, while shareholders may desire to increase enterprise risk after the interest rate of debt is fixed, managers may be reluctant to do so. The shareholders' inability to have complete control over the management of the corporate group reduces their opportunity to engage in misappropriations": *ibid* at 484-85.

20 IM Ramsay and M Blair, "Ownership Concentration, Institutional Investment and Corporate Governance: An Empirical Investigation of 100 Australian Companies" (1993) 19 *Melbourne University Law Review* 153.

21 Increasing ownership concentration of Australian companies may not result in a reduction of the separation of ownership and control if these few shareholders who have the potential to control the companies in which they invest do not actually

It can therefore be seen that the debate on creditor protection is largely unresolved. However, it does not need to be resolved in order to evaluate the merits of s 588V. This is because s 588V does not provide unqualified protection to creditors. It operates only where the subsidiary is insolvent. Consequently, the question of creditor protection can be phrased in a more precise way for our purposes. Is creditor protection warranted where the company, with which the creditor has contracted, is insolvent?

Parliament and the courts have long recognised that insolvency presents special problems for creditors. Parliament has enacted s 588G (previously s 592) of the *Corporations Law* which imposes a duty upon every director to prevent insolvent trading by his or her company. Courts have also been active. While the vexed issue of directors' duties to creditors remains unresolved,<sup>22</sup> there is consensus that the onset of insolvency imposes special obligations upon directors with respect to the interests of creditors. This is best articulated in the judgment of Street CJ in *Kinsela v Russell Kinsela Pty Ltd*:

In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise... But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency or the imposition of some alternative administration.<sup>23</sup>

*Kinsela* provides a powerful justification for creditor protection upon corporate insolvency. Shareholders' funds have been dissipated and it is now the creditors' funds which are at risk. However, there is a further justification for creditor protection. It has already been observed that one of the problems confronting creditors is excessive risk taking by shareholders.<sup>24</sup> As insolvency approaches, this problem is exacerbated. This is because the shareholders now have an even more powerful incentive to engage in risky investments given that most of their funds have been dissipated yet there is the possibility of a "bonanza payoff that will prevent insolvency".<sup>25</sup>

The existence of corporate groups exacerbates these problems for creditors. Although the problems created by corporate groups are dealt with in greater detail later in this article, it is worth observing at this stage that commentators have noted that the creation of complex group structures may be used to conceal the true

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exercise this control. These large shareholders are typically institutional investors and there are many reasons why such investors do not exercise control over the management of companies in which they invest: *ibid* at 179-80.

22 The cases and issues are evaluated in DA Wishart, "Models and Theories of Directors' Duties to Creditors" (1991) 14 *New Zealand Universities Law Review* 323 and V Finch, "Directors' Duties: Insolvency and the Unsecured Creditor" in A Clark (ed), *Current Issues in Insolvency Law*, Stevens and Sons, (1991).

23 (1986) 4 NSWLR 722 at 730.

24 See note 7 *supra* and accompanying text.

25 R Grantham, "The Judicial Extension of Directors' Duties to Creditors" (1991) *Journal of Business Law* 1 at 3, quoting J Coffee, "Shareholders versus Managers: The Strain in the Corporate Web" (1986) 85 *Michigan Law Review* 1 at 61.

financial position of individual companies from creditors. In addition, tort claimants may be uncompensated when their injuries are caused by undercapitalised subsidiaries of holding companies.<sup>26</sup> Finally, it has been noted that, where a company in a corporate group is in financial difficulty, managers may move assets from that company to other companies in the group that have a better chance of survival.<sup>27</sup> This will be at the expense of the creditors of the company in financial difficulty.<sup>28</sup>

Consequently, some protection for creditors upon the onset of insolvency of the company with which they have contracted is warranted. Whether s 588V provides appropriate protection will be considered in Parts V and VI of this article. Section 588V and its history are now outlined.

### III. SECTION 588V AND ITS HISTORY

Section 588V provides that a holding company contravenes the section if a subsidiary is insolvent when it incurs a debt or becomes insolvent by incurring the debt and at that time there are reasonable grounds for suspecting that the subsidiary is insolvent, or would so become insolvent, and:

- the holding company, or one or more of its directors, is or are aware at that time that there are grounds for so suspecting; or
- having regard to the nature and extent of the holding company's control over the affairs of the subsidiary and to any other relevant circumstances, it is reasonable to expect that:
  - a holding company in the company's circumstances would be so aware; or
  - one or more of such a holding company's directors would be so aware.

Section 588W provides that where a holding company contravenes s 588V in relation to the incurring of a debt by a subsidiary and the person to whom the debt is owed has suffered loss or damage in relation to the debt because of the subsidiary's insolvency and the debt was wholly or partly unsecured when the loss or damage was suffered, the subsidiary's liquidator may seek to recover from the holding company an amount equal to the amount of the loss or damage.

A number of defences to proceedings under s 588W are provided in s 588X. It is a defence if it is proved that:

- at the time when the debt was incurred, the holding company, and each relevant director (if any), had reasonable grounds to expect, and did expect, that the subsidiary was solvent at that time and would remain solvent even if it incurred the debt;

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26 See notes 64 to 68 *infra* and accompanying text.

27 W Frost, note 18 *supra* at 485.

28 For an example of where this occurred, see *Walker v Winborne* (1976) 137 CLR 1.

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

Where the court is satisfied that, at the time when the subsidiary incurred the debt, the creditor who suffered the loss or damage knew that the subsidiary was insolvent or would become insolvent by incurring the debt, s 588Y provides that the court may order that the compensation paid by the holding company is not available to pay the debt unless all the subsidiary's other unsecured debts have been paid in full.

The provisions outlined have their origin in a report of the Australian Law Reform Commission.<sup>29</sup> The recommendations of the Commission were broader than s 588V, in that liability for insolvent trading could attach under the recommendations of the Commission not just to a holding company but to any related company.<sup>30</sup> The Commission proposed that a court could order a company to be liable for the debts of a related company if the court determined this to be just. Three criteria to which the court should have regard were proposed:

- the extent to which the related company took part in the management of the insolvent company;
- the conduct of the related company towards the creditors of the insolvent company; and
- the extent to which the circumstances that gave rise to the winding up of the company were attributable to the actions of the related company.<sup>31</sup>

A detailed analysis of s 588V is undertaken in Parts V and VI. A criticism made in Part VI is that the scope of s 588V is too narrow in that the section relies upon a definition of subsidiary that can be avoided in a range of circumstances (and hence s 588V has no application) including where business activities pose a higher than usual risk of failure. Prior to undertaking the detailed analysis of s 588V, the approach adopted in other countries to holding company liability is reviewed.

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29 Australian Law Reform Commission, *General Insolvency Inquiry*, 1988.

30 *Ibid* at [334].



#### IV. THE LAW IN OTHER COUNTRIES

A study of the law in other countries governing the liability of holding companies for the debts of their insolvent subsidiaries reveals a piecemeal approach. These approaches can be classified as follows: piercing the corporate veil, the concept of "shadow director", contribution, consolidation and pooling of assets, equitable subordination and the more far reaching proposals adopted by Germany in its *Stock Corporation Law* (1965).

##### A. Piercing the Corporate Veil

Piercing the corporate veil is something that is undertaken in many European countries although, it has been argued, somewhat less aggressively than in the United States.<sup>32</sup> The main categories of veil piercing in the United States are fraud, absence of formalities, inadequate capitalisation and commingling of assets and control.<sup>33</sup> A recent empirical study has documented the significant degree to which veil piercing is undertaken by courts in the United States,<sup>34</sup> albeit that veil piercing in that country has been described as "vague and largely unprincipled".<sup>35</sup> Veil piercing is also undertaken by Australian courts but only to a very limited degree (for example, where a company is formed to avoid an existing legal obligation or to perpetrate a fraud).<sup>36</sup>

##### B. The Concept of Shadow Director

One means of establishing holding company liability for the debts of an insolvent subsidiary is where the holding company can be held to be a "shadow director" of the subsidiary. In the United Kingdom, s 214 of the *Insolvency Act* 1986 imposes personal liability upon a director for the debts of his or her company if the director knew or ought to have concluded that there was no reasonable prospect that the

31 *Ibid* at [335].

32 K Hofstetter, "Parent Responsibility For Subsidiary Corporations: Evaluating European Trends" (1990) 39 *International and Comparative Law Quarterly* 576 at 590.

33 HG Henn and JR Alexander, *Laws of Corporations and Other Business Enterprises*, West Publishing Company, (3rd ed, 1983), at [148]. R Clark, *Corporate Law*, Little, Brown, (1986) pp 72-3 refers to the following United States cases: "*Arrow, Edelstein & Gross v Rosco Productions Inc* (1984) 581 F Supp 520 at 525 (applying New York law; piercing is done where corporation formed for fraudulent, illegal, or unjust purposes or to mislead creditors); *State Dept of Environmental Protection v Ventron* (NJ 1983) 468 A.2d 150 at 164 (disregard of corporate entity used to perpetrate a fraud or injustice); *NCR Credit Corp v Underground Camera Inc* (D Mass 1984) 581 F Supp 609 at 612 (applying Mass law; disregard of entity depends on control or intermingling of activities, plus need to prevent fraud, wrong, or gross inequity). Some courts express a more elaborate list of factors. For example, *Walter E Heller and Co v Video Innovations Inc* (2d Cir 1983) 730 F 2d 50 at 53 (under NY law, criteria for piercing include (1) absence of formalities of corporate existence; (2) inadequate capitalization; (3) personal use of corporate funds, and (4) perpetration of fraud by means of the corporate vehicle)."

34 RB Thompson, "Piercing the Corporate Veil: An Empirical Study" (1991) 76 *Cornell Law Review* 1036, describing piercing the corporate veil as "the most litigated issue in corporate law" in that country.

35 H Hansmann and R Kraakman, "Toward Unlimited Shareholder Liability for Corporate Torts" (1991) 100 *Yale Law Journal* 1879 at 1931.

36 HAJ Ford and RP Austin, note 16 *supra* at [707].

company would avoid liquidation. Liability under s 214 extends to a shadow director, defined as a person in accordance with whose directions or instructions the directors of the company are accustomed to act. The concept of shadow director can encompass a holding company.<sup>37</sup> Similar liability could attach to holding companies under Australian law. Sections 588G-Q of the *Corporations Law* impose personal liability upon a director of a company where the company has engaged in insolvent trading. The definition of director in s 60 includes the concept of shadow director and it has been argued that this can include a holding company.<sup>38</sup>

The concept of a holding company being held liable because it is a shadow director of a subsidiary applies in a number of European countries. Under French law, a holding company becomes a "de facto director" of a subsidiary if it involves itself in the day to day management of the subsidiary without having been formally elected a director.<sup>39</sup> Swiss law permits creditors of an insolvent subsidiary to enforce damages claims against shadow or de facto directors of the holding company by way of a derivative action.<sup>40</sup>

A judgment of the German Federal Court in 1985 held that a holding company is liable to the creditors of an insolvent subsidiary for the debts of the subsidiary where the holding company was "permanently and extensively" involved in the management of the subsidiary.<sup>41</sup> Although not relying specifically on the concept of shadow or de facto director, the Court uses the same principles when it refers to involvement in the day to day management of the affairs of the subsidiary. Finally, the 1985 draft *European Community Ninth Directive* on corporate groups provides that where a holding company involves itself in the management of a subsidiary, it is liable for any breach of its fiduciary duties as a shadow or de facto director. This is similar to the de facto director concept contained in French law.<sup>42</sup>

One of the problems with imposing liability upon a holding company by reason of it being a shadow or de facto director is that, according to Hofstetter, the respective laws in France, Switzerland and Germany have not been vigorously enforced by creditors of subsidiary companies. He argues that there are several important reasons why there has been under enforcement.<sup>43</sup> First, under some of the laws, there is a need to show that the interests of the subsidiary were

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37 H Collins, "Ascription of Legal Responsibility to Groups in Complex Patterns of Economic Integration" (1990) 53 *Modern Law Review* 731 at 741. See also DD Prentice, "Group Indebtedness" in CM Schmitthoff and F Woolridge (eds), *Groups of Companies*, Sweet & Maxwell, (1991) pp 77-9.

38 HAJ Ford and RP Austin, note 16 *supra* at [1502].

39 K Hofstetter, note 32 *supra* at 585. Where a holding company is a de facto director of an insolvent subsidiary, it will be liable for the debts of the subsidiary where, inter alia, it disposed of the assets of the subsidiary as if they were its own, exploited the subsidiary in a way that led to insolvency or used the assets of the subsidiary in a way that impaired the interests of the subsidiary. Consequently, liability of the holding company under French law requires both that the holding company be classified as a de facto or shadow director and also some misconduct on the part of the holding company: *ibid* at 584.

40 *Ibid* at 590.

41 *Autokran*, 95 BGHZ 330 (1985), cited in K Hofstetter, note 32 *supra* at 583.

42 *Ibid* at 588-89.

43 *Ibid* at 593-94.

undermined for the purpose of ensuring that the interests of the holding company prevailed. However, it is often difficult to show that the subsidiary has a separate interest when the affairs of the holding company and the subsidiary have been merged for a significant period of time. Second, in some jurisdictions liability depends upon a breach of fiduciary duty by the shadow or de facto director. The definition of fiduciary duty requires reference to an independent interest of the subsidiary. As a result, Hofstetter argues that holding company liability will only be enforceable in the most egregious cases of holding company misconduct.<sup>44</sup> Finally, some jurisdictions require a breach of fiduciary duty by the de facto director to be enforced derivatively. Derivative litigation presents significant problems because of the lack of incentives to commence litigation.<sup>45</sup>

Several of these enforcement problems are less relevant under Australian and United Kingdom law. This is because liability under the insolvent trading provisions of these jurisdictions does not require proof of a separate interest of the subsidiary and neither does it require breach of a fiduciary duty by the shadow director. Moreover, the action is brought by a liquidator which overcomes many of the incentive problems evident in a derivative action. This is not to suggest that actions seeking to impose liability upon a holding company for the debts of an insolvent subsidiary are free of difficulties. A significant practical difficulty would lie in establishing that the holding company is a shadow director, that is, someone in accordance with whose directions or instructions the directors of the subsidiary are accustomed to act.

### C. Contribution, Consolidation and Pooling of Assets

Amendments made in 1980 to the *Companies Act 1955* (NZ), grant courts wide discretionary powers in respect of contribution and pooling assets of related companies of a company in liquidation. Under s 315A, the court can order that a related company contribute to the assets available for a winding up or, if there is more than one related company in liquidation, under s 315B, the court can wind them up as if they are one company. The court must consider whether it is “just and equitable” to make the order.<sup>46</sup> The United States bankruptcy principle of substantive consolidation permits the assets and liabilities of different companies to be consolidated and treated as one entity from which all of the claims against the consolidated debtors are satisfied.<sup>47</sup> This is similar to the concept of pooling of assets under the *Companies Act 1955* (NZ), although it goes further than the New Zealand legislation in that consolidation is available to merge the assets and

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44 *Ibid* at 594.

45 For discussion of the lack of incentives in the context of shareholder litigation, see IM Ramsay, “Shareholder Litigation, Corporate Governance and the Prospects for a Statutory Derivative Action” (1992) 15 *University of New South Wales Law Journal* 149.

46 For detailed discussion of the statutory provisions and the relevant case law, see J Farrar, “Insolvency and Corporate Groups”, presented as part of the University of Sydney’s Faculty of Law Continuing Legal Education Program, 13 March 1992.

47 *Ibid* at 49. See also TW Cashel, “Groups of Companies: Some US Aspects” in CM Schmithoff and F Woolridge, note 37 *supra* at 37-8.

liabilities of individual debtors with affiliate companies as well as merging the assets and liabilities of related companies.<sup>48</sup>

#### D. Equitable Subordination

Equitable subordination is a principle of United States bankruptcy law which allows a court to defer certain inter-company claims (for example, a debt owed by a subsidiary to its holding company) if it is just and equitable to do so. The court enquires into the conduct of the parties and the nature of the financial arrangements which gave rise to the debt and will often require a finding of fraud, mismanagement or other wrongful conduct before an inter-company claim is deferred so that external creditors receive priority.<sup>49</sup>

#### E. The German *Stock Corporation Law*

The German *Stock Corporation Law* (1965) has been described as “the most developed set of provisions based on the strategy of classifying and regulating different types of corporate groups”.<sup>50</sup> It divides corporate groups into three categories: integration concerns, contract concerns and de facto concerns.<sup>51</sup> In brief, an integration concern is where a holding company owns at least 95 per cent of the shares of a subsidiary and the two companies agree to integrate with the result that the holding company acquires unlimited power to direct the subsidiary but at the same time the holding company is liable for all existing and future claims of creditors against the subsidiary. A contract concern occurs where shareholder resolutions of both the holding company and the subsidiary are passed that grant the holding company the right to direct the subsidiary even when this is detrimental to the subsidiary, provided that any such directions are consistent with the interests of the corporate group as a whole. The holding company must compensate the subsidiary for all deficits occurring during the contract period. Finally, a de facto concern occurs where there is broad and systematic involvement by the holding company in the affairs of the subsidiary. This is prohibited unless compensation is granted to the subsidiary for any disadvantageous interference by the holding company.

Hofstetter argues that although the German *Stock Corporation Law* (1965) is unequalled by any other legislation in the world, it is subject to serious limitations.<sup>52</sup> First, it applies only to large stock corporations in Germany. However, as we have seen, German Courts have developed principles of holding company liability for other companies that are similar to liability imposed under

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48 J Farrar, note 46 *supra* at 51.

49 *Ibid* at 61. See also TW Cashel, note 47 *supra* at 35-6.

50 T Hadden, “The Regulation of Corporate Groups in Australia” (1992) 15 *University of New South Wales Law Journal* 61 at 83.

51 K Hofstetter, note 32 *supra* at 580-82. For further discussion of the *German Stock Corporation Law*, see NC Sargent, “Beyond Legal Entity Doctrine: Parent-Subsidiary Relations Under the West German Konzernrecht” (1985) 10 *Canadian Business Law Journal* 327.

52 K Hofstetter, note 32 *supra* at 579.

the concept of shadow or de factor director.<sup>53</sup> A more significant limitation evident in the German *Stock Corporation Law* (1965) is that it may be largely irrelevant to the operation of corporate groups in that country. Thus, Hofstetter describes integration concerns as being of “no practical importance in Germany” and contract concerns as being only “rarely used” because most corporate groups are not structured in this manner.<sup>54</sup> With respect to de facto concerns, Hofstetter describes these provisions of the legislation as “almost a dead letter” because successful actions for damages under these provisions are unknown.<sup>55</sup> The reason given for this is the difficulty of establishing detrimental interference by the holding company in the affairs of the subsidiary and high enforcement costs.<sup>56</sup>

## F. Summary

This review of the law in other countries governing the liability of holding companies for the debts of their insolvent subsidiaries reveals a wide variety of approaches. It also reveals that s 588V adopts a unique approach when compared with the countries surveyed. The law in these countries governing the liability of holding companies for the debts of their insolvent subsidiaries is not only piecemeal but also imprecise and uncertain. We have seen that it is difficult to know with precision when courts will lift the corporate veil or when a holding company will satisfy the requirements of being a shadow director. The German *Stock Corporation Law* (1965) is designed to regulate corporate groups and address some of the complex issues that arise from the existence of corporate groups, including insolvent subsidiaries, yet the relevance of the Law has been questioned by commentators.

Given the critical views of commentators on the various approaches adopted overseas, it is difficult to see these approaches satisfying the two key aspects of efficiency referred to in Part I; namely, that these approaches to holding company liability provide incentives to companies to take an appropriate amount of care in their activities and efficiently allocate risk among companies and those who deal with them. This is particularly so given that many of the international approaches are either not adequately enforced or too uncertain in their application.

Section 588V overcomes enforcement problems caused by a lack of incentives to commence litigation by requiring that claims under the section are commenced by a liquidator representing all creditors and not by individual creditors who may have insufficient incentive to commence litigation. Two of the most fundamental issues relevant to s 588V are corporate groups and limited liability. These two issues are analysed in the following Part.

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53 Note 41 *supra*, and accompanying text.

54 K Hofstetter, note 32 *supra* at 580-81.

55 *Ibid* at 582.

56 *Ibid*.

## V. CORPORATE GROUPS AND LIMITED LIABILITY

The key feature of s 588V is that it removes the limited liability that would otherwise apply between a holding company and its subsidiary where the subsidiary has engaged in insolvent trading and the holding company either was aware or should have been aware of this. In order to evaluate whether this is a justifiable incursion into the principle of limited liability, it is necessary to understand the reasons for both the establishment of corporate groups and limited liability.

### A. Reasons for Corporate Groups

Reasons why a company expands its business must be distinguished from reasons why that company establishes one or more subsidiaries even though the two may, in some circumstances, be related. When a company expands, for example, by entering a new line of business, it may do this by incorporating a subsidiary. However, this will not necessarily be the case.

There are a number of reasons that explain company expansion. There may be the possibility of economies of scale in production or distribution or a reduction in transaction costs. Expansion might also be caused by the need to obtain access to new markets or supplies, to eliminate competition or so that managers can increase their personal status and power.<sup>57</sup> Chandler observes that, whatever the motivation for expansion:

...the modern industrial enterprise has rarely continued to grow or maintain its competitive position over an extended period of time unless the addition of new [activities] (and to a lesser extent the elimination of old ones) has actually permitted its managerial hierarchy to reduce costs, to improve functional efficiency in marketing and purchasing as well as production, to improve existing products and processes and to develop new ones, and to allocate resources to meet the challenges and opportunities of ever-changing technologies and markets.<sup>58</sup>

Why might a company establish one or more subsidiaries so that its business is conducted as a corporate group rather than as a single company? First, the company can reduce the exposure of its assets by establishing a subsidiary. The principle of limited liability ensures that (subject to the exceptions noted in Part IV such as piercing the corporate veil) the assets of the holding company will be protected from any liability incurred by the subsidiary. Second, the operation of business by means of a corporate group rather than a single company can result in lower taxation.<sup>59</sup> Third, in some countries there can be accounting considerations

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57 AD Chandler, *Scale and Scope: The Dynamics of Industrial Capitalism*, Belknap Press, (1990) pp 15-7. For further discussion of these issues, see N Fligstein, *The Transformation of Corporate Control*, Harvard University Press, (1990).

58 *Ibid*, p 17.

59 T Hadden, note 50 *supra* at 65-6. See also JM Landers, "A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy" (1975) 42 *University of Chicago Law Review* 589.

resulting from the fact that the accounts of the subsidiary do not have to be consolidated with those of the holding company.<sup>60</sup>

Fourth, a company may want to acquire a business in partnership with an individual or another company. A convenient means of structuring the acquisition is for the respective interests in the new business to be represented by shares. This necessitates the new business being acquired as a company rather than acquiring the assets of the business. As a related point, it is frequently desirable to acquire a business as a company rather than acquiring the assets because stamp duty is significantly higher for asset sales than for share sales and the taxation advantage of carrying forward the losses of the acquired company will not be available to the acquirer of assets.<sup>61</sup> Fifth, a company may want outside investment in part only of its business. This can be done by incorporating that part of the business as a subsidiary and allowing outsiders to acquire the minority shareholding in the subsidiary. It allows the company to raise additional capital without forfeiting control.<sup>62</sup> Finally, the establishment of subsidiaries allows greater flexibility with respect to debt financing.<sup>63</sup>

The increasing influence of corporate groups is not without its problems. Hadden identifies six potential problems:

1. the techniques of group control, notably those involving interlocking shareholdings and directorships, may be used to entrench the positions of incumbent managers against any possible threat from external shareholders;
2. the techniques of integrated financing, notably the freedom to pass assets and liabilities from company to company within the group, and the creation of complex group structures may be used to conceal the true financial position of individual companies or of the group as a whole from their shareholders or creditors;
3. both techniques may be used to ensure that the interests of shareholders and directors of the group are preferred to those of minority shareholders in subsidiaries and to conceal that this has been done;
4. the techniques of integrated financing may be used to avoid taxation by ensuring that maximum profit is generated in forms or in jurisdictions which attract low levels of tax;
5. the creation of separate companies for particular operations, supplemented by the techniques of integrated financing, may be used to avoid liability to external creditors by relying on the limited liability of each constituent company within the group;
6. more or less complex group structures may be used to avoid the impact of regulatory measures on a wide range of matters, such as monopolies and mergers legislation, health and safety provisions, employee participation and planning requirements.<sup>64</sup>

60 RJ Gilson, *The Law and Finance of Corporate Acquisitions*, Foundation Press, (1986) pp 298-99. This cannot be done in Australia: G Gay and G Peirson, "Consolidated Financial Reporting" (1992) 10 *Company and Securities Law Journal* 153.

61 HAJ Ford and RP Austin, note 16 *supra* at [2002].

62 An example is the planned restructuring of US food and tobacco conglomerate RJR Nabisco. The company's share price has declined 25 percent in the past two years because of new taxes and legal action that has adversely affected the tobacco industry. The plan is to establish two separate subsidiaries for each of the tobacco and food divisions and offer existing shareholders shares in each of the subsidiaries: *International Business Week*, 22 March 1993, p 30.

63 DW Leeborn, "Limited Liability, Tort Victims, and Creditors" (1991) 91 *Columbia Law Review* 1565 at 1614.

64 T Hadden, note 50 *supra* at 65. See also JM Landers, note 11 *supra* at 528.

Recent Australian cases have focussed upon two particular problems. First, the difficulties created for tort claimants when their injuries are caused by an undercapitalised subsidiary.<sup>65</sup> Second, the tension between traditional legal principles, which treat each company in a corporate group as a distinct legal entity with its own interests, and commercial reality whereby participants within the corporate group and creditors dealing with companies within the group focus upon group principles rather than individual companies.<sup>66</sup> Blumberg describes the issue of whether the law should extend the rights and duties of a company within a group to reflect the activities of another company within that group as "one of the major problems in corporation law".<sup>67</sup>

One of the more significant problems with corporate groups arises in the context of insolvency, the very issue to which s 588V is addressed. The problem is described in a well known quotation from an English case:

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 or indirectly 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 its 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.<sup>68</sup>

## B. Reasons for Limited Liability

Given the problems identified in the preceding section, why are companies granted limited liability? Five reasons, based upon principles of economic efficiency, can be provided.<sup>69</sup> First, limited liability decreases the need for shareholders to monitor the managers of companies in which they invest because the financial consequences of company failure are limited. Shareholders may have neither the incentive (particularly if they have only a small shareholding) nor the expertise to monitor the actions of managers. The potential costs of operating companies are reduced because limited liability makes shareholder diversification and passivity a more rational strategy.<sup>70</sup>

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65 *Briggs v James Hardie & Co Pty Ltd* (1989) 7 ACLC 841.

66 *Qintex Australia Finance Ltd v Schroders Australia Ltd* (1990) 3 ACSR 267.

67 PI Blumberg, "The Corporate Entity in an Era of Multinational Corporations" (1990) 15 *Delaware Journal of Corporate Law* 283 at 288.

68 *Re Southard & Co Ltd* [1979] 1 WLR 1198 at 1208.

69 These reasons are drawn from FH Easterbrook and DR Fischel, *The Economic Structure of Corporate Law*, Harvard University Press, (1991) pp 41-4.

70 Easterbrook and Fischel also argue that limited liability reduces the costs of monitoring other shareholders. With unlimited liability, because any one shareholder could be responsible for all the debts of the company, it is necessary for that shareholder to ensure that other shareholders possess enough wealth to bear their share of any company debts. This requires costly monitoring of other shareholders: *ibid*. This justification for limited liability has been criticised on the basis that if unlimited liability means that individual shareholders are liable for company debts only in the proportion which their investment bears to that of the total investment in the company, shareholders would not need to monitor other shareholders. This is because under proportional shareholder liability, the wealth of other shareholders is irrelevant: SB Presser, "Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics" (1992) 87 *Northwestern University Law Review* 148 at 160-61.



Second, limited liability provides incentives for managers to act efficiently and in the interests of shareholders by promoting the free transfer of shares. This argument has two parts. First, the free transfer of shares is promoted by limited liability because under this principle, the wealth of other shareholders is irrelevant. If a principle of unlimited liability applied, the value of shares would be determined partly by the wealth of shareholders. In other words, the price at which an individual shareholder might purchase a share would be determined in part by the wealth of that shareholder which is now at risk because of unlimited liability. The second part of the argument (that limited liability provides managers with incentives to act efficiently and in the interests of shareholders) is derived from the fact that if a company is being managed inefficiently, shareholders can be expected to be selling their shares at a discount to the price which would exist if the company was being managed efficiently. This creates the possibility of a takeover of the company and the replacement of the incumbent management.

The third justification is that limited liability assists the efficient operation of the securities markets because, as was observed in the preceding paragraph, the prices at which shares trade does not depend upon an evaluation of the wealth of individual shareholders.

Fourth, limited liability permits efficient diversification by shareholders which in turn allows shareholders to reduce their individual risk. If a principle of unlimited liability applied and a shareholder could lose his or her entire wealth by reason of the failure of one company, shareholders would have an incentive to minimise the number of shares held in different companies and insist on a higher return from their investment because of the higher risk they face. Consequently, limited liability not only allows diversification but permits companies to raise capital at lower costs because of the reduced risk faced by shareholders.

Fifth, limited liability facilitates optimal investment decisions by managers. As we have seen, limited liability provides incentives for shareholders to hold diversified portfolios. Under such circumstances, managers should invest in projects with positive net present values and can do so without exposing each shareholder to the loss of his or her personal wealth. However, if a principle of unlimited liability applied, managers may reject some investments with positive present values on the basis that the risk to shareholders is thereby reduced. "By definition this would be a social loss, because projects with a positive net present value are beneficial uses of capital".<sup>71</sup>

Blumberg has demonstrated that a number of these justifications for limited liability have either limited application or no application to holding companies and their wholly-owned subsidiaries.<sup>72</sup> First, the justification that limited liability decreases the need for shareholders to monitor managers does not apply because of the clear incentive of a holding company to monitor the activities of its wholly-owned subsidiary. Second, the justification that limited liability provides

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71 FH Easterbrook and DR Fischel, note 69 *supra*, p 44.

72 PI Blumberg, "Limited Liability and Corporate Groups" (1986) 11 *Journal of Corporation Law* 573 at 623-26. It should of course be recalled that s 588V is not limited in its application to wholly-owned subsidiaries.

incentives for managers to act efficiently and in the interests of shareholders by promoting the free transfer of shares has less application to holding companies and wholly-owned subsidiaries although limited liability may reduce transaction costs in sales of the shares of a subsidiary because it can assist the separation of liabilities between the holding company and its subsidiary.<sup>73</sup>

Third, the fact that limited liability assists the operation of the securities markets is largely irrelevant in the case of a wholly-owned subsidiary although this justification is still relevant in the case of a partially-owned subsidiary where there is a market in which the publicly held shares are traded.<sup>74</sup> Finally, the fact that limited liability permits efficient diversification by shareholders which in turn allows shareholders to reduce their individual risk is less applicable to holding companies because they are less risk averse than individual shareholders. This follows from the fact that the individual shareholders of the holding company still receive the protection of limited liability which means that they can diversify their investments independently of the holding company's liability for the subsidiary.<sup>75</sup> This conclusion is not unqualified however. If companies are risk averse, they may forego investment opportunities with positive net present values if they are denied the avenue of isolating the risk of the investment in a subsidiary.<sup>76</sup>

It is therefore evident that a number of the justifications for why limited liability applies to companies are less relevant when the company is the holding company of a wholly-owned subsidiary. This provides general support for rethinking some aspects of limited liability in the context of corporate groups. Another reason for such a rethinking is the significant tension between the legal principle that a company is a separate legal entity and therefore deserving of limited liability even if it is part of a corporate group, and the fact that many corporate groups operate as a single entity because of the economic benefits that result from the integration of activities. Yet these reasons do not automatically justify a provision such as s 588V. What has been established is that limited liability is not an inviolable principle in the context of corporate groups. A more detailed analysis of s 588V will now be undertaken.

## VI. AN EVALUATION OF SECTION 588V

This Part commences with an evaluation of several criticisms that have been made of s 588V. One of these criticisms is that holding companies are not the best bearers of the risk of liability for the debts of an insolvent subsidiary. This leads to discussion of whether the holding company, the creditors (including tort claimants) of the subsidiary or the directors of the subsidiary are the best bearers of this risk.

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73 K Hofstetter, "Multinational Enterprise Parent Liability: Efficient Legal Regimes in a World Market Environment" (1990) 15 *North Carolina Journal of International Law and Commercial Regulation* 299 at 307.

74 PI Blumberg, note 72 *supra* at 624.

75 K Hofstetter, note 73 *supra* at 307.

76 GW Dent, "Limited Liability in Environmental Law" (1991) 26 *Wake Forest Law Review* 151 at 167.

The analysis demonstrates that tort claimants are the least able to contract to protect themselves against the risk of insolvency of a company which has harmed them. Yet s 588V provides no protection to tort claimants. This Part concludes with discussion of a further deficiency in s 588V, namely the reliance of the section on the legal definition of subsidiary. The definition has been shown in recent years to be seriously inadequate and it is predicted that this will limit the effectiveness of s 588V.

### **A. Criticisms of s 558V**

In a submission to the Federal Attorney General, the Law Council of Australia opposed s 588V on a number of grounds.<sup>77</sup> First, it argued that the section has the potential to discourage foreign investment in Australia. This is a surprising assertion given that, as demonstrated in Part IV above, major capital markets have laws which impose some form of liability upon holding companies for the debts of their insolvent subsidiaries. Consequently, most foreign investors would be familiar with laws that impose such liability upon holding companies.

Second, the Law Council argued that the section will “create problems of liability and exoneration where there are interlocking boards of directors”. Given that the objective of s 588V is to make a holding company liable for the debts of an insolvent subsidiary where the holding company was aware or should have been aware of the insolvency, and that one way of demonstrating this knowledge is to point to a director of the subsidiary who is a representative of the holding company, the statement of the Law Council does no more than acknowledge one of the proper consequences of the operation of the section.

Third, the Law Council stated that “even if there were some merit in the proposal if it were limited to wholly-owned subsidiaries, it does offend the fundamental principle of company law in Australia and elsewhere that separate companies have separate legal identities”. Two observations can be made in response to this argument. The first is that a provision such as s 588V cannot be limited to wholly-owned subsidiaries. This would create the obvious loophole of holding companies divesting themselves of one share in the subsidiary so that it is no longer wholly-owned. The second observation is that, as the preceding discussion in this article has demonstrated, it cannot simply be asserted that no reform is warranted because companies have separate legal identities. There are a range of existing exceptions to this principle both in Australia and elsewhere. What is required is careful evaluation of both the benefits and costs that might result from removing limited liability.

The fourth argument advanced by the Law Council was that s 588V will have a deleterious impact on various forms of financing, in particular, limited recourse and project financing. However, the Law Council does not demonstrate that such

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<sup>77</sup> Banking, Finance and Consumer Credit Committee of the Business Law Section of the Law Council of Australia, *Submission on the Corporate Law Reform Bill 1992*, 14 May 1992.

financing has been adversely affected in those many countries that impose liability upon holding companies for the debts of insolvent subsidiaries.

Fifth, the Law Council submitted that "the more appropriate course is to pursue regulation through the personal liability that can be sheeted home to directors, who do have control, rather than attempting to pursue companies up the line". This argument raises an important issue although it is not one that is addressed in detail by the Law Council. The issue is who best bears the risk of loss resulting from the insolvent subsidiary, and is discussed below.

## B. Who Should Bear the Risk of Loss?

The issue of who best bears the risk of loss resulting from an insolvent subsidiary, as we saw in Part I, is one of the two key aspects of a law and economics analysis of regulation. It should also be noted that the second aspect of efficiency (whether the regulation under analysis provides incentives to take an appropriate amount of care) is related to the first aspect. This is because if excessive risk is imposed upon someone, this undercuts the objective of having that person exercise appropriate care in their activities.

There are several alternative bearers of the risk of loss resulting from an insolvent subsidiary. Should it be the creditors of the subsidiary, the holding company or, as the Law Council argues, the directors of the subsidiary? Liability is most efficiently assigned to one who is able to avoid risk at the least cost.<sup>78</sup> This involves a combination of factors such as the cost incurred by alternative risk bearers with respect to monitoring the risk and the attitudes to risk of alternative risk bearers which will be determined by the extent to which these risk bearers are able to diversify their risk.<sup>79</sup>

When these factors are considered, it becomes clear that directors of the subsidiary are the least efficient bearers of the risk of liability that results from the insolvency of the subsidiary. While directors are efficient acquirers of information regarding corporate risk, they are generally more averse to risk than either creditors or shareholders. There are justifications for imposing personal liability upon directors. This follows from their unique position in monitoring management and corporate risk. These matters have been emphasised in recent cases, where it is argued that:

...it is of the essence of the responsibilities of directors that they take reasonable steps to place themselves in a position to guide and monitor the management of the company.<sup>80</sup>

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78 K Hofstetter, note 73 *supra* at 309.

79 *Ibid.*

80 *AWA v Daniels* (1992) 7 ACSR 759 at 864, per Rogers CJ. This is also a theme in recent cases brought by creditors under s 592 (now s 588G) of the *Corporations Law: Statewide Tobacco Services Ltd v Morley* (1990) 2 ACSR 405 at 431, per Ormiston J and *Commonwealth Bank of Australia v Friedrich* (1991) 5 ACSR 115 at 126, per Tadgell J. The role of legal liability in encouraging the efficient management of companies is discussed in P Redmond, "The Reform of Directors' Duties" (1992) 15 *University of New South Wales Law Journal* 86 at 90-5 and I Ramsay, "Directors who do not Direct: The Resurrection of the Marquis of Bute on his Centenary" (1992) 6(2) *Commercial Law Quarterly* 18.

Yet directors are inefficient bearers of risk because of their inability to diversify risk. Both equity and debt investors are able to diversify their holdings and thereby minimise the risk associated with investing in any one company. However, directors are much more risk averse because their human capital is invested in only one company.<sup>81</sup> Even in the case of non-executive directors, the human capital of these directors is invested in only a small number of companies and therefore cannot be fully diversified.<sup>82</sup> Consequently, it is inappropriate to impose liability solely upon the directors of the subsidiary.

The analysis becomes more complex with respect to evaluating the relative monitoring costs incurred by creditors and shareholders. A possible consequence of s 588V is that the monitoring costs of creditors will be increased.<sup>83</sup> Creditors of the subsidiary may incur additional costs monitoring the creditworthiness of the holding company because the financial position of this company is now more relevant to the creditor. A counter to this argument is the possibility of the creditor incurring lower monitoring costs with respect to the subsidiary because there is less concern that the holding company will strip the subsidiary of its assets and thereby render it insolvent because of s 588V. In other words, s 588V imposes incentives upon the holding company to exercise appropriate care in dealings with its subsidiary.

More important according to Posner is the fact that the monitoring costs of creditors of the holding company may increase because the assets of the holding company will be available to creditors of the subsidiary. Creditors of the holding company may consequently need to monitor the creditworthiness of the subsidiary. If so, the holding company's cost of credit will increase.<sup>84</sup> However, secured creditors may only undertake monitoring to the limited degree which is required to satisfy themselves that the holding company has assets available to satisfy their claims. Where this occurs, the holding company's cost of credit which is obtained on a secured basis should not increase as a result of s 588V.

In the context of large public companies, a powerful argument can be made that creditors are superior monitors than individual shareholders and therefore are in a better position to bear the risk of loss resulting from insolvency. Large public companies are typified by diffuse ownership structures. As a result, shareholders

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81 Remuneration schemes may attempt to overcome this risk averse bias of directors. An example is the use of share option plans. For discussion of the theory and evidence on this issue, see IM Ramsay, "Directors and Officers' Remuneration: The Role of the Law" (1993) *Journal of Business Law* 351; A Defina, TC Harris and IM Ramsay, "What is Responsible Remuneration for Corporate Officers? An Empirical Investigation into the Relationship Between Pay and Performance in the Largest Australian Companies" (1994) *12 Company and Securities Law Journal* (forthcoming).

82 A study of the largest 250 Australian companies revealed that 80 percent of the directors of these companies held only one directorship, 12 per cent of the directors held two directorships while 8 per cent held three or more directorships: R Carroll, B Stening and K Stening, "Interlocking Directorships and the Law in Australia" (1990) *8 Company and Securities Law Journal* 290. See also M Alexander and G Murray, "Interlocking Directorships in the Top 250 Australian Companies: Comment on Carroll, Stening and Stening" (1992) *10 Company and Securities Law Journal* 385.

83 This issue is discussed by Posner in the context of piercing the corporate veil: RA Posner, "The Rights of Affiliated Corporations" (1976) *43 University of Chicago Law Review* 499 at 516-17.

84 *Ibid* at 517.

may fail to exercise sufficient control over managers, thereby enabling them to pursue their own ends. This is a consequence of shareholders not having appropriate incentives to monitor managers because the costs associated with taking action exceed the expected benefits.<sup>85</sup> The fact that shareholders in large public companies are inefficient monitors of managers provides one of the justifications for limited liability.<sup>86</sup>

Creditors may be superior monitors of managers than individual shareholders for several reasons. First, the creditor may be an institutional investor such as a bank with specialised knowledge of the company and the industry in which it operates. This specialised knowledge is generally reflected in loan agreements that contain detailed covenants specifically applicable to the company.<sup>87</sup> Second, even if a creditor is unsophisticated, this creditor may be in a superior position to that of an unsophisticated shareholder. This is because, as we have seen, shareholders frequently lack appropriate incentives to monitor managers because of the free-rider problem.<sup>88</sup> In contrast, the free-rider problem for creditors is often significantly reduced because a trustee is employed to take action on behalf of the creditors.<sup>89</sup> An example is the requirement contained in the *Corporations Law* for debenture holders to receive the protection of a trustee.<sup>90</sup>

The conclusion that creditors are superior monitors of managers than individual shareholders requires two major qualifications. The first qualification arises where the shareholder is not an individual but a holding company. A holding company can be expected to be in a much better position to monitor the activities of its subsidiary than either a creditor or an individual shareholder. It can evaluate risk at less cost than an outsider such as a creditor, or an individual shareholder. Because it is a better monitor of these risks, it is efficient to allocate at least some of the risk of loss resulting from the insolvency of the subsidiary to it. This is of course the objective of s 588V.

The second qualification relates to the need to distinguish between different types of creditors because some are more efficient bearers of risk than others. Section 588V makes such a distinction in that it only operates to provide compensation to unsecured creditors. In other words, the holding company can only be made liable for the unsecured debts of its insolvent subsidiary. The basis for this distinction is that insolvent trading has its most significant impact upon

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85 The expected benefits of monitoring are lower because a shareholder who wishes to take action faces the prospect of other shareholders free-riding on his or her efforts. The first shareholder is unable to exclude other shareholders from sharing in the benefits of this action or is unlikely to recoup expenditures incurred to this end. The expected costs associated with shareholders taking action will be increased in a company with diffuse shareholdings because knowledge of corruption, negligence or inefficiency by management will be more expensive to communicate to a majority of the shareholders than otherwise would be the case. For further discussion of this issue, see IM Ramsay and M Blair, note 20 *supra*.

86 See note 69 *supra* and accompanying text.

87 CW Smith and JB Warner, note 7 *supra*.

88 See note 85 *supra*.

89 M Blair and IM Ramsay, "Collective Investment Schemes: The Role of the Trustee" (1992) 1 *Australian Accounting Review* (No 3) 10.

90 *Corporations Law*, s 1052.

unsecured creditors.<sup>91</sup> This is a logical distinction. However, it reveals a manifest deficiency in s 588V which is discussed in the following section.

### C. The Need to Protect Tort Claimants

The creditor least likely to be able to contract to protect him or herself against the risk of harm by a company is a tort claimant. There are a number of reasons why this is so. First, unlike other creditors, a tort claimant or victim is not in a contractual relationship with the company. For this reason, he or she cannot contract to be compensated for assuming the risk of injury and the tort claimant cannot contract around the rule of limited liability the way other creditors do.<sup>92</sup> Second, the tort claimant cannot assess the creditworthiness of the company before the tort occurs. Other creditors do have this opportunity prior to entering into a contract. Third, the tort claimant will be an inefficient monitor of managers compared to other creditors.

In brief, the principle of limited liability permits companies to externalise the risk of their operations by imposing uncompensated losses upon tort claimants. This is inefficient, as it does not provide companies with an incentive to exercise an appropriate amount of care in relation to tort claimants. Furthermore, because tort claimants typically cannot contract to protect themselves against the risk of harm and may remain uncompensated for harm sustained, they are inefficient bearers of this risk.

The problem is particularly serious in the context of corporate groups. This is because a company can establish subsidiaries, each with minimal assets, for the purpose of conducting hazardous activities that may result in tort claims. These subsidiaries minimise the exposure of the assets of the corporate group to tort claims. An Australian example is the establishment of under capitalised subsidiaries to conduct asbestos mining.<sup>93</sup> Similarly, in the United States:

[a]lready, strong empirical evidence indicates that increasing exposure to tort liability has led to the widespread reorganization of business firms to exploit limited liability to evade damage claims. The method of evasion differs by industry. For example, placing hazardous activities in separate subsidiaries seems to be the dominant mode of insulating assets in the tobacco and hazardous waste industries. In contrast, disaggregating or downsizing firms seem to be the primary strategy for avoiding liability in the chemical industry and, more recently, in the oil transport industry.<sup>94</sup>

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91 Australian Law Reform Commission, note 29 *supra* at [320].

92 In the context of private companies it is common for creditors to contract around the rule of limited liability by obtaining personal guarantees from the shareholders of the company: D Fox and M Bowen, *The Law of Private Companies*, Sweet & Maxwell, (1991) p 14.

93 House of Representatives Standing Committee on Aboriginal Affairs, *The Effects of Asbestos Mining on the Baryulgil Community* (1984) and the case of *Briggs v James Hardie & Co Pty Ltd* (1989) 7 ACLC 841 in which the New South Wales Court of Appeal considered the appeal of an Aboriginal miner who had contracted asbestosis and who sought to make the holding company of the mine operating company liable because the subsidiary had insufficient assets to satisfy the tort claim.

94 H Hansmann and R Kraakman, "Toward Unlimited Shareholder Liability for Corporate Torts" (1991) 100 *Yale Law Journal* 1879 at 1881.

Collins refers to this as the capital boundary problem:

Firms enjoy considerable freedom both in law and in practice to determine the limits of their boundaries...a firm can operate through numerous corporate entities... No laws limit this freedom to organise production through external contractual relations with other firms or through subsidiaries... The capital boundary problem which arises consists of this: because the firm determines its own size, it also chooses the limits of its legal responsibilities, which in turn provides an open invitation for the evasion of mandatory legal rules.<sup>95</sup>

Having established that tort claimants are the least likely of all creditors to be able to protect themselves and that this problem is particularly acute in the context of holding companies and insolvent subsidiaries, it is surprising that s 588V provides no protection to tort claimants. This is because the section is premised upon a company "incurring a debt" and according to a recent judgment and the views of commentators who have examined this phrase in a different context, it confines liability to debts which a company incurs voluntarily with the result that tort liabilities are excluded.<sup>96</sup>

The problem with s 588V is not just that tort claimants are less able to contract to protect themselves than other creditors. There are several reasons that make it efficient to give tort claimants priority over financial creditors.<sup>97</sup>

- financial creditors, unlike tort claimants, can easily diversify their loss because it is limited to the amount of the loan;
- if tort claimants are given priority over financial creditors, these creditors will have an increased incentive to monitor corporate tort risks;
- granting priority to tort claimants will negate the incentive of holding companies to establish subsidiaries with minimal assets solely for the purpose of limiting the exposure of the assets of the corporate group to tort claims.

Consequently, there are persuasive reasons, based upon principles of efficiency, why s 588V should protect tort claimants.

#### D. The Definition of Subsidiary

The lack of protection for tort claimants is not the only deficiency evident in s 588V. A major shortcoming in the section is its reliance upon the definition of

95 H Collins, note 37 *supra* at 736-37.

96 In *Geraldton Building Co Pty Ltd v Woodmore* (1992) 8 ACSR 585 at 590, Master Bredmeyer stated with respect to s 592 (now s 588G) of the *Corporations Law* which imposes a duty upon directors to prevent insolvent trading: "A director is not liable for damages. Debt and damages are quite distinct. According to *McGregor on Damages*, (15th ed, 1988) at [3] and [6], damages is pecuniary compensation, obtainable by success in an action for a wrong which is either in tort or a breach of contract, the compensation being in the form of a lump sum which is awarded unconditionally. It is distinct from actions for money payable by the terms of a contract, which is a clear illustration of an action for a debt. Another example of a debt is an action claiming money under a statute, where the claim is made independently of a wrong which is a tort or breach of contract. Incurring a liability for damages does not constitute the incurring of a debt for the purpose of s 592."

See also, A Herzberg, "Insolvent Trading" (1991) 9 *Company and Securities Law Journal* 285 at 292 and RC Williams, "Fraudulent Trading" (1986) 4 *Company and Securities Law Journal* 14 at 23.

97 The following reasons are drawn from DW Leeborn, "Limited Liability, Tort Victims, and Creditors" (1991) 91 *Columbia Law Review* 1565 at 1643.



“subsidiary”. Section 46 of the *Corporations Law* defines a company to be a subsidiary of another company if that other company:

- controls the composition of the board of directors of the subsidiary;
- 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 subsidiary; or
- holds more than one-half of the issued share capital of the subsidiary.

This definition has manifest deficiencies. They became obvious during the collapse of the Adelaide Steamship group of companies in 1990-91. Before the collapse, Adelaide Steamship held just under 50 per cent of the issued shares of several public companies, including David Jones Ltd. By insisting that these companies were not subsidiaries within the meaning of s 46, the group was able to avoid the obligation to publish consolidated accounts and was also able to report higher levels of apparent profitability than might otherwise have been possible.<sup>98</sup>

In the aftermath of the Adsteam collapse, the government moved away from the legal definition of subsidiary for the purpose of defining when consolidated accounts are required and legislated for the broad economic criteria contained in Approved Accounting Standard AASB 1024. This Standard defines “control” to mean “the capacity of an entity to dominate decision-making, directly or indirectly, in relation to the financial and operating policies of another entity so as to enable that other entity to operate with it in achieving the objectives of the controlling entity”.<sup>99</sup> Further recognition of the deficiencies inherent in regulation based upon the legal definition of subsidiary lies in the recent amendments regulating financial benefits to related parties of public companies.<sup>100</sup> In order to prevent avoidance of these provisions, the government again relied upon the broad definition of control contained in the Accounting Standards.<sup>101</sup>

It is now possible to see why s 588V presents obvious strategies for evasion. An “Adsteam” type structure for a group of companies would not be classified as a holding company-subsidiary relationship and therefore would be outside the scope of s 588V. Another possibility is the establishment of joint ventures to undertake particularly hazardous activities that may result in insolvency. These would also be outside the scope of s 588V. Allowing this to occur satisfies neither of the two aspects of efficiency referred to in Part I. With respect to the first aspect, given that s 588V is a response to holding companies endeavouring to externalise the risk of business activities by allowing subsidiaries to trade while insolvent, permitting avoidance of s 588V undercuts the objective of ensuring that companies exercise reasonable care and diligence in their business activities.

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98 T Hadden, note 50 *supra* at 66.

99 For discussion of the different meanings of control employed in company law, see JH Farrar, “Ownership and Control of Listed Public Companies: Revising or Rejecting the Concept of Control” in BG Pettet (ed), *Company Law in Change*, Stevens, (1987).

100 *Corporations Law*, Part 3.2A.

101 *Corporations Law*, s 243E.

The second aspect of efficiency is ensuring that risk is allocated to those who are the best bearers of the risk. We have seen that s 588V satisfies this efficiency criteria in that it is appropriate for the holding company to bear the risk of loss resulting from a subsidiary trading while insolvent. Yet allowing s 588V to be avoided means that this efficiency objective will not be achieved.

To the extent that restructuring of the way in which business activities are undertaken is a response to s 588V, we return to Collins' capital boundary problem.<sup>102</sup> As companies are able to determine freely the manner in which they conduct business (that is, whether they conduct business by way of a subsidiary, joint venture or some other means) they can also choose the limits of their legal responsibilities which can lead to evasion of legal rules such as s 588V. In this respect, the provision is a weak response to the capital boundary problem. This is particularly so given that the government did have the option of relying upon a broad definition of control contained in the Accounting Standards rather than the narrow legal definition of subsidiary contained in the *Corporations Law*.<sup>103</sup>

## VII. CONCLUSION

Section 588V represents a new approach to the problem of holding companies externalising the risk of business activities by allowing subsidiaries to trade while insolvent. However, it is only a partial solution to this problem. In particular, it fails to protect tort victims, the category of claimants least likely to be able to contract to protect themselves against the risk of loss resulting from the insolvency of a company that has harmed them.

In addition, the section is likely to see a continuation of the capital boundary problem, as the forms by which business activities are undertaken are restructured to ensure that assets are beyond the reach of unsecured creditors. It will be in precisely those high risk business activities that carry the greatest risk of insolvency and loss for creditors, that this restructuring will occur.

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102 H Collins, note 37 *supra*.

103 Other evasion strategies are also evident. For example, a holding company might rely more on debt capital to finance its activities as a response to s 588V. This capital is not available to the unsecured creditors of an insolvent subsidiary in an action brought pursuant to ss 588V-W. A holding company could also reduce its assets available to the unsecured creditors of an insolvent subsidiary by leasing rather than owning some of its assets.